Foreign Direct Investment in Developing Countries: Impact on Distribution and Employment

A Historical, Theoretical and Empirical Study

Thesis

Presented to the Faculty of Economics and Social Sciences
at the University of Fribourg - Switzerland
in fulfilment of the requirements for the degree of
Doctor of Economics and Social Sciences

by

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Accepted by the Faculty of Economics and Social Sciences on February 19th, 2008
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Fribourg, Switzerland
2008

The Faculty of Economics and Social Sciences at the University of Fribourg neither approves nor disapproves the opinions expressed in a doctoral thesis. They are to be considered those of the author (Decision of the Faculty Council of 23 January 1990).

To my family

Acknowledgments

Firstly I would like to express my deep gratitude to Prof. Dr. Heinrich Bortis, my thesis supervisor and first advisor. I am really indebted to him for his encouraging advice and his huge support.

During almost 7 years of endeavour, lessons and discussions that changed my way of thinking on economic issues, he enabled me to go beyond the typical mainstream frameworks without fear of failure. He was more than a teacher to me. I hope I have been able enough to benefit from his great insight and knowledge, and especially his great personality. I would also like to thank Prof. Dr. Sergio Rossi for accepting to act as Second Advisor and for his very useful remarks on form and content of the thesis.

My special thanks go to Dr. Piyasiri Wickramasekara, whom I have the pleasure to be linked in friendship, for encouraging and supporting me and for providing precious advice.

I would also like to thank Mr. Pascal Fessard, Dr. Marc Schnyder, Dr. Elmar Baeriswyl, Miss Carmen Baeriswyl and Miss Uschi Anthamatten who contributed substantially at different stages of writing up this dissertation to improve its form, but also its content. However, the responsibility of all imperfections of form and content, the literary style in the main, remain of course mine.

In chapter 4 my thesis supervisor permitted me to quote large passages of his book "Institutions, Behaviour and Economic Theory" (Bortis 1997) and of his article "Keynes and the Classics" (Bortis 2003a), because I wanted to present the entire classical-Keynesian model to the Iranian reader. There would have been no point in translating these passages into Persian and to retranslate them into English.

I also appreciate the support of the Research Department of Central Bank of the Islamic Republic of Iran.

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Abbreviations

BITs	**Bilateral Investment Treaties**
DAEs	**Dynamic Asian Economies**
DNMEs	**Dynamic Non Member Economies**
DTTs	**Double Taxation Treaties**
EIAs	**Economic Integration Agreements**
EIIAs	**Economic Integration Investment Agreements**
ECLAC	**Economic Commission for Latin America and the Caribbean**
FDI	**Foreign Direct Investment**
GATT	**General Agreement on Tariffs and Trade**
GDP	**Gross Domestic Product**
GNP	**Gross National Product**
IIAs	**International Investment Agreements**
ILO	**International Labour Organisation**
IMF	**International Monetary Fund**
M&A	**Mergers and Acquisition**
MNE	**Multinational Enterprise**
OECD	**Organization for Economic Cooperation and Development**
OPEC	**Organization of Petroleum Exporting Countries**
PI	**Portfolio Investment**
R&D	**Research and Development**
TNC	**Transnational Corporation**
UN	**United Nations**
UNCTAD	**United Nation Conference on Trade and Development**
WTO	**World Trade Organisation**

Introduction

What is planted today will be harvested tomorrow. (Persian proverb)

I Problem and Plan

Economic development is a dream that became reality for some countries in the West (Western Europe and North America) and some selected countries and regions elsewhere (Japan, South Korea, Chinese coast regions). Here even fabulous wealth has come into being. Large parts of the world, however, have not succeeded in realizing the dream of economic development. There has even been a decline of living standards in vast parts of the world (parts of Africa, Asia and Latin America). Indeed, according to eminent international organizations and well-known economists, like Joseph Stiglitz, two thirds of humanity – more than four billion human beings – lives in misery with less than two dollars per head and per day; moreover, out of a working population of about three billion people, one billion is unemployed or underemployed. The problem here is about sheer survival. Indeed, in this context it is important to distinguish between poverty and misery. Poverty may be a choice or one may get out of it through a special effort; misery, however, is, like involuntary unemployment, system-caused and crushes the individual (Bortis 2003d, pp. 84-85).

However, man has always attempted to improve his material condition through effective use of resources, such as fertile lands, more productive use of labour, and, finally, as is directly related to the subject of this study, real capital: tools, machinery and equipment. Yet it is almost certain that the economic success of some – highly – developed countries has been brought about not only by domestic, but also by foreign resources. John Hobson argues forcefully that the development of the West has been enabled by Eastern knowledge – inventions made in China for example – and Eastern resources and markets (Hobson 2004). Moreover, many countries have been trying to attract and accumulate wealth in general and to attract foreign direct investment (FDI) in particular. Many developing countries rely on foreign capital to overcome domestic issues such as young people and unskilled workforce both having a low education level, which limit a country's ability to master its economic problems. Furthermore, based on free market economic principles and theories, they have been encouraged by international organizations and investors and the worldwide economic structure to borrow from abroad and use foreign investment for meeting domestic needs, convinced that foreign

investment can solve all their problems. Since the second half of the last century, the independent developing countries have been overwhelmed by the capitalist structures and have not been able to understand the proper basis for development in their countries. Those struggling for survival did not succeed to do so in any case, and for a few, it seems, the problems are permanent, and the leaders of these countries are convinced that they are facing special conditions that require special support to be improved.

II Background

The political and social changes of late 20th century and the recent technological advancements have brought about important and deep changes in the economic situation of the present world. The failure of the planned economies and their retreat from the global economy, the development and the rising influence of free and open market economies, the ever stronger tendency towards a global economy predicate deep changes in various interacting spheres (e.g. economical, political and social) of the world community in the future.

The problems and possible solutions have changed in form and content. The old restrictions and limitations of monopoly are substituted by relationships and interactions. Previously grim faces have been transformed, taking on friendly smiles and gentleness of international politics. The iron doors of a closed economy (blocked by worker's trenches) are now wide open, having rolled out the red carpet to agents of capitalism and victorious invaders pertaining to the open capitalist economy. Tendencies of depolarisation are confused and result in new situations the significance of which cannot yet be clearly assessed. Official and nonofficial economic, political and social institutions and countries now find themselves in a new and entirely different situation. Today, even great powers are unable to dominate the world economy. While attempting to expand their global influence, they encounter cultural and political resistance and, simultaneously, they suffer from economic attrition. At the same time, formerly dependent countries rose to prominence to become new economic and political rivals. The present situation is more complicated and difficult than ever before for developing countries. They are thrown into an ambiguous and tangled situation, in which they are forced to protect their own interests by finding their way through a labyrinth to reach a suitable course of action. Despite the fact that the flow of capital, as well as profitable activities, are more readily

available, most of the movement is unfortunately not in the direction of countries with developing economies.

It is by now possible to transfer with high speed large volumes of capital for economic and political purposes. One would hope this process to continue even more intensely, taking account of the need of the developing countries. There is, however, little hope for these countries. Indeed, the data suggest that the main flux of these transfers have been moving toward developed, even to the highly developed countries, specifically to the eight most industrialized countries. Most of the developing countries have not enjoyed substantial inflows of capital. The same is true of China, Russia and other previously socialist countries with closed economic systems. As a result, after the historical downfall of the self-confident and national policies associated with a closed economy, such developments point to very serious shortcomings of globalisation of goods and financial markets and of the underlying neoclassical free market doctrine.

Investment is the engine of growth and requires that a surplus over necessary wages be realized. Moreover, there must be money and capital markets to provide the financial needs for production and capital accumulation. Domestic capital may be complemented by foreign investment the effects of which on economic development are central to this study.

III Objectives of the Thesis

Following up the profound, worldwide changes in the political and economic situation since the early 1990s, the traditional topic of the effects of foreign investment on recipient countries appears in an entirely new light. The need to understand these effects, approximately at least, is vitally important for countries with developing economies.

In this thesis, it will be argued that traditional neoclassical theory is not able to come to grips with the effects of foreign investment on the recipient country in the new global situation that has come into being since the breakdown of the socialist system. The central reason is that markets, even if competitive, are not self-regulating, implying that the neoclassical exchange approach proves inadequate to deal with fundamental socio-economic issues. Modern economies are basically monetary production economies. This, as will be argued, requires taking account of classical and Keynesian elements of economic analysis that is Classical-

Keynesian Political Economy as is set out in Bortis 1997 and 2003. This approach contributes to an approximate understanding of fundamental socio-economic problems, value, distribution and employment for example, and provides the foundation for sensible social and economic policies. This is particularly significant to the decision-making process for managing domestic and foreign investment in the developing countries in the new and still unfamiliar global situation. In this research, therefore, we first present a historical and comparative study of various approaches in economic theory, especially the presently dominating neoclassical theory of the free market economy and an analysis of theoretical alternatives, especially classical-Keynesian political economy, which is a synthesis of classical and Keynesian elements of economic analysis.

In the second place, the real world data related to foreign investments and their effects are considered and discussed in the light of the existing theories. In a complementary vein, this investigation will provide the necessary foundations for analysing the appropriateness of present theories, free market theories versus theories based upon the principles of protectionism and nationalism and their related policies such as import substitution, and self-sufficiency of closed economies in a global free market framework.

In the third part, an alternative economic policy adapted to the situation of the developing economy countries is proposed. The present study focuses upon two variables: employment and distribution. This analysis should help foreign investment managers in making appropriate decisions for countries with a developing economy, which are benefiting from foreign investment inflows.

IV The Procedure Adopted (Research Hypothesis)

In this thesis, foreign direct investment (FDI) is examined from two points of view: first, from the neoclassical (free-market) standpoint and, subsequently, from alternative (interventionist) perspectives. This discussion of principles allows to determine a suitable policy, that is, as will emerge, a flexible policy based upon Classical-Keynesian political economy. This will be done, first, through reviewing the history of economic theories and policies from both the neoclassical and alternative issues and then comparing those with the classical-Keynesian view and second, through providing a statistical analysis of real world data of the effects of FDI on

countries with developing economies, considering, in particular, employment and income distribution. This leads on to establishing the following hypothesis:

1. In order to benefit from FDI, specific economic preconditions have to be established in a country with a developing economy.

2. Economic activities take place within economic institutions, enterprises and households most importantly. These are a part of a comprehensive social system, which include a set of sustained and permanent parts, social institutions to wit, that is political, legal, and cultural institutions. The behaviour of the people within these social institutions represent the unique and temporary parts of the social mechanism. On the policy level, the temporary behavioural dimension of the social mechanism might show up in specific economic policies and in a specific economic behaviour, regarding FDI for example. Hence, the economic problems (here related on countries with a developing economy) are multi-dimensional phenomena, needing multi- dimensional and flexible solutions. This is so because of a complex and evolving reality.

3. A rigid extreme protectionist system, associated to interventionism, and a rigid extreme free-market system both cannot, in general, form the basis of multi-dimensional development plans and particularly plans to manage FDI. There must be simultaneity, and, according to the circumstances, interventionism may be needed to some variable degree or, to a certain extent, liberalization may take place.

4. Flexible socio-economic policies based upon Classical-Keynesian political economy represent a suitable alternative to establish sensible plans for economic development.

V The Problem of Economic Development and FDI

Development is a complex theoretical concept and its definitions may differ widely. However, it is more effective to focus, according to the nature of the problem, on just one aspect of these definitions. Hence for simplicity and efficiency, appropriate definitions will be used for different economic situations. The definitions depend mainly on the basic philosophical views of the different schools of thought and their founders. This also accounts for their complexity. It is important to understand the concepts of economic development, on one hand, and on the other hand to recognize methods for achieving, keeping, and enhancing the forces behind

development in order to maintain a dynamic, strong and permanent development process. These are problems faced by economists and leaders in all countries, but especially those in the group of developing countries, on which the present study naturally focuses. Obviously, investment and the forces enhancing it are crucial in the process of economic development. In this thesis, the role of investment in economic development is examined for countries with an underdeveloped economy.

Indeed, studying the effects of Foreign Direct Investment (FDI) on the countries with developing economy is the central purpose of this thesis, and the main theme of this study. Studying the effects of foreign direct investment on countries with a developing economy, more than anything else relates to the study of economic development in general and to the economic development of social classes in particular; indeed the process of development may produce winners and losers. In this view, we are studying the effects of "foreign direct investments" on quantitative and qualitative aspects of factors such as employment and distribution of income. In doing so, the differences in theoretical views held and policies pursued in varying historical conditions have to be taken account of. This leads on to a framework of comparative historical study. To compare the various schools of economic thought is of particular importance. In this thesis, the comparative historical study also relates to theoretical views held about FDI, to policies pursued regarding FDI and to the results obtained. The study especially focuses on the analysis and comparison between the Neoclassical and the Classical-Keynesian views related to the thesis subject. To this general analysis specific considerations on countries with developing economy will be added. This leads on to a theoretical synthesis and to suitable policies regarding FDI. The other aspect of the study considers time series data of quantities of foreign direct investment (the independent variable) to make rough guesses on the impact of FDI on specific (dependent) economic variables, with employment and distribution of income being the most important. The analysis will be predominantly macroeconomic, with microeconomic and managerial aspects also touched upon. Policy conclusions will also be drawn in order to tentatively assess whether FDI is useful for countries with a developing economy or not.

VI Microeconomics, Macroeconomics and Political Economy

Economic phenomena, for example prices, distributional shares and employment levels, result from social activities. This, as will be seen, can be brought to the open by looking at the relationship and interaction of a set of internal and external elements. When specific details of the relationship between elements are considered, a micro-economic approach is put to use; for example, to deal with distribution the neoclassical economists would make use of the marginal productivity approach relating incremental input and output. In a neoclassical view, macroeconomics is complementary to microeconomics. In fact, macroeconomics aggregates microeconomics to consider, for example, the impact quantities of factors of production on output and employment, and, in fact, upon the economic system as a whole. While micro- and macroeconomics deal with quantitative aspects of the economic system, political economy considers qualitative aspects, most importantly moral aspects of economic system. For example, a political economist might ask to what extent specific policies or economic phenomena, FDI for example, have positive or negative impacts on the economy and on society as a whole. When one is dealing with social ethical problems, pure economic theories are not able to deliver quick and clear-cut answers because situations are complex and constantly evolving, frequently in an unforeseeable way. For example: what does happen when some countries follow the advice of specialists of the World Bank or of other global institutions? These specialists provide advice on the basis of a specific economic theory that is neoclassical theory as a rule implying that the economy is a self-regulating mechanism. Since however, as will be argued, modern economies are not self-regulating, the inflow of foreign resources may lead to increased dependence from abroad, an increasingly unequal income distribution and to growing unemployment.

Another point is that pure and value free economic theory does not exist. For example, in the course of the Cold War period economic theory became increasingly ideological. The free market economy had to be defended against the totalitarian planned economy. Given this, neoclassical theory dominated almost completely the theoretical scene. Theoretical reasoning along neoclassical lines went on unquestioned. The impressive mathematical structure of neoclassical mainstream theory made a critique of this theory very difficult if not impossible. Moreover, the post Keynesian approach led to a collection of theories, not to a coherent

theoretical system. Given this, mainstream economists could always argue that there was no alternative to the neoclassical theory, while admitting that there were problems with their theory specifically that, in many instances, neoclassical theory very imperfectly reflected real world phenomena. This situation was and still is exceedingly difficult to deal with for countries with an underdeveloped economy. In fact, these countries had no choice. They had to accept mainstream economic theory and the associated policies prescriptions, implying the application of the free market doctrine domestically and regarding economic relations with the outside world. The latter implies opening domestic markets to foreign goods and services, e.g. to participate in the process of free-market globalisation.

In this thesis, we shall attempt to present a theoretical alternative to the neoclassical system and to derive policy prescriptions, which will differ crucially from the neoclassical mainstream views.

VII Criteria to Assess the Effects of FDI

The effects of FDI on underdeveloped economies can be studied in different ways. Two main approaches dominate, i.e. the theoretical and the empirical-statistical approach. The theoretical approach has prevailed to give rise to prolific writing on the effects of foreign direct investment. However, the point of view taken has been almost exclusively that of the economically *developed* countries. Basically, the argument was always the same: Capital is scarce in countries with an underdeveloped economy, and the rate of saving is low. Since saving governs the volume of investment, domestic investment is also low and so is the rate of economic growth. As a consequence, foreign investment is required to complement domestic investment and to raise the rate of economic growth, thus speeding up the process of economic development.

The crucial importance of saving in the process of development is put to the fore in classical and neoclassical literature, starting with Adam Smith and David Ricardo. Modern representatives of this view are, for example, Rosenstein–Rodan (1943), Prebisch (1950) Nurkse (1953), Lewis (1954), Leibenstein (1957), Hirschman (1958) and Rostow (1960). Current views, however, hold that economic development and the associated process of economic growth require a systematic reallocation of factors of production from the traditional

consumption goods sector to the modern capital goods sector: Buckley and Casson (1976), Hennart (1982), Rugman (1980), (1986), Buckley (1988), Dunning and Rugman (1985), and Teece (1985). All these authors focus specifically on the theoretical approach, which contains various strands: macroeconomic, microeconomic as well as political economy approaches.

The initial statistical-empirical studies on FDI make use of a wide range of economic variables such as industry structure (Dunning and Rugman, 1985) or marginal export ratios. Socio-economic factors have also been considered. Among these, two factors have emerged to be of particular importance in the context of holistic reasoning on economic phenomena: employment and distribution. What are, in principle, the effects of FDI on the level of employment and on the distribution of incomes, and how is FDI related to these crucial variables in the real world? Such questions have not only been of interest to economists, but also to social and state managers and others dealing with societal problems. Moreover, historically speaking, employment and distribution have always been among the most important socio-economic and political issues. Both problems have also been crucially important in the modern age, specifically for managers and state leaders in countries with a developing economy. According to Keynes: "The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes" (1936, p.372).

Given this, FDI has frequently been considered a miraculous means to solve the problems of employment and distribution, and, simultaneously, to spur economic development. Consequently, for this very reason, many countries with a developing economy, have accepted to go deeper into debt or to gladly welcome foreign direct investment.

Is it appropriate to focus on just two elements, crucially important though, to safeguard developing countries looking for additional foreign resources from unwanted side effects FDI might eventually produce? In the following, our answer will be to the affirmative: unemployment and unequal distribution of income are and remain the main problems confronting societies attempting to come to grips with modernity. Consequently, in this study we shall use employment and distribution as the two main criteria for comparing ideas, theories and schools of thought, and we shall study the probable effects of foreign direct investment on developing countries based on these criteria.

VIII The Question Asked in This Study

With domestically restricted resources, social problems – unemployment and poverty, for example – get amplified in countries with a developing economy. It is generally thought that foreign direct investment is the golden key to overcome socio-economic difficulties and to open up the way to economic success. All the attention and all hopes are focused on this key variable. Foreign investment is recommended by most of the world's economic specialists in the field as well as by international social and economic organizations at which countries with a developing economy participate. For these organisations, it goes without saying that the benefits of foreign investment are, in a global world, the best way for economically underdeveloped countries to enhance development and to remain a part of the global economy.

This optimistic view is fundamentally questioned in the present study. To be sure, foreign investment may contribute to economic development in specific circumstances. However, there is an almost absolute lack of theories dealing with the effects of foreign investment adapted to the specific situation of developing countries, since the theories in question almost exclusively take the point of view of developed, even highly industrialized economies. This is the starting point of the present analysis. Therefore, to develop a theory to assess the effects of foreign investment in the specific circumstances of countries with a developing economy is the basic aim of this thesis.

In the first place, one has to go back to consider theories of economic development adapted to countries starting the process of economic development or countries continuing an already ongoing development process (Chang 2004). In a second step, these theories have to be adapted to the rapidly changing socio-economic and political situation, bearing in mind that fundamental differences exist between highly developed and economically underdeveloped countries. For example, high specialization and highly advanced division of labour have brought about deep gaps between developed and developing economies. Both points clearly point to the need to develop theories adapted to the specific circumstances of developing economies providing thus useful policy suggestions to countries with a developing economy.

To work out such theories requires considering the theoretical situation in a historical context. Specifically, the neoclassical (liberal) theories are considered, including the policies based on these theories, and their relationship to historical reality examined. Moreover, we

shall examine theories of the Classical, Keynesian and Classical-Keynesian type. It will be argued that the latter theories are basic for flexible policy action that is policies adapted to specific circumstances. Indeed classical-Keynesian political economy will enable us to answer the basic question to be asked in this thesis: Under what circumstances is FDI beneficial to developing countries?

IX Content of the Thesis

Chapter 1 briefly presents some important features of theoretical debates on fundamentals, related to FDI. This chapter is a historical review to set forth the advantages and the disadvantages of FDI since the age of mercantilists. Here different types of economies are considered: open systems, closed economies and comprehensive systems encompassing both the internal and the external mechanism of determining economic activity. On the one hand, these systems emerge from considering the strength and weaknesses of pre-classical, classical, neoclassical and Keynesian approaches to our subject. On the other hand, considering these approaches should clear the way to adapt them to the specific problems encountered by countries with a developing economy. These considerations are required because western-type theoretical models are frequently poorly adapted to the conditions in countries with a developing economy. Plans for economic development were, as a rule, based on inappropriate theories. In fact, there has been, as a rule, no discussion of theoretical alternatives to find out a theory better adapted to the conditions of developing countries. As a consequence, theories applied to countries with a developing economy could not work well simply because they were too far away from the real conditions. For example, the absence of a primary set of channels to distribution or redistribution of goods prevents the principle of effective demand from working appropriately. Similarly, the lack of market infrastructures renders illusory the interaction between supply and demand and hence an eventual tendency towards an equilibrium.

The comparison of theories in this chapter ends up in considering a recent theoretical challenge of the neoclassical approach through Classical-Keynesian political economy. The flexibility of the latter approach should contribute to close the gap between theory and real conditions. Simultaneously, the limits of the neoclassical approach will be brought to the open. For example, can neoclassical theories really justify the inflow of FDI into countries with a

developing economy?

Chapter 2 develops the problem at a different level, to explain how countries with a developing economy apply FDI policies in real world conditions, given the fact that in recent theoretical and empirical work, foreign direct investment has been identified as a key variable determining economic growth (Meier 1995, p. 560). Various types of policies are examined and, subsequently, compared. Moreover, in this study, we investigate into the probable effects of FDI as are related to different policies that have been pursued. It could indeed by very helpful to find out which FDI policy is likely to be most useful in the attempt to solve the socio-economic problems of the countries with developing economies in practice to a satisfactory degree.

We start by comparing past and present global situations to broadly evaluate neoclassical and alternative economic policies. Hence, this and the previous chapter deal with the implementation of economic policies and the need for theoretical foundation of these policies. It attempts to demonstrate which theoretical foundations and associated policy conceptions could be useful to explain the effects of FDI, mainly their contribution to economic development. This is very important at present since, as has been suggested already, FDI is generally considered the only remaining economic means for developing countries to enhance development. To summarise, the first and the second chapter discuss the specific characteristics of the theories and policies related to the effects of FDI in countries with a developing economy to prepare them for evaluation.

Chapter 3 applies the theoretical concepts to statistical data. This can be considered a comparative study of the probable effects of FDI in different countries. Those who have suggested that FDI is the key to development and economic growth would certainly expect a positive effect. However, the main conclusion that emerges from this analysis is that the effect of FDI on countries with a developing economy is not positive. Specifically, no dynamic development process is set into motion in an open economy and under free market conditions. Indeed, the common belief that FDI is always beneficial to a developing country under neoclassical free market conditions, generally fails to be supported by the empirical evidence.

The effects of FDI will be examined within a political economy framework, which takes a holistic and comprehensive view of socio-economic phenomena. FDI data are considered and an attempt is made to broadly examine the effects of FDI on the world economy, and on

individual countries, regions, and sectors. Our theoretical analysis focuses especially on countries with a developing economy and attempts to evaluate two important criteria here: employment and distribution of income. How foreign direct investment is concretely related to employment and distribution is, in the first place, an empirical question, and, undoubtedly, the situation will vary from country to country, specifically if developed or developing countries are considered. The interpretation of the empirical results, however, requires a robust theory to be set forth in the subsequent chapter.

Chapter 4 pictures the Classical-Keynesian theoretical framework, which represents an elaboration and a synthesis of post Keynesian political economy. Based upon this theoretical framework a comprehensive socio-economic policy conception may be set up. This comprehensive policy framework brings together differing policy conceptions based, in principle, upon the internal *and* the external mechanism of employment and development. The Classical-Keynesian policy synthesis represents, as will be argued, a flexible policy conception. This stands in contrast to neoclassical economic policies that, in practice, redly on the external development mechanism and export-led growth. This practice is uneasily associated with general equilibrium theory, which is said to be realised through endogenously given free and competitive markets. In this thesis we shall argue that neoclassical equilibrium theory is, basically, an ideological cover-up.

An alternative to this concept is an economic policy based upon the internal development mechanism. Associated to this mechanism are specific endogenous economic elements such as tax and tariff on import. In a complementary way, then, the Classics- Keynesian synthesis brings together these mechanisms to deal with economic problems through both the internal and the external mechanism. Hence, this comprehensive policy relies upon internal elements, like government expenditures, and external factions, exports and import management for instance. While, as will be seen, the principles are given, the policy applications are fully flexible. In fact, the flexibility of this policy conception is mainly due to the fact that the internal and the external development mechanism may be applied in varying and changing degrees, adapted to some specific situtation. Given this, enhanced awareness of problems, their appropriate analysis and possible solutions to the problems considered as relevant get particularly important. In this context, to give an example, an important issue is the possible conflicts between the FDI host countries and home countries. These have to be solved in a way

satisfactory to both sides. To conclude: While neoclassical free market policies regarding FDI and the alternative protectionist policies are unsatisfactory, the flexible Classical-Keynesian policy is appropriate and necessary.

The final chapter (5) extends the analysis into a comparative study to form a conclusion and propose a specific application of Classical-Keynesian theory and policy set forth in the preceding chapters to make appropriate use of FDI for countries with developing economies. Taken together, these chapters illustrate the ability of this approach, which synthesizes economic and social factors within a systematic analysis of national production and international exchange, to deal with the effects of FDI on countries with developing economies, which is the central focus of this research.

Chapter 1 :
Theoretical Foundations, Some Historical Aspects

The tone of the papers ranges from guarded optimism to pessimism in the ability of modern capitalist system to return to 'Normalcy', at least without drastic changes in political and economic institutions (John Cornwall 1991, p. Xiii).

1.1 Mercantilism: The Beginning of Attracting and Accumulating Capital

The study of foreign direct investment (FDI) connected to capital accumulation goes back to pre- Classical views. Indeed, the mercantilists were, in a way, the first to reflect on attracting foreign capital and to set up investment plans. They attempted to clarify the role of capital within the economy and, in this context, set up the first macroeconomic model based upon the external employment mechanism. The basic idea was to realize a surplus of exports over imports. The rationale behind this endeavour is set out in a very concise way in chapter 23 of Keynes's *General Theory:* "For some two hundred years both economic theorists and practical men did not doubt that there is a peculiar advantage to a country in a favourable balance of trade, and grave danger in an unfavourable balance, particularly if it results in an efflux of the precious metals" (Keynes 1936, p. 333). Subsequently, Keynes pictures the essential characteristics of mercantilist economic thought.

First, "Mercantilists thought never supposed that there was a self-adjusting tendency by which the rate of interest would be established at the appropriate level. On the contrary they were emphatic that an unduly high rate of interest was the main obstacle to the growth of wealth; and they were even aware that the rate of interest depended on liquidity preference and the quantity of money [...] and several [mercantilist writers] made it clear that their preoccupation with increasing the quantity of money was due to their desire to diminish the rate of interest" (Keynes, 1936, p. 341). Moreover, "one must add that "in mercantilist times, the only possibility to increase the quantity of money was an excess of exports over imports, unless, of course, a country possessed gold or silver mines" (Bortis 2003b, p. 64).

Second, "the mercantilists were aware of the fallacy of cheapness and the danger that excessive competition may turn the terms of trade against a country" (Keynes, 1936, p. 345). Subsequently, "the squandering of a country's products on foreign markets at low prices has become known as immiserising growth" (Bortis 2003b, p. 65).

Third, the "mercantilists were the originals of 'the fear of goods' and the scarcity of money as causes of unemployment which the classicals [and the neoclassicals] were to denounce two centuries later as an absurdity" (Keynes 1936, p. 346). They „were conscious that their policy

[of aiming at a trade surplus] killed two birds with one stone. On the one hand the country was rid of an unwelcome surplus of goods, which it was believed to result in unemployment, while on the other the total stock of money in the country was increased, with the resulting advantages of a fall in the rate of interest"(ibid. p. 347). This argument can quite naturally expanded: "The surplus of exports over imports is an autonomous or primary demand which leads to a multiple of (induced or secondary) demand for consumption goods. What mattered for the mercantilists was the primary and secondary employment thus created. Inserting beggars and people without work into the process of production was a fundamental mercantilist preoccupation associated with the ‚fear of goods' (Heckscher, 1932). This is the 'real' side of the argument associated with a direct output and employment effect of an export surplus, the monetary side being linked with the rate of interest and its influence on investment" (Bortis 2003d, p. 65). This leads to an indirect link between export surplus and employment which is of a monetary nature: "The surplus of exports over imports leads to an inflow of precious metals or an increase in the quantity of money. The rate of interest declines as a consequence and, as a rule, the volume of investment increases which, again, means a rise of primary or autonomous demand inducing a secondary or indirect demand for consumption goods. On the whole, the mercantilists expected, as a rule, a cumulative process of employment creation from an export surplus, leading to a cumulative increase of national wealth in the form of a higher social product" (Bortis 2003d, p. 65).

Fourth, and finally, the "mercantilists were under no illusions as to the nationalistic character of their policies and their tendency to promote war. It was national advantage and relative strength at which they were admittedly aiming" (Keynes, 1936, p. 348). Indeed, "with substantial involuntary unemployment in the various trading countries and no tendency towards full employment, competition becomes a struggle for survival. This struggle was economic and political-cum-military in mercantilist times, when the European nations were basically formed. An export surplus was one important element leading to a 'strong' economy capable of yielding high tax revenues which, in turn, enabled a country to build up an efficient army or, much more important, a strong navy to protect the merchant fleet and to keep colonies or dependent regions under control. Hence a strong state (army, navy) would make the economy stronger, and vice versa. There was a cumulative interaction between the economy and the state, above all regarding its military dimension. Basically with mercantilism, sometimes combined with

absolutism, with France being the leading example of this combination, the economy stood, as a rule, in the service of the state, which in turn, depended upon the economy. Agriculture and the peasants were no longer able to produce a surplus that was sufficiently high to carry the state, which, therefore, more and more relied upon trade, local and overseas, and upon manufactures to obtain the tax revenues required, in line with the ambitions of the emerging nation states" (Bortis 2003d, pp. 64-66).

This implies that the mercantilist economies were at first interventionist economies. In fact, the aristocratic and absolutist governments of the nascent European nation states intervened heavily in the economy since Renaissance times. Specifically, the state deliberately attempted to promote employment and growth. This links to the problem of foreign investment: "[The process of economic growth may be interrupted] by the insufficiency of the inducements to new investment. [Such inducements] may be found in either in home investment or in foreign investment (including in the latter the accumulation of precious metals), which, between them, make up aggregate investment. In conditions in which the quantity of aggregate investment is determined by the profit motive alone, the opportunities for home investment will be governed, in the long run, by the domestic rate of interest; whilst the volume of foreign investment is necessarily determined by the size of the favourable balance of trade" (Keynes 1936, p. 335).

However, one must be careful here when speaking of foreign investment because the mercantilist economies were *real exchange* economies. Here we have an exchange of goods against goods, because the precious metals are commodities that have an intrinsic value, the property of these commodities are that they are most easily exchangeable. Hence the balance of trade surplus means an *outflow* of foreign investment from the real point of view: more goods are exported than imported. However, there is obviously an inflow of 'financial' foreign capital because the real flow is paid for by money represented by the precious metals. In this latter sense, it is correct to say that the mercantilists attempted to attract 'financial' capital from overseas. This financial capital was, as a rule, held by bankers or, at a smaller scale, by goldsmiths who were able to provide credits to investors. This led to a cumulative process as pictured above.

Second, paradoxically, the protectionist mercantilist model pictures a modern free-market phenomenon. Indeed, the highest developed economies with a large division of labour attract

most of foreign direct investment (FDI). Hence the results of the mercantilist's attracting financial capital emerged as a system of unilateral capital flow. This resulted from specific policies, such as governmental intervention in economic activities with a tendency to promote the accumulation of capital and a protectionist policy represented by taxes on import and direct subsidies on export, through low money wages and prices for example.

In addition, Mercantilist policy also advocated the export of goods with high value added while importing cheap raw materials and agricultural goods from their colonies and dependent areas under conditions of unequal trade, which for example, supported the British economy during 1715-1815. (Hobson 2004, pp. 275, 279)

Thirdly, there was not just the economic dimension of trade. Economic domination was complemented by military and political domination that was exerted on overseas civilizations. Large parts of the revenue from tariffs and taxes out of profits resulting from trade activities were used to reinforce the military power and political domination overseas (Hobson, 2004, pp. 106, 250 and 253).

On the global level, the mercantilist system led to the formation of dominating centres and a dependent periphery. There were unilateral flows of financial capital – mainly precious metals from Central and South America – to the centre, that is Spain in the first place and, subsequently, Western Europe. This flow of financial resources enabled the accumulation of real capital manufactures and capitalist agriculture – in specific regions of England and France, for example.

This is in line with John Hobson who argues that the East (Asia) and the Americans were not simply bystanders while the West was developing: "The East [and the Americas] enabled the rise of the West through two main processes: diffusionism / assimilationism and appropriationism. First, the Easterners created a global economy and global communications network after 500 along with the more advanced Eeastern 'resource portfolios' (e.g. Eastern ideas, institutions and technologies) diffused across to the West, where they were subsequently assimilated, through what I call oriental globalisation. And second, Western imperialism after 1492 led the Europeans to appropriate all manners of Eastern economic resources to enable the rise of the West. [To these American resources, precious metals in the main, may be added]" (Hobson 2004, p. 2).

To conclude, the specific characteristics of the mercantilist system are presented (see

Bortis 2003d): First, it was a socio-economic system that encouraged the gathering of financial capital and the accumulation of real capital. Second, state intervention was, in a way, considered natural. Domestic activities were supported. For example, mainly in France, the state founded model manufactures. Or, in England, following the advice given by William Petty, public work programmes were carried, setting into motion a cumulative demand for consumption and investment goods. Moreover, export subsidies were provided in order to give confidence to domestic producers. Also, barriers to the outflow of precious metals were erected through taxes and tariffs on import goods. The accumulation of capital was enhanced through protection of domestic producers and through making exports competitive.

1.1.1 Results of the Mercantilist Accumulation System

It has been argued above that the inflow of precious metals resulting from an export surplus was largely equivalent to the inflow of financial capital. A monetary and financial capital stock could be built up. The former rendered easier current production and circulation, the latter was conducive to capital accumulation. However, continental Europe, with the exception of Holland, entered a period of stagnation from broadly 1650 onwards (see for example Nef 1963, p. 148 for the case of France). In a Keynesian vein, this may have been due to the fact that the profit-investment mechanism had resulted in the building up of overcapacity. Moreover, as is well known, the inflow of precious metals from Central and South America led to rise in prices and to more unequal distribution of income. This, in turn, resulted in stagnating or, perhaps, even declining effective demand. Overcapacity and a lack of effective demand resulted in stagnation.

However, in the mercantilist era, not only the export surplus but also the associated inflow of precious metals was of importance. The structure of exports and imports was also significant. For example, the successful countries and regions of England and of the continent attempted to export mainly manufactured products and to import primary products (raw materials and agricultural products). This led to specific division of labour emerged on the European and on the world level. The developed countries concentrated on the production of – labour-intensive - manufactured and later on industrial products, the economically underdeveloped countries had to be content with producing primary products which, by

definition, were land-intensive and, as such, created relatively few new work places. And this process went on under the shadow of the warships accompanying the merchant navy. Military and political power finally resulted in unequal exchange reflected in worsening terms of trade for the economically underdeveloped countries (see, for example, Hobson 2004, p. 263). The division of labour on a world level initiated by Mercantilism was greatly accentuated by the English Industrial Revolution. England and, subsequently, Western Europe became the industrial workplace of the world. And the colonies and dependent regions were to become producers of primary goods that were exchanged against industrial goods. In this way, the countries of the Third World, as they were called later, provided the basic inputs for industrial productions while, at the same time, becoming outlets for industrial products. Chronic underdevelopment and dependency became the basic characteristics of these countries.

1.1.2 The Limits of Mercantilist Unilateral Relationship Models

Considering the principles, the mercantilist model implies a unilateral and asymmetric relationship. The successful country that realizes an export surplus creates a cumulative process of demand. This opens up new investment possibilities. These may be financed in part through the incoming precious metals. England is certainly a prime example for success. The contrary holds in the deficit country. Here a process of disaccumulation sets in, as happened to Spain and later to colonized and dependent countries; an important example is India.

However, serious limits came into being even in successful countries, the prime example perhaps being France. In general, from literature on Mercantilism, specifically from Heckscher's work on mercantilism (Bortis 2003b) and from Keynes's account (1936, chapter 23, pp.333-373) the following points may be made:

- It is likely that too much capital was accumulated; this lead to a stagnation from 1650 onwards. Given this, unemployment, which had been a permanent feature of development along mercantilist lines, presumably increased relative to the working population.

- Unemployment, in turn, was probably due, in the main, to an unequal distribution of incomes. Economic historians generally agree that the inflow of precious metals led to an inflation, which in turn, rendered income distribution more unequal. The unequal distribution of incomes negatively influenced effective demand and, consequently, employment.

- Following up unemployment, poverty increased, above all in rural areas. The mercantilist policy of promoting exports through low prices led to a reduction of money wages. To ensure subsistence of the workers the prices of agricultural products had to be lowered. This led to a reduction of agricultural incomes and to an impoverishment of the rural areas in France. This led, in the first place, to a reaction on the theoretical level that is François Quesnay's Physiocratic system, which will be considered below. In the second place, the impoverishment of the rural population had a crucially important political dimension. Rural poverty certainly was a crucial element bringing about the French Political Revolution. This greatly reinforced the sentiment of injustice that, according to Alexis de Tocqueville (2004/1856) prevailed France: Part of the hereditary Nobility still had feudal rights, mainly the right on part of the agricultural surplus, without having obligations to serve the nation. Hencehere were Rights, but no longer Duties. According to de Tocqueville, this injustice was the main reason for the French Revolution.

1.1.3 Historical Lessons for FDI to be drawn from Mercantilism

In principle, Mercantilism constituted a unilateral system of – financial – capital inflows in the form of precious metals for the countries enjoying a surplus of export over imports. This led to a redistribution of the enormous quantities of precious metals that were transferred to Europe from Central and South America and all over the world, specifically to China to pay for silk and china (Hobson 2004, chapter 9). This inflow of financial means went on without regarding the amount of investment that could be undertaken. The question of a fair distribution of the precious metals worldwide was not even considered, nor of course questions of economic development through increasing real investment, output and employment.

First, on the macroeconomic side, mercantilist policy led to a massive increase in the amount of saving in the export surplus countries. Large parts of saving could not be invested, almost certainly due to a lack of investment opportunities. This led to increase of unproductive financial capital circulating in a Keynesian *Treatise on Money* vein, in the financial sector. These parts of financial capital could not play any positive role in the economy through circulating in the productive sector through higher investment, with the associated multiplier effects leading to a cumulative increase in effective demand. Quite the contrary, not only had

this unproductive capital no effect on employment at all, but is likely that the effect was negative. Indeed, through its very circulating in the financial sphere, unproductive capital lead to price increases of already existing goods. Inflation, in turn, lead to a more unequal income distribution which reduced effective demand, and, as a consequence, output and employment. Hence the mercantilists were unable to manage the economic system properly, that is to make sensible use of the inflowing foreign resources. The accumulation of unproductive capital was the main cause of their problems. (This way of arguing is based on Keynesian-cum-Classical/Keynesian political economy, as set fore at the end of this chapter and in greater detail in chapter 4).

Second, in a macroeconomic-monetary perspective, the mercantilists did not pay any attention to keep the equilibrium balance relation between investment and saving and avoid the accumulation of unproductive capital and its adverse effects on the economies, mainly through worsening distribution of incomes (on the real side, saving must of course equal investment). These adverse effects of the financial capital inflow, sketched above, have, probably, offset, at least partly, the positive effects brought about by the export surplus, which constitutes autonomous demand capable of setting into motion a cumulative process of increased consumption and investment. Indeed, in Keynesian terms, the inflow of financial capital resulting in a more unequal distribution increased the saving ratio and reduced the size of the multiplier, annihilating thus, partly at least, the positive effect on output and employment brought about by the export surplus.

Hence, as the third point, the mercantilists did not pay any attention to distribution. Certainly, they did not understand the relation between distribution, effective demand and employment. A notable exception was Daniel Defoe who had always emphasized the importance of high wages for labour productivity and effective demand (Bortis 1997, p. 329).

Fourth, the mercantilist economists intuitively understood that the emerging monetary economies were not self-regulating (Bortis 2003b, p. 64). State intervention was therefore necessary; for instance, in England William Petty proposed public infrastructure projects, in France Colbert had set up state manufactures to enhance output and employment. In fact, given the non-selfregulating character of the emerging monetary economies, employment policy was a crucial component of mercantilist policy as Heckscher (1932) extensively argues.

Finally, it is important to note that the mercantilists paid due attention to the world

economic system as a one-way flow economic resource in a closed system. The surplus of export over import included some *real* foreign investment abroad to sustain trading activities. The returns were huge and appeared as a permanent movement of financial resources, which is precious metals, from the outside world to the country considered. Seen in this way, the mercantilist trading activities appear as a round-trip system. This system channelled direct investment abroad, to build up trade bases for example, and the huge profits subsequently returned to the local economy in the form of financial [FDI] capital (Yasheng Huang, 2005. p.4).

1.2 The First Internal Mechanism Models: Considering a Self-Contained and Self-Sufficient Economy

The physiocratic model, which emerged in the middle of the 18th century as a reaction to mercantilism, represents an entirely new way of looking at the functioning of an economy. Indeed, Francois Quesnay (1694-1774) considers a closed, self-contained and self-sufficient economy with social relations and internal production capacities playing a crucial role. This way of looking at the economy had been taken up by Marx, who put the social process of production at the centre of his considerations, and by List who argued that developing the forces of production within the national economy was fundamental, and that foreign trade was of a secondary importance. If compared with the outside oriented mercantilist model, Quesnay's internally oriented model turns out to be its opposite. In the Physiocratic model production already appears as a social process and there is interaction between social groups, landlords, manufacturers and farmers. For the first time, the economy appears as an organized system. This idea inspired not only Friedrich List and Karl Marx, but also Maynard Keynes as is clearly evident from the *General Theory* (Keynes 1936), the *Clearing Union* (1944/1980), and from *National Self-Sufficiency* (Keynes 1933).

The physiocratic vision of the economy is summarized by the – fundamental – Tableau Economique as is set forth in Kuczynski and Meek (1972) The spending of agricultural rent (2000£) by the landlords, in fact state expenditures, sets the economy, that is production, into motion. In fact, 1000£ are spent on agricultural products and 1000£ on manufactured products. In agriculture, each input, for example amounting to 1000£, reproduces itself and produces a

surplus of the same size, that is 1000£ in this case. Only agriculture, that is nature, is capable of producing a surplus, totalling up to 2000£; the monetary equivalent of the surplus is the rent paid to the landlords. This is the reason why Quesnay calls agriculture the productive sector, and the farmers the productive class. The manufacturing sector, however, is called sterile sector because inputs originating from agriculture (2000£) – raw materials: 1000£ and agricultural products (food): 1000£ - are transformed into a manufactured output amounting to 2000£. No surplus is created since input equals output. Therefore, in Quesnay view, the manufacturing is "sterile" and the manufacturing class is called the "sterile class". For our subject the use of the manufacturing output is of some relevance. Indeed, half of manufacturing production (1000£) is transferred to the landlords, made up of luxury consumption goods in the main. The other half, 1000£, flows to the (productive) agricultural sector and is made up of consumption goods as well as of *capital goods*. These real capital goods are, in fact, replacement investments, with the purpose to maintain the real capital stock in the agricultural sector.

In Quesnay's model there is no net investment and, hence, no growth. The important problem, however, is that replacement investment is uniquely domestic. Foreign investment is not even considered. This aspect of the Physiocratic model is taken account of in the next section.

1.2.1 The First Self-Contained Model - Reliance on Domestic Capital

The system of physiocrate represents a self-contained and inward directed system in comparison with the outward oriented mercantilist system. While the former relies on domestic capital – the replacement investments mentioned just before - the latter relies on attracting financial capital from abroad. While the mercantilists attempted to initiate economic development through an aggressive foreign trade policy, physiocrate doctrine emphasized the management of the economy through organising a self-contained, social system. The regulation of distribution was at the heart of long-period economic policy making aims at building up a socially appropriate institutional system. In the physiocratic scheme distribution appears a problem of proportions. In Quesnay's vision, the proportional relationships between wages, interests and land rents had to be such that an optimum social product, and a maximum surplus obtained. These proportional relationships in the sphere of distribution represented also social

relationships between labourers, farmers and manufacturers, and landlords. Hence, because distribution is a social, even a political problem, we may call the physiocratic model a system of political economy. According to Bortis, "He should therefore be considered the founder of political economy" (1997, p. 393).

François Quesnay had clearly perceived that the appropriate regulation of income distribution was fundamental to bring about harmonious relations between the social classes. Moreover, Quesnay realized that the socially appropriate regulation of income distribution through bringing about socially appropriate proportional relations between incomes was also linked with the optimal scale of economic activity. Production, employment and the social surplus were maximized. Production appears as a social process based on an interaction between the various social classes. In a way, then, the correct regulation of distribution brought about a well-organized economy and a well functioning society. François Quesnay, like David Ricardo, considered distribution the fundamental and most important problem of political economy.

The physiocrats, specifically François Quesnay, clearly recognized the danger of over-saving which would lead to a flow of financial resources into the financial circuit where it would remain sterile. In fact, Quesnay worried that landlords might not spend the whole of their rent income (amounting to 2000£). Hence, Quesnay already considered the problem of effective demand that to be taken up in a systematically approach by Maynard Keynes in the 1930s.

1.2.2 Summary and Conclusions of the Internal Model Based on Domestic Capabilities

1- François Quesnay's 'internal' model was the first scientific attempt to study production and consumption as social and circular processes. His approach was taken up by Ricardo, Marx and List, and, later, in the Classical-Keynesian system. François Quesnay may be considered the founder of Classical-Keynesian Political Economy as is extensively argued in Bortis 1997. Indeed, his approach to production, value and distribution was taken up by Piero Sraffa (Sraffa 1960, p. 93). Moreover, he also considers the scale aspect of economic activity as worked out by Keynes (Bortis 2003a, pp. 460-67).

2 – Economic activities appear in the course of socio-economic relations, that is the interaction of social groups (Pasinetti 1977, p.5). This is closely associated to a vision of economic activities as interactions between industries and sectors was taken up later by Leontief and Sraffa.

3 – For the first time, the scale of economic activity is shown to result from a multiplier relationship linking autonomous expenditures – the spending of land rents – to output and, implicitly, employment (Bortis 1997, p.153).

4 – Fundamentally new concepts are put to use in economic science for the first time, such as *net product, social surplus* and *distribution of income* (Pasinetti 1977, p. 5).

5 - Production, distribution of income and employment appear as the fundamental elements of the socioeconomic system (Bortis, 1997. p. 286).

6 – This first system of political economy represented a new way of looking at economic phenomena, opening up new areas of investigation for economic analysis. In fact, the economy appears as a flow of money and of goods steered by an *internal* mechanism. Real capital is in the background and is maintained through replacement investment. There is no reliance on foreign resources at all. The entire social product, comprising necessary consumption and the social surplus, is produced by domestic means of production embodying domestic technical capabilities. These points are extensively argued in (Pasinetti 1977).

1.2.3 Historical Lessons to be learned from the Domestic Capabilities Model

The Physiocratic model can provide the theoretical basis to undertake the first steps toward economic development based on domestic capabilities. The starting point for economic development must indeed be based upon the internal or domestic development mechanism. This implies that developing countries must, in a first step, rely on their own forces, which means to rely on domestic investment and have to be careful about foreign capital. From an analytical point of view Quesnay's ″Tableau Economique″ provides the starting point for input-output Leontief analysis dealing with quantities and for Sraffa's model which deals with the problem of value and distribution within the social process of production. All these models exhibit the nature aspect of the social process of production as is set forth in Pasinetti (1977):

Primary products – raw materials and agricultural products (food) – circulate between industries to enable the production of intermediate and final products. These horizontal production models put to the forth the crucial importance of the basic goods taken from nature (Bortis 2003, pp. 433-436). This led Quesnay to argue that only nature was productive and that a surplus could arise in agriculture only. Marx, however, argued that the process of social production represented an interaction between land and labour. Now, in vertically integrated models it is precisely labour which is put to the forth, "…where value at natural prices becomes equal to the physical quantity of labour-and in the economic system as a whole – where the total value of all consumption goods becomes equal to the total labour force" (Pasinetti 1981, p148). Both the horizontal and the vertically integrated models are evidently complementary as is set forth in Bortis (2003a).

In addition to putting to the fore the importance of basic goods, Quesnay's Tableau also emphasizes the crucial role of income distribution. A socially appropriate distribution of income is fundamental to the proper functioning of the economy, in a way, a healthy state of the economy. This is related to the fact that distribution is closely linked with demand which, in turn, governs the scale of economic activity and hence the level of employment. A socially appropriate distribution creates the demand required to bring about full employment and, consequently, to bring about maximum production and the highest possible surplus. This, as will be seen, is the hallmark of the classical-Keynesian model set forth in Bortis (1997 and 2003a).

The relation between saving and investment as it appears in Quesnay's model is of an entirely Keynesian nature: given the fact that there is no net investment saving immediately leads to a reduction of the demand for consumption goods and, hence, to a reduced level of output and employment.

The closed and self-contained model relying on domestic capabilities might even be adapted to foreign investment. First, one might postulate that additional primary products – oil, to give a modern example relevant to Iran - are produced in the agricultural sector of Quesnay's model. These primaries might be exported to buy investment goods. Net investment and growth would come into being. One may imagine, however, that foreign investment is *transhipped,* that is adapted to domestic needs and domestic technological standards (domestic capabilities). These investment and capital flows may now be channelled by direct investors to special

sectors, to relieve bottlenecks for instance, and subsequently be extended to other sectors to bring about balanced growth. As will be seen later, this requires creating demand, for example through expanding government expenditures – to be financed by taxation – which would set into motion a cumulative process of additional consumption and investment demand. Again, these features of the 'domestic capabilities model' appear in the classical-Keynesian framework of political economy as put forward in Bortis (1997 and 2003).

1.3 The Classics: Foreign Investment and Trade in Economics and in Political Economy

The classical political economists went beyond the still strongly intuitive thoughts of the mercantilists, and, in part, of the physiocrats to establish a system of social science, particularly a logically coherent political economy. Their theories were erected based on specific hypothesis. These codified causal relations between economic phenomena. Scientific reasoning led on to asking questions on the essence and significance of wealth, capital, labour, output, surplus, prices, distributional outcomes – wages, profits, rent - production and trade. A social ethical element entered with Ricardo through the notion of the natural wage which is immediately related to the concept of the social surplus. In Adam Smith's system, ethics entered directly the market place through the concept of *propriety*, which governed natural prices, made up of wage, profit and rent elements. These notions already point to the important differences between Adam Smith and David Ricardo.

Adam Smith puts the market and exchange into centre of his approach to analyse economic phenomena. The basic socio-economic aim to be pursued is wealth and its growth. Two major concept are of importance. First, there is the natural state with the natural prices of final goods and factors of production governed by propriety, a socially appropriate combination of self-interest and fellow feeling. Through the concept of fellow-feeling ethics directly enters the market place. Given this, the natural state is much more than an economic equilibrium. It is a socio-economic equilibrium implying a well functioning society. Here, rationality is not purely individual, but also contains, through propriety and fellow-feeling, a social dimension. Second, there are also macro-economic causality relations. Economic growth depends on saving which, in turn, is directly associated with the social surplus. The surplus is larger if

wages are lower, reflecting the well known classical postulate that a high growth rate requires a more unequal income distribution. Economic development, sketched in Book III of the Wealth of Nations, is brought about by an interaction between industry and agriculture resulting in a cumulative process of growth. The agricultural surplus is sold by the tenant or owner farmers to the industrial workers who spend their money wages to buy the necessaries of life, agricultural products in the main. Subsequently, the farmers spend their sales receipts to buy industrial goods, consumption and investment goods, the latter consisting in agricultural tools, for example. In this way agriculture and industry mutually create their markets. On account of rising labour productivity, brought about by technical progress, these markets expand, which means that there is economic growth. The interaction between the two sectors is reflected by flows of goods and money moving in the opposite direction. It is here that "money as the great wheel of circulation" (Adam Smith, Wealth of Nations, p. 289) appears most clearly.

Since Adam Smith deals primarily with the behaviour of individuals on the market place, he may be considered the founder of economics. The behavioural approach implied in economics has later been taken up by neoclassical economists.

The neoclassical economists have, however, watered down Adam Smith through transferring the ethical element out of the market into the framework surrounding the market. Neoclassical rationality is entirely based on self-interest. The general equilibrium is also a (social) Pareto-Optimum. The question of distribution, i.e. the initial endowments, is not dealt with, however, by pure economic theory. This is, in Walras view, a matter of social theory.

Ricardo was primarily an economist of production who saw production as a social process. This view of production naturally led to the labour theory of value and to the surplus principle of distribution. Distribution thus emerges as a social phenomenon with social classes – landowner, capitalists and labourers - being involved. Thus, Ricardo deals with economic phenomena in the context of society as a whole. This is the reason why Ricardo wrote on the principles of *political economy* (Ricardo 1951/1821): economic theory is associated with social production and society. This contrasts with Adam Smith's economics which is based on behaviour. For some issues associated with economics and political economy (see Bortis 1997, pp. 78-79).

Throughout this thesis, we shall argue that the distinction between economics and political economy is of the greatest importance to assess the impact of foreign direct investment

on countries with a developing economy. In the classical model, however, the main reason being that classical economic theories, both of the economics and of the political economy type, are basically supply oriented. *Say's law* holds, implying that *saving is always invested,* implying that money never is a store of value. This has a very important and straightforward implication for foreign direct investment. FDI adds domestic saving and thus domestic investment brings about a higher rate of economic growth and thus speeds up economic development; FDI appears as an import surplus, $M - X > 0$, which adds domestic saving S to make up the volume of investment:

$$S + (M - X) = I$$

This supply-oriented conclusion has, in another shape, been taken up by neoclassical economics and still represents the basic attitude towards FDI at present, held by economic policy makers worldwide, including international monetary and financial institutions. It is the main aim of this thesis to criticize, at a fundamental level, this classical and neoclassical proposition regarding FDI.

1.4 The Neoclassical Free Market Model: The Foundations of Economic Liberalism

In the past century, the free market system has grown into an ideal global institution, partly after World War II, and almost completely after the breakdown of the Socialist systems. First, this enabled the developed countries to continue the colonial period in other ways. Implicitly, this was initiated already within the framework of "the Marshall Plan, which financed the reconstruction of infrastructure and physical capital destroyed by the war" (Adelman 2001, p.106). Secondly, the rise of the free market system to global significance also resulted from the ideological competition between political and commercial power regimes. On the one hand, United States became the world's economic power and on the other side, the Soviet Union (USSR) with a closed economics system became a serious rival, especially in the military domain. As a result, countries with developing economy had to keep their economic position between the two sides or to associate to one power block in an exaggerated comparative and competitive atmosphere resulting from the cold war.

Simultaneously the political and economic leadership in the countries with developed

economies became a promoter of the free market economy at the world level with the double aim of securing outlets for final products and of procuring new sources of primary products (raw materials and energy resources). However, the developed countries always have had a mixed economic system with considerable state intervention ever since mercantilist times. The state and the economy interacted and mutually strengthened themselves (Chang 2004). This weakened the countries with developing economy compared to the past, because these countries simply were not prepared to compete with developed countries in free market conditions.

Parallel to this, neoclassical theory postulating competitive and open free markets was advocated all over the world. According to Irma Adelman "it was optimistically assumed that a similar injection of finance in to now-independent former colonies would lead to their rapid economic development" (Adelman 2001, p. 106).

Moreover, the industrialized (market-seeker) countries spread the free market doctrine in theory and practice through international institutions, which in a way became the spearhead of Western economic liberalism. Again, according to Irma Adelman, the postulation that "a deficiency in capital is the fundamental cause of underdevelopment was the basic principle underlying the Bretton Woods's institutions, as well as bilateral foreign assistance programs" (Adelman 2001 p. 106). To simplify somewhat, the development plans set up by these institutions have been an application of the Heckscher-Ohlin international trade model, where factor endowments are crucial to the determination of the pattern of trade (Bortis 2003b, p. 69).

In addition, the theories based on neoclassicism grew ever more complex in details. The Walrasian general equilibrium model and its developments, for example in the shape of the rational expectations system became a kind of an ideological fortress. Criticism became exceedingly difficult since considerable technical (mathematical) knowledge as well as a profound knowledge of theoretical alternatives was required. The dominance of neoclassical theory had crucially important policy implications: "[Neoclassical economists]. . . continued to cherish the idea that governments should not interfere with the price system. That meant disdain for regulation, for substantial public investment, for industrial policy, or for measures to allocate investment or redistribute income and wealth. If and when governments did intervene, their actions should be as 'market like' as possible. Keynes was relegated to a footnote, in effect, and the majestic ideal of a self-regulating economy marched on. The equations grew

ever more intricate, but the basic idea persisted. So if laissez-faire was sidelined by the Depression, by wartime planning, and by post-war recovery, it lived on in the hearts of the economists" (Kuttner 1991, p. 4).

In spite of the Great Depression of the 1930s and of the Second World War, a new golden age for laissez-faire came into being in the post-war period. In a first period, from the end of the war to the early 1970s, laissez-faire was tempered by the Welfare State and government intervention to maintain high employment levels. However, since the monetarist counterrevolution in the early 1970s, Keynes was definitely pushed into the background and laissez-faire became more and more unfettered. This trend got greatly reinforced after the breakdown of Socialism and the dissolution of the Soviet Union, which was achieved in the early 1990s.

However, in the new era (after 1991), the neoclassical – self-regulating - free market system has been continuously considered the best possible means to organise the global economic system. The situation is now different from the previous era for two reasons. First, there was the collapse of the closed socialist economies. The existence of the socialist block was an important reason for exaggerating the advantages of the free market system in order to present it as the great superior alternative. Seemingly, the fall of Socialism hailed the definitive victory of the neoclassical free market system on a world level, creating thus a wave of almost unlimited optimism. However, a competitive world market emerged not peacefully; on the contrary, new rivals for the established western industrialized nations came into being, the Eastern European states and, above all, China.

A second reason for optimism was linked with a variant of neoclassical theories, which since Samuelson, has been called the neoclassical synthesis. Based on a specific interpretation of this theory, some economists have suggested that after the breakdown of the Cold War block system, the global economy will stabilize with a powerful nation playing the role of a flywheel, which would keep the world economy going at high employment levels (Kindleberger cited in Kuttner 1991, p.12). They optimistically guessed that competition would result in a fair distribution of incomes, enhancing thus the spending power of the world population, which in turn, would bring about high employment levels. Moreover, the operation of the price system would lead to an optimal allocation of resources. Given this, labour would be employed in the most productive and efficient way, based on the logic of division of labour and specialization,

each producer is doing what he can do best (Kuttner 1991, p.5). The danger, however, is that oligopolies and even monopolies may come into being on a world level, implying thus a New Industrial World State with the economy largely dominating the existing national political power systems (Galbraith 1967, pp. 180-188). Such a state of affairs would, clearly, not be in line with competitive free market principles, which lie at the heart of neoclassical economic theory.

It is clear that the modern neoclassical economic theory of competitive markets is even more idealistic than Smith's traditional classical economic theory of the invisible hand type. For example, governments should not at all intervene in markets, which, if put into practice, has particularly disastrous consequences in countries with a developing economy. However, the historical fact is that when the presently highly developed countries were still developing, government intervened heavily (Chang & Grabel 2004, p.12). Particularly, the government played an important role in Great Britain, France, Germany, the United States, and Japan; for example, it is well-known that protective tariffs have been very high in the United States in the time-period 1865-1914, up to peaks of more than 40% of the value of imported goods (Chang 2002, p. 28). In this context, it is interesting to note that "Britain was the first country successfully to launch an infant industry promotion strategy. However, its most ardent user was probably the USA – the eminent economic historian Paul Bairoch once called it 'the mother country and bastion of modern protectionism'"(Chang 2002, p. 24).

1.4.1 The Background of Neoclassical Theory

Freedom of choice, in the liberal view, is the main meaning of liberty. This also implies the liberty to distinguish and to criticize theories and their goals to be able to set up a sustainable and robust system of economic thought. The neoclassical Free Market System is based on such a philosophy (Sen 2001, p.512). The free market doctrine came into existence at a specific historical instance, that is at the time when the Industrial Revolution was setting in, in the last third of the 18th century. Indeed, Adam Smith's Wealth of Nations appeared in 1776. His free market system was, simultaneously, a reaction against the heavily interventionist mercantilist doctrine and the liberal answer to the complexities of modernity brought about by

the rapidly growing division of labour. While Adam Smith proposed the idea that behaviour of individuals ideally is regulated by propriety, David Ricardo studied the functioning of social production and established theories of value and distribution associated with the social process of production. Both, Adam Smith and David Ricardo, upheld Say's Law, which as has been already suggested, has important consequences regarding the effects of FDI on countries with a developing economy.

The neoclassical free market theory grows out of classical theories: Adam Smith provided the 'laissez-faire' and 'invisible hand' background associated with 'self-regulation'; Ricardo provided the marginal principle which was taken up by the neoclassical, generalized and reinterpreted, and associated with the notion of substitution (Keynes 1936, p. xxv). This implied expanding classical theory in two important directions. First, the concept of the market price, fundamentally governed by the preferences of consumers, replaced the natural concept of labour value which is associated with the social effort undertaken to produce commodities. Second, the fundamental economic problems – value, distribution, and employment – were now solved through a standardized and anonymous economic mechanism, that is the market; the market forces, supply and demand, resulted from the rational and egoistic behaviour of individuals, utility and profit maximization. As a result, ethical considerations, as were present with Adam Smith through the notion of propriety, were now eliminated from the market place and transferred to the framework surrounding the market. Neoclassical theory thus got a purely economic shape, and became rigid and ideological. As a result neoclassical theory gives the same prescription to different countries with different problems through standardized economic approaches.

In continuation and related to this, Keynes started from the neoclassical (Marshallian) system to elucidate the role of investment and effective demand; he set forth the multiplier relationship and pointed to the important role of money in economic system. Later, after the Second World War, Paul Samuelson combined Marshall and Keynes, establishing thus the so-called neoclassical synthesis. However, these theoretical developments along Keynesian lines went on without special reference to countries with developing economies. Hence, economically underdeveloped countries were supposed to develop on the basis of supply-side based development plans. This also has been largely inadequate in emerging monetary economies since Keynes's short-term theories of effective demand, investment and multiplier

relationship, were absent in development plans of countries with developing economy, development frequently became an empty notion. These already points to the need for a flexible theoretical framework adapted to a monetary production economy, combining supply side and effective demand elements, to be applied to developing countries. This would imply bringing together elements of classical political economy – labour values, prices of production, and the surplus principle of distribution – with the Keynesian heritage (money, effective demand, investment and employment) adapted to classical long-period theory. Such a theoretical system could be called a classical- Keynesian synthesis (Bortis 1997 and 2003), which, subsequently, will be put to use to tackle issues associated with the impact of foreign direct investment on developing economies.

Nevertheless, it will be attempted here, to review how far economic problems, including the effect of FDI, could be solved through applying neoclassical economic theory. And in what circumstances alternative theories, particularly classical-Keynesian political economy, are more appropriate to deal with the effects of FDI, its costs and benefits, in countries with a developing economy.

Moreover, this chapter brings to the open the differences in the policy aims implied in the different theoretical approaches. Regarding socio-economic policies, the classical-Keynesian view implies a fair dealing with social and economic problems associated with foreign direct investment, employment and distribution in the main, and the neoclassical theory just takes into account purely economic elements to evaluate costs and benefits of FDI.

This chapter also very briefly assesses the free trade approach regarding the great social, political and economic problems such as distribution and employment as well as the quality and the quantity of gross national production. In contradistinction, the political economy approach is essentially of an ethical nature; the classics have indeed considered issues of justice, Adam Smith in relation with propriety, David Ricardo in connection with distribution, specifically in relation to the natural wage. On a more general level one may say that the production and the exchange approach lead to an entirely different appreciation of the great economic problems (Bortis 1997, specifically ch. 5).

The next issue is associated with government intervention. For example, in the classical – Keynesian system government expenditure is crucially important since it sets the economy into motion. Here, the question to role of markets arises and how the government could support

their proper functioning. According to Kuttner, there would be a hybrid, with elements of managed trade and elements of liberal trade. It would have to be acknowledged that government must be involved in setting up a national economic strategy. The result would not be "free trade" in the textbook sense; nonetheless trade would be freer, fairer, and more efficient than what we now have (Kuttner, 1991, pp. 16, 115, 124).

1.4.2 Some Fundamental Elements of Neoclassical Theory compared with Classical Theory

In this section, we briefly deal with the roots of Adam Smith's and David Ricardo's (classic) theories in comparison with the basic elements of the neoclassical approach, which is actually dominating. Classical and neoclassical theories are in various respects remarkably similar. The theory of comparative advantage can be regarded as an instance of these similarities: "There are certain commodities that each nation can produce relatively more efficiently than others, given its natural resources, labour force, and technological capabilities. If all countries specialize in the commodities in which they possess comparative advantages, exporting these goods and importing others, an optimal allocation of world resources would result. The welfare of each individual country, as well as of the world as a whole, would be maximized through free trade. It follows that any effort to protect a domestic economy necessarily involves sacrifices in national and international efficiency, although some groups in society may benefit at the expense of others e.g., English landlords in Ricardo's time [or recently Microsoft function in software computer market]" (Kuttner 1991, p116).

There are further similarities. In fact, both classical and neoclassical theory free market economies are based on the division of labour on the world level, specialization, individualism, self-interest and rational allocation of resources; also full employment is essential and goes almost without saying (Say's Law). These are crucial implications of the invisible hand principle which is associated with a self-regulating economic system. This system provides, in principle, equal opportunities for all individuals who maximize their utilities. This implies suppliers and demanders exchanging their goods and services in their mutual self-interest (Kuttner 1991, p. 6).

However, there are also deep differences between classical and neoclassical theories.

While classical (Ricardian) political economy is shaped by complementarites in the process of production and by the surplus principle, neoclassical is essentially characterised by substitution and by the marginal principle. Based on these principles, two different types of neoclassical theory emerged broadly from, 1870 onwards, Walrasian and Marshallian. Walras's basic idea was to set to the open the implications of Adam Smith's invisible hand. By means of a real exchange model he showed that a General Equilibrium of prices and quantities could exist. Walras took it for granted that a natural tendency towards a – stable – equilibrium exists. Money is there to facilitate exchange. A general equilibrium situation is also socially optimal; it corresponds, in fact, to a Pareto-Optimum. The Walrasian model is important to our subject because it is the basic neoclassical model on which liberal arguments of all kinds, also concerning FDI, are founded, mainly rationality (profit maximizing behaviour of producers and utility maximizing behaviour of consumers) and competitive conditions. The latter have eventually to be brought about through creating larger markets.

Neoclassical models of the Marshallian type are pragmatic and take account of the fact that money plays an important role. In fact, Marshall has developed the idea of the partial equilibrium with goods being exchanged against money. Marshall, therefore, considers a monetary exchange economy (Bortis 2003c, pp. 87-88). He wanted to maintain continuity in economic theory. Therefore he took up Ricardo's marginal principle to which he gave a wider significance and combined it with the principle of substitution. Say's Law works through perfect interaction of markets. For example, if there is unemployment, wages fall relative to interest and profit rates; investment rises, creating new workplaces; interest and profit rates increase and capital becomes more expensive relative to labour which sets into motion a process of substitution of capital by labour; this again creates new work places. These processes go on until full employment is reached. The Marshallian variant of the neoclassical theory is also relevant to FDI. The relevance is mainly practical: Cost-benefit analysis on particular projects is carried to evaluate the projects in question.

A further difference between classical and neoclassical models came into being in the course of the Great Depression of the 1930s and the Second World War through the Keynesian revolution. Keynes transformed monetary theory into a theory of output, employment and money, with the investment multiplier playing a crucial role (Shackle 1967). Subsequently, Keynes theory of effective demand was incorporated into the Marshallian framework by

Samuelson's neoclassical synthesis. Keynes's theory of effective demand created entirely new possibilities for assessing the desirability of foreign investment for developing countries. For example, through stimulating effective demand by running a government deficit new market could be created. This opened perspectives for FDI inflows that could add to domestic investment, being thus beneficial for the recipient country.

A final difference between classical and neoclassical economy occurred with the entirely new socio-economic and political environment that came into being with the breakdown of the socialist block around 1990. To this the information revolution, information technology (IT), Internet and Email, was added that made the world a village. Multinational and transnational enterprises gained importance. Mergers were intensified. Galbraith's *New Industrial State* (1967) came into being on a global level, contrasting with the cosy pre World War I situation where small and medium-sized enterprises dominated the picture. FDI now became of decisive importance for economic development. But entirely new problems occurred. For example, within the framework of transnational enterprises an international division of labour came into being. Parts of line of production lines were carried out in locations with low costs of production, with assembling done in the home country. This rendered possible dramatic rises in profitability for transnationals, to the benefit of the home countries. And for developing countries, new dependencies came into being.

However, regarding our subject matter, the essential questions remained unchanged, though in in changing terms. Therefore, in this thesis, we attempt to answer some questions as are related to alternative, sometimes complementary theoretical alternatives:

- Are the neoclassical theoretical prescriptions, such as free market theory, appropriate to underpin development plans of developing economies?

- Can a lack of real capital be remedied through FDI in a global competitive market with no state intervention?

- What are the benefits of FDI for developing countries in the new situation (since 1991), under free market conditions?

- How could FDI be useful on a free market basis, with – supposed - self-regulation, the presence of large multinational, transnational and joint ventures enterprises, for countries with a developing economy set in this new world of global competition?

- Could countries with a developing economy successfully manage their development

programs by making use of FDI in an open free market system without interventions within markets?

- How could developing countries improve their capacity to capture more of the advantageous effects of foreign direct investment in an open economy? (Kuttner 1991. p.12)

- How could the desire of all nations to maximize their welfare be reconciled with FDI based on a coherent system of rules for open market economies, even if these rules are not the rules of laissez-faire?

1.4.3 Neoclassical Economic Theory and Capital Movements

The necessity for external financing becomes evident from the relationship between national-income analysis and balance-of- payments analysis. For example, if there is an internal macro imbalance between national expenditure and national saving, then there will be an external imbalance in the balance of payments (Meier 1995, p. 213). The relations set forth below have, in fact, general validity. They hold for neoclassical and Keynesian analyses. The analysis of this section is in the spirit of Samuelson's neoclassical synthesis, combining neoclassical and Keynesian elements.

The starting point is a simple macroeconomic equation picturing the composition of the gross social product Q:

$$Q = C + I + G + (X - M) \qquad (1.4.1)$$

In this definitional relation, C is consumption; I gross investment, G government expenditure, X exports, and M imports. The disposal of national income is given by:

$$Y = C + S + T \qquad (1.4.2)$$

Here Y is national income, S gross saving, and T taxes.

Now, in a macro-economic supply-and-demand equilibrium the social product Q must equal national income and its spending Y (Meier 1995, p. 213). This leads to a relationship between national-income analysis and balance-of- payments analysis:

$$(I + G) - (S + T) = (M - X) \qquad (1.4.3)$$

This fundamental relationship shows how a country is spending on investment and government expenditure and how the required resources are released through private savings and taxation, given a certain state of the balance on current account. If domestic demand exceeds supply, there will be a resource gap within the economy, and then imports will be greater than exports and vice versa. Therefore, the domestic resource gap spills over into the balance of payments and creates a foreign-exchange gap. The way to validate investment and government expenditures in real terms when insufficient resources are being released at home by savings and taxes is by importing goods and services. For a country with a developing economy, it is assumed to have low private savings, negative financial government balance and a deficits on current national account that could be shown by relations such as, $I > S$ and $G > T$, and $M > X$. In real conditions, when imports exceed exports, the country confronts a foreign-exchange gap that has to be filled. The financial inflow to fill the foreign-exchange gap allows the real capital transfer to proceed. This can be done by losing foreign-exchange reserves or through external financing. For a country with a developing economy, the sources of external financing are foreign aid, foreign loans by government to government, the World Bank, the IMF and commercial banks, or private foreign investment, portfolio investment and foreign direct investment (Meier 1995, p. 213). If we take Keynesian perspective, the amount of capital inflow depends on the target level of GNP.

To support the target GNP, the gross capital inflow must cover the balance-of -trade deficit (M - X) generated at that level of GNP, plus any servicing of external debt, outflow of interest, dividends, and profits on private foreign investment, capital flight, and the desired build up of foreign- exchange reserves. If domestic investment is then to be high, the inflow of foreign capital will have to be large (Meier 1995, pp. 213-14). This process can be pictured differently, for example by the two-gap analysis of capital (Chenery and Bruno, 1962. and Hollis B. Chenery and Alan H. Strout, 1966). Foreign capital resources could fill both, the savings gap and the foreign-exchange gap. In filling the savings gap, foreign capital provides an equivalent additional to the capital stock. If, however, the foreign-exchange constraint prevents the country from importing goods and services that are required to complement domestic capital in production, then the inflow of foreign capital will not only add additional

capital but will also allow domestic capital that, would otherwise be redundant to be utilized in production (Hollis B. Chenery and Michael Bruno, 1962. p.72)

An increase in domestic savings (S) should also relax the foreign-exchange constraint through the release of resources for import-substitute industries or for exports. According to Gordon (1994, p.3), neoclassical economists believe that investment and capital market operations can be used to obtain desirable macro-economic outcomes. This belief is, however, based on certainty about future, self-regulating market, free competition, rational and self-interested behaviour, which all represent the main characteristics of neoclassical economics. If size and structure of gross domestic production (GDP) per head are important criteria in economic development literature, neoclassical macro-economists analyse the level and the growth in national income or output. "The level of output is determined in the labour market and the growth in output is determined in capital market, both under condition which guarantee full employment and economic security. The assumption which produced this ideal state of affairs are certain knowledge of the future and perfectly competitive markets for producers, labour and capital" (Gordon 1994, p.3). This in fact implies, in a Walrasian vein, a real exchange model where Say's Law holds and involuntary unemployment cannot occur; nor does money play any role.

If the neoclassical equilibrium model is to provide the basis for development plans, exogenous elements are required to bring about changes, for example economic growth and development. In fact, the Walrasian equilibrium implies a maximum level of production and full employment of all resources, including of course labour; moreover the rates of interest and profits are zero in a long-run equilibrium position.

In a Schumpeterian vein, these elements could be discoveries of new raw material reserves, innovations leading on to improve methods of production (technical progress), new products, foreign resources such as aid, loans or FDI. All these elements would counter the diminishing returns occurring in production which bring about the Walrasian equilibrium (Gordon 1994, p. 3). Thus Schumpeter dynamic entrepreneur and foreign resources are the crucial factors bringing about economic development. At present, neoclassical economists consider FDI as particularly important.

In the two- gap analysis, however, development may be hampered for structural reasons: there may not be sufficient domestic substitutes for necessary imports, there may be a fixed

coefficient between imports and domestic output, and exports may face a highly inelastic demand. Again, FDI might be helpful in these cases since bottlenecks could be relieved.

The analysis of this section shows how fragile neoclassical analysis is because of its very problematic assumptions. It also indicates why FDI emerges as a kind of saviour for countries with a developing economy. Given this, we present, in section 5, a rather robust alternative to the neoclassical model that is the classical-Keynesian model. This model will enable us to take a more differentiated view on the impact of FDI on developing economies.

1.4.4 Neoclassical Free Market Theory and the Effects of FDI

It has already been suggested that the Walrasian general equilibrium model may be used to set out principles of neoclassical theory and policy (Blaug 1992, chapter 13). In this section we simply suggest in what ways FDI might modify neoclassical principles.

The first aspect, and a starting point, of the Walrasian model is the idea that consumer strive to maximize his or her utility. The utility function is supposed to be unique. Maximisation is constrained through budgets. Similar considerations are true about other agents and institutions who supply or demand commodities on the markets for final goods and on factor markets. Therefore, workers try to maximize their utility, entrepreneurs and capitalists strive to maximize their interests and profits. These maximization processes go on under competitive conditions in the absence of ethical considerations that are relegated to the framework surrounding markets. If now FDI enters a developing country, then dualities between the traditional (competitive) sector and the advanced (systemic) sector dominated by large enterprises arise, as a rule.

Such dualities may come into being through technology, which is simple in the traditional sectors, sophisticated in the advanced modern sector. In the traditional sector wages are low, relative to the modern sector, where FDI has a tendency to push wage levels upwards. This creates a social cleavage between the traditional and the modern sectors. In the latter living standards will be higher and the way of life different. The social cleavage may deepen because of unfavourable terms of trade between developing and developed countries (Prebisch 1964, pp. 11-16). The relatively high prices of imported ‘modern’ still more depress living standards in the traditional sector. Socio-economic problems like these simply cannot be treated within a

neoclassical (Walrasian) framework. This is one important reason why developing economies should turn to an alternative approach.

Second, market price competition may be strong and widespread in traditional conditions where simple techniques are put to use. However, if market is relatively small a tendency to a monopoly may develop, if modern, more capital intensive are employed. Since average costs are falling as the amounts produced increase, the output of one modern firm may become so large as to be able to satisfy all the demand of a relative small market, creating thus a monopoly situation. This well-known issue has been dealt with by many writers, most importantly perhaps by Piero Sraffa in his (1926) article on the laws of returns under competitive conditions (see also Blaug 1992, pp. 215-16). Sraffa in fact started the whole discussion on imperfect competition.

Third, in a free market economy all economic phenomena are interrelated. There are connections between the behaviour of consumers, entrepreneurs, workers and capitalists. Therefore, there are connections between prices and rates of output of the different commodities. Since, however, a traditional and a modern sector co-exist, a dual price and quantity system comes into being.

Fourth, a modern economy not only needs well functioning markets as is, in fact, implied in neoclassical (Walrasian) theory, a well functioning social production system as pictured by the Leontief model is also required. Moreover, there must be channels of distribution and redistribution as well as an information and transport infrastructure. In addition, the economic system can function properly only if there are adequate social, political, legal institutions, and, perhaps most importantly, if there is an appropriate education system. Needless to say that there are serious inadequacies in these respects in many economically underdeveloped countries. For our problem, this means that the preconditions for hosting FDI projects are, frequently to a large extent, not fulfilled.

Fifth, the neoclassical theory implies that saving governs investment. Since economic growth directly depends upon net investment, a large amount of saving is a precondition for high growth rates (Blaug 1992, p. 217). Moreover, saving increases if the distribution of income gets more unequal. Thus, increasing inequalities in income distribution is, in a neoclassical perspective, conducive to higher economic growth. However, if in modern monetary production economic investment governs saving, a fact Keynes has insisted upon,

then the whole chain of causation gets reversed. Indeed, at the outset of the last chapter of his General Theory, Keynes writes: "[Up] to the point where full employment prevails, the growth of capital depends not at all on a low propensity to consume but is, on the contrary, held back by it; and only in conditions of full employment is a low propensity to consume conducive to the rate of growth of capital. Moreover, experience suggests […] that measures for the redistribution of incomes in a way likely to raise the propensity to consume may prove positively favourable to the growth of capital" (Keynes 1936, pp. 372-73). This is another important reason why the neoclassical model is not adequate to deal with the effects of FDI in countries with a developing economy.

Sixth, the allocation of resources among different economic activities is considered as an important point. Entrepreneurs will move to sectors where profits are high and move out of sectors where they are low, or even losses occur. If sectors are complementary, then bottlenecks may occur if a specific sector is too small. If equate domestic investment is, for technological reasons not available domestically, FDI may play a role in relieving bottlenecks.

On the whole, however, the points raised in this section suggest that there are great problems with neoclassical theory in interpreting economic phenomena in general, and the effects of FDI in particular. This is the reason why in the next section an alternative approach will be considered.

1.4.5 Conditions to Initiate the Inflow of Foreign Investment

In the neoclassical view, the conditions to initiate the inflow of foreign investment are very simple ones. In principle, the marginal productivity of capital has to exceed the rate of interest. This condition will, as a rule, be satisfying for two main reasons. In the first place, real capital is scarce in developing countries; this means that the marginal productivity of capital or the rate of profits is high. Secondly, since foreign capital is of a higher technical standard than domestic capital, the marginal productivity of foreign capital is likely to be much higher than that of domestic capital. As a consequence, the conditions for the inflow of foreign capital are likely to be satisfied in almost all cases. As already mentioned in the previous section, this is the reason why foreign capital is seen as the best possible means to bring about economic growth and development.

The neoclassical theory of economic growth and the conclusions derived for foreign investment relate to an ideal situation of a smoothly function exchange economy. In the real world of economic development problems are certainly much more complex. As has just been alluded to, there is dual economy, a traditional sector and a modern sector. Other factors play an important role. For example, the developing economy is likely to be an emerging monetary production economy, and no longer an exchange economy. Money there plays a crucial role. Inflation may threaten at times. Moreover, due to an unequal income distribution the general purchasing power is low. Consequently, there is likely to be a considerable lack of effective demand that implies high levels of involuntary unemployment. There may be social unrest and political instability. Institutions may not be stable. Moreover, there may be rapidly changing situations due to the vagaries of international politics. All this implies that the general uncertainty about the future is very high, with the specific uncertainty related to a specific investment project being even higher. How to calculate the rate of return in these conditions when the future is uncertain? The conclusion that a fundamentally different alternative approach is required to assess the effects of foreign investments in countries with a developing economy is reinforced by these considerations.

1.5 The Classical – Keynesian Synthesis

The classical-Keynesian system of political economy is a synthesis of classical (Ricardian) views on value and distribution and Keynes's theory of output and employment determination through effective demand in a monetary economy (Bortis 1997, 2003). The following section provides the main aspects of Classical-Keynesian synthesis as is related to our subject (FDI). Moreover, Classical-Keynesian political economy, which is a part of alternative modern political economy, is to be compared with neoclassical economics. Based on this comparison, it will turn out that the Classical-Keynesian system represents a more appropriate alternative to the neoclassical market theory for countries with a developing economy. Therefore, in chapter 4 below, this comprehensive alternative system will be put to use to come to grips with the impact of FDI on developing countries in general and Iran in particular.

Here we first take a brief look at the classical economic theories, which form the base of the Classical-Keynesian synthesis, including some characteristics of the social production

system and the (natural) labour value principle, implying the surplus principle of distribution. This is related with some considerations on long-period problems such as distribution of income based on the social surplus and the multiplier relationship which is associated with the employment problem. In a complementary way, some aspects of Keynes' monetary approach to economic problems are considered, that is short-run phenomena like employment determination with a given capital stock and the concept of effective demand. These various classical and Keynesian elements are combined in a long-term monetary theory of production. Finally, the treatment of money in our thesis will be briefly sketched. On the whole, it will be suggested that the Classical-Keynesian political economy synthesis is much more appropriate to deal with the effects of foreign investment on countries with developing economy than the conventional neoclassical free market theory. This will be set out in greater detail in chapter 4.

1.5.1 Introduction

With the passage of time, parallel to unsuccessful theories attempting to provide answers to new questions, alternatives approaches came into existence. Mainly, this was because of a deep gap between neoclassical theory and socio-economic reality. These theoretical alternatives can be the result of inventions and discoveries which, as a rule, are based on useful past pieces of knowledge elaborated by great authors.

In economic theory, the fact of learning from the past has a long record. For example, Adam Smith, while criticising Mercantilism, nevertheless used mercantilist's concepts, like the concept of Wealth, which he borrowed from William Petty while giving it a more precise content. Marx was strongly influenced by Ricardo regarding the theory of values and distribution. Hicks's significant work of combining neoclassical and Keynesian concepts by the IS – LM diagram, is a piece of aggregate General Equililibrium Theory. Piero Sraffa's theory of value and distribution within the social process of production, Leontief's input-output analysis and Pasinetti's model of vertical integration are other examples. All of them were in fact undeniably influenced by the way of looking at economic phenomena taken by François Quesnay and David Ricardo (Prue Kerr, 2005. p. 491). The new synthesis of neo- Keynesian or modern neoclassical theory is another example (Gordon 1994, p. 7). As a rule, a new theoretical synthesis is able to solve new problems or to provide a deeper and wider insight

regarding socio-economic phenomena.

The classical-Keynesian synthesis, too, has important and deep roots in theoretical work undertaken in the past. The works done by Quesnay, Ricardo, Marx, Keynes and Pasinetti are of particular importance. In fact, the Classical – Keynesian political economy synthesis represents a diversified framework of analysis based on the combination of great theories, attempting to take up faithfully their basic principles. This theoretical approach is suited to tackle appropriately the immensely complex socio-economic problems of the modern world in a way in which other approaches are not able to. Moreover, the classical-Keynesian approach is able to deal with the specific situations countries with a developing economy are in, above all with the new situation that has come into existence since the breakdown of socialism around 1990.

However, it is not sufficient to work out a comprehensive theoretical system. Indeed, according to Bortis: "To establish classical-Keynesian political economy as an alternative to neoclassical economic and to the economic theory of socialism will require the elaboration of comprehensive treatises in order to convince professional economists and, at a subsequent stage, the writing of textbooks to popularise the approach" (Bortis, 1997, 351). The classical-Keynesian approach must be taught in order that it can, in a Keynesian vein, enter the minds of political economists to shape sensible socio-economic policies.

1.5.2 The Method implied in the Classical - Keynesian Synthesis

The method implied in the classical - Keynesian synthesis thoughts represents a specific way of thinking about real world issues in view of obtaining (probable) truth. This is clear characteristic of political economy theories, for example, Ricardo's and Marx' systems of political economy. In fact, this is a heritage of Aristotle's definition of science. Aristotle combined the deductive (idealistic) method with the inductive, empirical and historical method, with intuition playing a fundamental role. In fact, for Aristotle, theory was fundamentally vision. Aristotle's realist method has been combined with Keynes's concept of probable knowledge and put to use in Bortis (1997 and 2003). The necessity for adopting this method to deal with socioeconomic phenomena arises from the immense complexity of these phenomena. Indeed, in the classical-Keynesian view normal or long-period prices and quantities, including

the level of employment, depend, directly and indirectly, on the whole institutional-technical system of which the social process of production is the basis. Moreover, distribution is a complex social issue and, from the normative viewpoint, a problem of social ethics and is, as such, closely linked with the labour value principle (Kerr, 2005, p. 478). The Keynesian-Aristotelian method rests, in fact, upon an interaction between metaphysics and science. "[Metaphysics is about] principles [which] represent the essential elements underlying a certain phenomenon, or the constitutive elements of a object; as such, principles also denote the fundamental and ultimate causal forces governing phenomena like prices, employment levels, and distributional outcomes, for example. To distil such principles the whole of society and man must be considered, and all the information available must be taken account of, scientific and non-scientific, theoretical and empirical and historical, whereby the objectively given material is dealt with by reason based upon a metaphysical vision which, in turn, is associated with intuition. This implies, as, in our view, Keynes suggested, that science and metaphysics interact: principles guide scientific work, and the results of science eventually modifies the scientists fundamental outlook and may induce him to adopt another approach in his scientific work, based upon a different set of principles. The notion of principles is closely associated with Aristotle's essentialist theory of knowledge: The human mind does not remain at the surface of phenomena but tries to understand the essential or constitutive forces behind, perhaps better, inside, the phenomena. Here, the distinction between essentials and accidentals is crucial as is the comprehensive point of view which implies that all the relevant information – with the history of economic theory perhaps being most important - has to be taken into account if a complex problem is investigated, for example the formation of prices or the determination of involuntary unemployment. Only what is considered to be essential or constitutive to a phenomenon is included in the model which is a picture, in fact a *reconstruction or recreation* of what *probably constitutes* a phenomenon, for example, prices, quantities and employment levels in political economy" (Bortis 2003, pp. 412-13).

The classical-Keynesian system results from a great tradition in political economy: Quesnay's circular view of production and consumption, Ricardo's and Marx's approach to value and distribution, Keynes's theory of output and employment based upon the principle of effective demand represented by the investment multiplier, Sraffa's theory of value and distribution within the framework of the social process of production, and Pasinetti's important

work on the classical labour theory of value which, together with the surplus principle of distribution, emerges as basic component of his natural system.

In short, the classical-Keynesian system represents a synthesis of the classical (Ricardian) long-period theory of value and distribution and Keynes's (short-term) employment theory adapted to the long-term method. Given the fact, that principles may come into being in very different forms, the classical-Keynesian system represents a flexible tool to guide social and economic policies.

1.5.3 A Review of the Classical -Keynesian Synthesis

Classical-Keynesian political economy, then, is a synthesis and a development of lines of thought initiated by classical political economists in a broad sense, such as Quesnay, Ricardo and Marx and Keynes's monetary vision of the economy. To establish this synthesis the long-period classical approach has to be combined with the short-period Keynesian one. To do this some technical innovation is required (see on this Bortis 2003). The starting point is the vision of social production as an interaction between man (labour) and nature (land). The horizontal Sraffa-Leontief input –output model, capturing the nature aspect of production, has to be transformed into a vertically integrated Ricardo-Pasinetti labour model, in order to be able to extend Keynes's short-run behavioural model, with the system acting through effective dema§nd, to a long-term political economy model picturing the functioning of the institutional-technical system. This model incorporates long-term classical elements like the social process of production and the labour value principle required to deal with the distribution of income. Moreover, Keynes's short-term theory of employment and effective demand has to be transformed into a long-term employment theory based upon the supermultiplier.

To bring together classical and Keynesian political economy requires carrying out the Pasinetti transformation, linking the horizontal Sraffa-Leontief input–output model and Ricardo-Pasinetti's vertically integrated labour model to be able to tackle the scale (employment) aspect of a monetary economy (Bortis 2003, p. 438). The classical-Keynesian system of political economy represents the political economy of Social Liberalism (Bortis 1990). This is a third-way alternative to neoclassical theory, which is the economic theory of Liberalism, and to the political economy of centrally planned socialism associated with the

doctrine of Socialism.

The social process of production is at the centre of classical-Keynesian political economy. As already mentioned, this process represents an interaction between man and nature. This interaction takes place permanently on the basis of the available and evolving technology and through a variety of institutions, enterprises in the economic basis, legal and political institutions in the institutional superstructure, for example. All the fundamental socio-economic phenomena, values and prices of production, long-period distribution and employment, are governed by the institutional-technical system. The relations between government, institutions and individuals' economic activities are important here. The size and the structure of the economy also play an important role here to determine the relations and interactions between the elements. Therefore, social production is an organized combination of parts in view of permanently aiming at economic goals beneficial to society. There are important preconditions to a well-functioning social production, that is, a socially appropriate regulation of income distribution along social ethical principles, and the highest possible level of employment achievable.

The social production process is linked up with two important elements, first, the social surplus based, in principle, on labour values, and, second, institutions. Both the social surplus and institutions are crucial elements of the Classical-Keynesian synthesis.

Although numerous economists did not consider value as a subject of economic debate, the classical economists, specifically Ricardo, consider it as crucial, also in its relation to the social surplus. The surplus is produced by 'productive' labour, that is, in modern terms, labour active in the 'profit sector' of an economy. In producing the surplus, labour is assisted by fixed capital. Profits are part of the surplus. The normal rate of profits on invested fixed capital represents an ingenious means of organizing social production. If, in some sector, the realized profit rate is higher than the normal rate, capital flows into this sector, and vice versa if the realized profit rate is lower than the normal one. Ideally, the largest part of the surplus ought to used to build up a political, social, legal, political and cultural superstructure, made up of institutions within which social and cultural values are permanently pursued (see on this Bortis 2003, pp. 423-27). This Ricardian vision of social production, value, distribution, and employment is a crucially important part of the classical-Keynesian synthesis. Subsequently, Pasinetti has, based on Ricardo, analysed the social process of production in a different way

(Pasinetti 1974, 1981). In his vertically integrated model, output is produced by direct and indirect labour put to use at different layers of the process of process. At the bottom layer primary goods are produced (steel, electricity, gasoline), then intermediate products, and, on the top layers, final products emerge. In fact, moving from the bottom to the top, each output becomes an input at the next step, that is to produce ever higher level goods in a vertically integrated process. In this process direct, and indirect labour, in association with past labour (real capital), has, together with land, the main role in social production. As a consequence, value is defined in terms of production cost, which, in turn, reflects the effort undertaken by society to produce the various goods. This vision of production has been summarised by Pasinetti: "[…] there is a production process behind each final commodity, which goes right back to what have traditionally been called the 'factors of production': labour alone in our simple case " (1981, p 30). In Bortis (2003a) the simple Pasinetti case – production by direct and indirect labour – has been taken up and complemented by past labour, that is real capital.

In Bortis (2003a, pp. 433-36), the social process of production is, in a Marxian vein, conceived as an interaction between nature (land) and man (labour). The Leontiev-Sraffa model pictures the nature aspect of production, and the Ricardo-Pasinetti model sets forth the labour aspect of production. In the Leontiev-Sraffa model the price equations are of immense complexity. In fact, the prices of production depend on all the coefficients of production and upon income distribution (money wages and profits). The Pasinetti-Transformation (Pasinetti 1981 pp. 109-112 and Bortis 2003a, pp. 437-38) paves the way from the Leontiev-Sraffa nature model to the Ricardo-Pasinetti labour model. In the latter the (absolute) prices of production are governed by efficiency wages (money wage in relation to labour productivity) and the mark-up upon total average costs at normal capacity utilisation. In ideal condition, vertically integrated prices of production are equivalent to labour values (Bortis 2003a, pp. 436-440).

The labour value principle and the uniform rate of profits are both of fundamental importance to organise a monetary production economy and to bring about as much social justice is humanly achievable (Bortis 1997, pp. 158-80 and Bortis 2003a, pp. 423-27). The uniform rate of profits provides incentives to produce efficiently and to realise high quality standards; moreover, the uniform profits is a very simple and robust tool to bring about a tendency towards a structural equilibrium. Labour values represent the essence of prices, and "the labour value principle and the associated surplus principle allow us to deal in a

comprehensive way with the problem of distributive justice associated with the structure of wages, profits and rents and with the size of the surplus, comprising profits, ability rents and land rents. The labour value principle may also be associated in a straightforward way to the study of social relations, for example between people working in the profit and non-profit sectors respectively" (Bortis 2003a, pp. 424). The labour value principle, the uniform rate of profits associated to the surplus principle, and the principle of effective demand are all fundamental and constitutive to Classical-Keynesian Political Economy.

Money is necessarily of a fundamental importance in Classical - Keynesian monetary theory of production. First, money expresses values, material means of production in interindustry analysis (Sraffa) or quantities of labour in vertically integrated analysis (Pasinetti) in money terms, both giving rise to prices; indeed, in a Marxian vein, prices express values in money terms. Money wage rates, and profit rates and mark ups, making up lead on to the formation of money incomes, linking thus the theory of value with the theory of distribution. The distribution of incomes is, in turn, a crucial determinant of effective demand, expressed in monetary terms. Finally, monetary effective demand governs the levels of output and employment. This leads on to the supermultiplier relation which represents the classical-Keynesian theory of output and employment and, as will be seen, embodies two mechanisms, that is the internal and the external employment mechanism.

Since within the process of social production and of circulation goods are always exchanged against money, a monetary production economy simply could not function without money. This is immediately evident from the sequence M – C … P … C' – M'. Incidentally, this is not the case in the basic neoclassical model, that is the Walrasian model, which, in principle, is a pure barter economy (C – C'), which may eventually become a monetised economy, where money is an intermediary (C – M – C'). In section 1.5.5.2. some additional remarks on money will be made in order to bring to the open the role of money in the present thesis.

Some important implications follow from value analysis and the formation of money prices as have been dealt with within the framework of Leontief-Sraffa interindustry models (Pasinetti 1977) and vertically integrated labour models (Pasinetti 1981). First, labour values appear as basic and natural values. These are linked to the prices of production (Pasinetti 1977, chapter V). The relationship between labour and prices of production has given rise to a

fundamental capital-theoretical debate which has established the surplus principle, associated with the social process of production, as the fundamental distribution principle at the expense of the marginal principle which implies the existence of factor markets (Bortis 1997, chapter 5). Second, the formation of prices within the social process of process can be captured at each stage of vertical integration, which leads from basic products, through intermediate products to final products (Pasinetti 1981, pp. 133-36). On each stage of vertical integration, distribution is regulated through the surplus principle, represented by the money wage rate and the normal rate of profits. In the third place, the links between values and the social surplus may be clearly established if vertical integration is considered (Pasinetti 1981); similarly, the relation between prices of production and distribution (the rate of profits) may be clarified; indeed, the prices of production depend on the conditions of production (all the Leontief-Sraffa) production coefficients and upon distribution, that is money wages and the uniform rate of profit (Pasinetti 1977). Fouth, as suggested above, the fact that prices are not independent of distribution has been a crucial element in the capital-theoretic discussion. This discussion has shown that the classical theory of value and price (labour values and prices of production) and the associated surplus principle is likely to be superior to the neoclassiclassical market theory of value and distribution. Fifth, and finally, the classical-Keynesian approach allows to establish a clear link between production, employment and distribution. This point will be given particular emphasis in chapter four below, specifically in relation with foreign direct investment.

After having discussed the importance and the implications of the labour value principle, a second important characteristic of Classical-Keynesian Political Economy is to be briefly discussed, that is the role of institutions (Bortis 1997, pp. 89-95). The role of institutions is to enable the members of a society to reach permanently specific individual and social aims in various spheres, economic, social, legal, political, cultural and religious. For example, enterprises and households are economic institutions; cities, villages and associations are social instutions; the Government, the Parliament and government administration are political institutions; moreover, there are obviously also institutions in the legal sphere, cours of justice for example; in the sphere of culture, the educational system, primary and grammar schools, and universities, academies of fine arts, also represent institutions. Finally, there are religious institutions. Institutions are of the utmost importance in a modern society because they enhance the potential inherent in human beings. This is most evident from the educational institutions

which are, perhaps, most important in a society. Primary schools, apprenticeships, grammar schools, economic and technical high schools and universities, and universities in general lay the basis, so to speak, to unfold the potential inherent in the social individuals and enables them to broaden their capacities. To render this possible precisely requires institutions in various domains: economic, social, legal, political, and cultural. Hence individual action takes place within an institutional framework, and instiutions set restrictions to or even determine in part the behaviour of individuals.

A modern society may be conceived as a system of institutions (Bortis 1997, pp. 89-95, specifically, scheme 1, p. 94). In a classical vein, this system is broadly ordered through a material basis (the economy) and an institutional superstructure. In fact, the economy, more precisely, direct and indirect labour, assisted by past labour (real capital) produces the social product. Part of the social product is used up in the social process of production in the form of necessary wages. The remaining social surplus may be used to build up an institutional superstructure to pursue values in the legal, political, social, cultural and religious domains. This values cannot be measured in money terms. However, the surplus which constitutes the material means to pursue the various values can be measured in money terms. For example, within universities intellectual and spiritual values (higher learning and research) are realised more or less perfectly. These activities require material means, for example buildings and a university administration, which have to be provided by parts of the social surplus.

Employment and distribution of income are, in a Keynesian vein, the basic socio-economic problems dealt with by Classical-Keynesian political economy. The Classical-Keynesian analysis of distribution and redistribution builds on the work of Quesnay, Ricardo and Marx and Pasinetti, specifically upon Ricardo, who, when formulating his surplus principle of distribution, has called distribution “the principal problem of Political Economy”(Ricardo 1951/1821, p. 5). The theory of employment determination through effective demand has been developed by Keynes (1973/1936) for the short-run, with productive capacities given, and adapted to long-period period analysis within the framework of classical-Keynesian political economy, which pictures a monetary production economy. In chapter 4 the Classical-Keynesian system will be put to use to deal with the impact of foreign direct investment on a developing economy in general and on employment and distribution in particular. There, distribution will emerge as a problem of proportions, employment as a problem of the scale of

economic activity. In relation with the latter, two employment mechanisms emerge from the classical-Keynesian system, the internal and the external output and employment mechanism (Bortis 1997, pp. 190-98). With the internal mechanism government expenditure and consumption as depending on income distribution are crucially important in governing the scale of economic activity; and exports and import dependence with the external mechanism. In chapter 4 it will emerge that both mechanisms are crucially important to analyse the effects of FDI on output and employment.

A third important feature of the classical-Keynesian system of political economy, in fact the political economy of Social Liberalism (Bortis 1997), is related to the role of the government. Given the fact, that the economy is not self-regulating the state in general, and the government in particular, has, in a social liberal view, a very important role to play. In the first place, a social basis has create a solid socio-economic basis, most importantly full employment and a fair distribution of incomes. A second task of the government is to bring about socially appropriate institutions in the institutional superstructure mentioned above, or to favour the coming into being of such institutions. Ideally, the institutional system should be such that the social individuals may prosper, that is unfold their dispositions. This means that the role of the government is not just mechanical, for example, attempting to equate government expenditures and tax receipts. The government and the top civil servants must have a vision of the society they should like to build, that is a system of social ethics. This, in turn, requires a strong and robust theory, which, in our view, is precisely classical-Keynesian political economy. Based upon this system flexible policies may be pursued, for example, paying attention to the internal and the external employment mechanism. And policies ought to be pursued in collaboration with important socio-economic institutions, for example, the central bank, entrepreneurial associations and trade unions. All these crucial points on state and society will be expanded somewhat in chapters four and five, also in relation with foreign direct investment.

As a result, the Classical-Keynesian synthesis is about the functioning of modern monetary production economies and about the interaction between the behaviour of producers and consumers, entrepreneurs and bankers, and the socio-economic (institutional-technological) system.

1.5.4 Important Practical Steps in line with the Classical – Keynesian System

In a classical-Keynesian vein, the first important practical step to be undertaken is to set up and to consolidate the social production system, which, in a developing economy, necessarily consists of a traditional and a modern sector. Ideally, full employment should be realised on the basis of traditional techniques. This would prepare the terrain for a gradual extension of the modern sector. The second step is to put to use the concept of labour value - the basic discussion of political economy – in view of establishing a fair distribution of income; basically, this means setting up reduction coefficient leading on to desirable wages structures. Thirdly, a socially appropriate allocation of resources has to be brought about by setting a socially appropriate uniform rate of profits. Distribution, most importantly the determation of the wages structure and the uniform rate of profits, is essentially a social ethical problem.

The social process of production implies labour which are brought into concrete existence through prices of production, from which market prices, as a rule, deviate (Kerr 2005, p. 490). The fourth step is to regulate different interactive economic relations including, government, and institutions, such as the central bank, entrepreneurs and land owners, labour and trade-unions, to clear the relation between production, investment, saving, distribution of income and employment, when there is no self-regulating co-ordination of individual actions on the basis of free market forces (Bortis, 1997. pp. 253-254).

In a wider policy the economy becomes an instrument in service of society, in the sense that the social surplus emerging from the social process of production provides the material basis for setting up a socially appropriate institutional surperstructure in line with the dominant values of a society. As such political economy and the associated socio-economic social policies are part of the moral sciences, as Keynes has emphasised time and again.

1.5.5 A Long-term Classical-Keynesian Political Economic Synthesis: Important Elements

1.5.5.1 The Social Process of Production in a Wider Setting

The social process of production stands at the centre, perhaps better at the basis of the technological-institutional system that makes up society and the state. Since technology and, above all, institutions are associated with permanence and duration, the various elements of this technological-institutional system enter as the constant or slowly evolving parameters and variables into classical and classical-Keynesian systems of political economy.

The wider significance of the social process of production P, implying the horizontal nature aspect and the vertically integrated labour aspect, emerges most appropriately from Marx's famous scheme of production and circulation (Bortis 1997, pp.180ff.):

$$M - C \ldots P \ldots C' - M' \qquad (1.5.1)$$

In this scheme M stands for money and the financial (banking) sector which provides the financial means (own funds and credits) to acquire means of production C (labour, primary and intermediate products, and real capital). In the social process of production these means of production are transformed into final products C'. These are bought by effective demand M'. The surplus (M' – M) is produced within the social process of production and can only be realised in the long run, that is permanently, if there are autonomous expenditures (government expenditures and exports) which give rise to derived demand for consumption and investment goods (Bortis 1997, pp. 158ff., specifically relations 7b and 7c, pp. 168-69).

The social surplus S produced by productive labour in the 'profit sector' is defined as follows:

$$S = Q - wN = Ws + P + R \qquad (1.5.2)$$

All the magnitudes are in real terms, for example in terms of a bundle of necessary consumption goods. S is the social surplus, w represents the socially necessary wage, N is employment in the profit-sector, Ws are surplus wages, P the profit sum and R land rents and ability for exceptionally gifted persons or rents due to privileges. As has already been

suggested the surplus S, produced by the material basis enables a society to set up an institutional superstructure. It is of great importance to note that the surplus, if its size is socially appropriate, has nothing to do with exploitation but is socially necessary. Indeed, on the one hand, the institutional superstructure enables a society to have an orderly social, political and cultural life for its members, including of course those who are active in the material basis. On the other hand, a well-organised material basis enables a society to produce a higher surplus. From the definition

$$Q = A\,N \tag{1.5.3}$$

and taking account of relation (1.5.2) it is immediately evident that the size of the social product Q and of the social surplus S depends upon labour productivity A and of the level of productive labour N. The higher A and N, the larger is the surplus S, and the greater are the social possibilities of a society in terms of a larger institutional superstructure. The crucial importance of employment and distribution appear once again and will be given particular attention chapter 4 below.

Hence according to the Classical-Keynesian synthesis, investment, employment, and a fair distribution have to be managed in view of solving social problems and attempting to reach social aims. This is entirely different in the neoclassical view; here employment and distribution are supposed to be determined by self-regulating markets. As a consequence, there is no surplus since the distribution problem is solved on factor markets.

The social liberal vision of society sketched above is entirely different from the nationalist-protectionist-cum-planning vision on the one hand, and from the neoclassical free and self-regulating markets view. With Socialism the aim is to set up an institutional framework such as to maximise the scope of freedom of the social individuals. This scope of liberty is obviously severely restricted in the nationalist protectionism-planning approach which, at the extreme, may involve the planning of prices and quantities reducing thus entrepreneurs to bureaucrats. In the liberal view, self-regulating market form the center of society and institutions constitute the legal, political, social and cultural framework. Since, as suggested above, markets are not self-regulating and since the nationalist planning-protectionist model is highly unsatisfactory for obvious reasons, we shall, in chapter 4, put to use the

classical-Keynesian synthesis in order to deal with the impact of FDI on a developing economy, specifically employment and distribution.

1.5.5.2 The Treatment of Money and Banking in the Present Thesis

The present thesis is written from a real, not a monetary point of view. Hence we consider prices and quantities, including distributional quantities, in relation to the functioning of a monetary production economy, with money and the functioning of the banking sector and of financial institutions as the stock exchange remaining in the background. This can perhaps be explained best by the Marxian formula for production and exchange set forth above:

$$M - C \ldots P \ldots C' - M' \qquad (1.5.1)$$

To start with, we take it for granted that a monetary production economy simply could not function without money. Indeed, goods are always exchanged against money, and there is never exchange of goods against. There are, therefore, flows of money and of goods which circulate in opposite direction in the processes of production P and circulation M-C and C'-M'. In Adam Smith's words, money "by means of which the whole revenue of the society is regularly distributed among all its different members, makes itself no part of [the revenue of society]. The great wheel of circulation is altogether different from the goods which are circulated by means of it. The revenue of a society consists altogether in those goods, and not in the wheel which circulates them" (Adam Smith 1976/1776, p. 289). In its capacity as a wheel of circulation money may have intrinsic value or not. Monetary economists have perceived long ago that money may fulfil its function without having intrinsic value, if it is legally stipulated that money must be accepted as ultimate payment for goods and services, or to clear debts. In this thesis we consider modern money, having no intrinsic value, which, however, represents value. Indeed, the money rate expresses labour values in terms of money and prices, in principle, express the value of a commodity in money terms.

Given this and considering scheme (1.5.1) above, we deal in this thesis with the sequence C'-M' to deal, first, with output and employment determination through effective demand. Moreover, we look at the determinants of effective demand, most importantly consumption as depending upon income distribution, government expenditures, as well as exports and imports.

Morever, the properties of the social process of production P are set out, enabling us to investigate the formation of prices and quantities, and distributional outcomes; moreover, the conditions for a smooth functioning of the social process of production are set forth to be able to locate eventual bottlenecks. This comprehensive analysis is required to enable us to deal with the impact of FDI on a developing economy in general and, specifically, on employment and distribution.

However, we take for granted the financing of the means of production, in the short and in the long run, through the banking system, that is the sequence M-C in scheme (1.5.1) above. In the short run, firm finance the means of production – labour and intermediate products - through current account credits which are balanced through incoming sales receipts. The financing of long-term means of production, investment or additional real capital, goes on the basis of own means, mostly non-distributed profits, and by incurring debts, through long-term bank credits, bonds and new shares in the main. Hence, in a modern monetary production economy, investments are financed before saving occurs. Moreover, in a Keynesian vein, saving adjusts to investment. This relation between finance, investment and saving can be clarified somewhat through taking account of the nature of money and through the Keynes concepts of industrial circulation and financial circulation (Keynes 1930, vol. I, chapter 15). The question as to whether money is endogenous or exogenous also enters the picture here.

In fact, in a long-period perspective endogenous money is intimately associated with credits and investment. As has been suggested above, investments not financed by own financial means, are financed through long-term bank credits, bonds and new shares. This is equivalent to money creation, implying that investment is financed through already existing and newly created money. Now, we have suggested above that money represent values. Hence, the banking system finances long-term means of production (investment or new real capital) through representative value, that is in money terms. The real 'financing' of investment goes on, however, through saving. Indeed, saving releases and thus makes available productive resources – direct and indirect labour and past labour (real capital) – to produce new real capital, that is investment goods. This is the reason why saving must always equal investment. In fact, the real 'financing' of goes on with the real equivalent of the monetary financing of investment, that is means of production put to use in the in the social process of production, P in scheme (1.5.1) above – direct and indirect labour and past labour (already existing real

capital) – to produce the new capital goods, or investment goods. These processes between money and credits (money creation), investment and saving are pictured in great detail in Keynes's *General Theory*, for example (Keynes 1936, pp. 81-85). Moreover, in Keynes short-period view, saving, in principle, adjusts to investment through variations in the level of output and employment. However, in a wider, classical-Keynesian long-period view, prices are determined with the social process of production and, with technology given, would not change when output varies (Bortis 2003a).

As soon as output is produced and, simultaneously, incomes are formed, that is once the process of value creation is completed, the money endogenously created through bank credit is now associated with real values, labour values in principle, and, as such, becomes exogenous. "[Incomes and] prices of the things (primarily securities), the purchase of which is the natural alternative to holding money, necessarily change until the aggregate of the amounts of money which individuals choose to hold at the new level of incomes and prices thus brought about has come to equality with the amount of money created by the banking system. This, indeed, is the fundamental proposition of monetary theory" (Keynes 1936, pp. 84-85). Moreover, when incomes are formed individuals have to decide on consuming or saving the newly created incomes. Once this decision is made, "there is a second decision which awaits [an individual], namely, in what form he will hold the command over future consumption which he has reserved, whether out of his current income or from previous savings"(Keynes 1936, p. 166). Life-time saving may be hold in cash, according to liquidity preferenc, or be used to buy shares, bonds, land, gold, old masters, and so on. It now of crucial importance, how much finance is used to buy new shares and bonds, leading on to new investments (additional real capital), and what part of realised current profits are directly used to finance new investments. Indeed, these financial means would be channelled into the industrial circulation because investment goods have to be produced. Since, however, the banking system through providing credits creates additional financial means to finance new investments, it is likely that only part of the current saving will flow back into the industrial circulation. This part is likely to become ever smaller as money in the financial circulation accumulates. Therefore, an ever larger part of the amount saved and showing up as bank deposits will flow into the financial circulation, to buy already existing real and financial assets. This means that an increasing part of the saving that has emerged from the industrial circulation flows into the financial circulation. Moreover,

this part of saving will be the higer the more is saved; saving, in turn, increases if income distribution becomes more inequal. Hence with growing inequality in income distribution more money will be channelled into the financial circulation. Now, Skidelsky writes: "Depressions arise, Keynes wrote in his Treatise on Money, when money is shifted from the 'industrial circulation' into the 'financial circulation'"(Skidelsky 1992, p. xxiv). This is due to two aspects of money circulating in the financial sphere, the speculation and the enterprise aspect: "[Appropriating the term speculation for the activity of forecasting the psychology of the market, and the term enterprise for the activity of forecasting the prospective yield of assets over their whole life, it is by no means always the case that speculation dominates over enterprise. [In fact,] speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enerprise becomes the bubble on a whirl-pool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done"(Keynes 1936, pp. 158-59). Now, since the early 1970s Keynes's enterprise, passive in the 1950s and 60s, has become more and more active and aggressive. Indeed, with more and more financial capital accumulating in the financial sector, finance capital was looking for ever more profitable assets. Takeovers, friendly and unfriendly, mergers and acquisitions, restructurations, mostly accompanied by dismissals, asset stripping became almost normal. Simultaneously, the prices of stock, above all the prices of share of very profitable enterprises, reached exceedingly high levels. Enterprises had to realise ever higher profits to pay dividends and to keep share prices at a high level, precisely to prevent takeovers, eventually followed by restructurations and dismissals. In a Marxian vein, active enterprise thus meant increasingly hunting sources of surplus within the broad framework of wealth management. On the one hand, this means considering interests as parts of the social surplus (Keynes's liquidity theory of the rate of interest remains of course valid for the speculator). On the other hand, hunting of surplus sources, almost inevitably leads on to increasing inequalities in income distribution and, as will be seen in chapter 4, higher levels of involuntary unemployment. Given this we may say that the financial resources circulating in the financial sector are, in a way, unproductive capital – a term we shall use in chapter 4 - since the tend be invested into already existing goods, that is existing shares and bonds, including of course treasury bonds, land, gold, old masters, and other. And the problem is that unproductive capital cannot become productive financial capital, that is get invested into new real capital goods, that

is additional real investment. Indeed in chapter 4 it will be argued that, in the long run, effective demand limits the normally profitable investment volume to a normal or trend level.

However, the accumulation of financial resources has still another dimension. Cyclical fluctuations may become more pronounced. The problem is that banks also wish to secure a larger part of the economic surplus through an extension of credit, also to borrowers who not be very credit-worthy, with Hyman Minsky being on the agenda again. This leads on to the creations of far too large productive capacities. Once the downturn sets, investment breaks down as indeed happened in the great crises of the 1930s. The US subprime crises might be another instance for a sharpe reductions of investment volumes, following up too large a credit expansion.

From the above emerges that money is endogenous in the case of productive use of credits, that is if credits finance real investment which leads on to an expansion of the real capital stock, that is in the sequence M-C … P in the scheme (1.5.1) above. However, once the process of production is achieved and incomes formed and effective demand becomes active – C'-M' in (1.5.1) above - money becomes exogenous (Keynes 1930 and 1936). Given this, we may restate the present thesis is of a real, not a monetary nature. The above remarks just link our real theory with monetary theory.

1.5.5.3 Differences between Neoclassic Free Market Theory and the Classical-Keynesian Synthesis

The picture may be completed through considering differences between neoclassic free market economics and Classical-Keynesian political economy. These differences emerge most clearly from the foundations of the two approaches: In fact, Classical-Keynesian political economy starts from the social production process, that is from gathering and organizing inputs and labour force. Moreover, the necessary conditions for production based on the technical system, the forces of production, and the associated social relations have to be set up. These notions are solidly anchored in the real world, and are, as such, constant or slowly evolving. On the other hand neoclassics start from the notions of the market and of utility notion, both of which are based upon quickly changing behaviour. Moreover, both have been generalised in various directions. Specifically, the notion of marginal utility has been applied to production in the form of marginal productivity. This notion is particularly fallacious because no well-behaved

demand curves for capital can be established on the basis of this concept (see Bortis 1997, pp. 281-95). Second, the Classical-Keynesian synthesis considers the functioning of the system of social institutions instead of the behaviour of individuals in the various markets. Third, in a Classical-Keynesian vein, productive activities are shaped by (effective) social demands; effective demand is governed, in turn, by functional distribution and subsequent redistribution; finally, distribution is the fundamental problem of social ethics. Fourth, social production relies upon co-operation, and not just upon gains through exchange. Moreover, money is neutral is neoclassical economics. In classical-Keynesian political economy production just could not go on without a banking system which finances production and investment; morever, effective demand, as expressed through multiplier and supermultiplier relations, is in terms of money.

Market prices play an important role in neoclassical economics; in the classical-Keynesian view, however, the natural prices (labour values) are fundamental; these are realised through the prices of production, from which, in turn, market prices may deviate. Finally, in the neoclassical view, growth is based upon supply factors, population growth and endogenous and exogenous technical progress, and capital accumulation. In the classical-Keynesian view, supply factors are necessary, but not sufficient; there must be demand to realise the productive potential. Effective demand is associated with two mechanisms; the internal employment mechanism relies on government expenditures and private consumption, depending upon distribution, and on normal investment. With the external mechanism, exports and export growth figure prominently, together with technical and cultural import dependence to determine the level of employment. Both mechanisms will be considered extensively in chapter 4 below.

1.5.6 Conclusions

What is planted today will be harvested tomorrow. (Persian proverb)

Today, there are great historical doubts about the theoretical foundations *really* underlying the now highly developed industrial countries.

Similarly, there are great doubts about the conceptual foundations underlying the development theories, emphasing the key importance of FDI, that have been and still are

recommended to countries with a developing economy.

Taking a broader view, a great variety of ideas exists on the problem of economic development, from highly optimistic to profoundly pessimistic views. Consequently, it is important in the first place, to establish a comparative review of the differing fundamental approaches to the problem of economic development. Second, it is important to find the roots of theories that is the causes of success and failure of today's economic attempts to come to grips with the problem of economic development. Third, it is important to become clear about the role of foreign resources in each approach.

Fourth, it is useful to have clear of the evolution of motivations to attract foreign finance, especially FDI. The problem is to tentatively find out how FDI has been seen historically by the various theoretical approaches. This may lead on to a balanced evaluation of the effects of FDI in developing countries and, as a consequence, lead on to enhancing prosperity in these countries. The importance of this theoretical review emerges from this fact that theories related to our subject are, if unaccompanied, unable to cover the multidimensional and polyhedral problems of countries with developing economy. Therefore, in the next chapter, some features of these theories are mentioned and the need for new theories, such as the classical-Keynesian synthesis, is put to the fore. Here we provide a very short overview.

There are two types of pre-classical, mercantilist, models. One group of mercantilists favoured the attraction of foreign resources in view of accumulating capital. The other group relied on domestic resources and domestic capabilities. However, both emphasise the importance of effective demand and of a more equal income distribution, the benefits of investment and the sacrifice associated to saving. The classical models, taken in a wider sense, are also of two broad types. One classical strand continues to emphasise the importance of international trade to enhance domestic welfare through overcoming the limited size of markets (Adam Smith) or the effect of diminishing returns in agriculture (David Ricardo). However, classical and physiocratic strand (François Quesnay) lead on to protectionist/nationalist, self–contained and self-sufficient economic models. These political ecominists advise to strengthen the economy domestically in different ways, before opening up an economy to competitive markets on a world level. Classical models also deal, on the one hand, with the allocation of resources, efforts to increase productivity, division of labour, specialisation and free trade and the advantages of free trade based on comparative cost differences; on the other hand, however,

the attention paid to the economic surplus as a socio-economic phenomenon and, above all, the efforts made to increase the surplus led on to phenomena like colonialism, imperialism, exploitation and monopoly capitalism.

Neoclassical economists focused with particular emphasis on the allocation of resources. Therefore, exchange became the crucial phenomenon. As a result, international trade got a very important role in increasing welfare. Saving, accumulation of capital and production associated with optimal factor allocation became engines of economic progress. Say's Law in the form of smoothly working markets made involuntary unemployment impossible As a consequence, employment and great social problems were seen to be solved easily by the market mechanism; government intervention was beliefed to be unnecessary. In this vein, it was postulated that distribution, too, was regulated on factor markets. Economic growth depends, in the neoclassical view, essentially on supply factors: growth of the labour force, capital accumulation, and technical progress, increasingly considered endogenous. In this view, foreign resources become complementary to domestic resources, contributing thus to enhance economic growth. To conclude, individual rationality was, ideally, co-ordinated by self-regulating markets such that a social optimum, that is a Pareto-optimum, obtained.

Keynes, for the first time, convincingly argued that, in a monetary, economy Say's Law did not hold, that is that an equilibrium with involuntary unemployment was possible. In his system, saving no longer depends upon the rate of interest, but on income. This leads straightaway to the theory of the short-run investment multiplier, which, in assoiciation with the volume of investment, represents Keynes's short-period theory of emplyoment. Interest became a monetary phenomenon, in fact, the price to be paid if liquidity was to be given up. On the basis of Keynes's system, capital movements could be dealt with in a more appropriate way. For example, if in an underdeveloped economy, saving represents a bottleneck, FDI would add entirely add to domestic investment. If, however, saving is high, due to an unequal distribution of incomes, investment opportunities will be limited, due to a lack of effective demand, and FDI will possibly squeeze out domestic investment.

Finally, Classical-Keynesian political economy synthesis as a combination of classical and Keynesian concepts. In classical (Ricardian) theory the starting is the labour principle of value, which, together with the surplus principle of distribution provides the starting point for positive and normative theories of income distribution; in positive distribution theory power

relations are fundamental, while distributive justice provides the fundamental concept for normative distribution theory. Keynes short-period employment theory, based upon investment and the investment multiplier, has been developed into a long-period theory of output and employment based upon the supermultiplier which links institutionally determined autonomous variables, government expenditures for instance, to output and employment. The classical-Keynesian system provides a new framework of analysis. This framework will enable us to carry out a comprehensive analysis of the positive and negative effects of FDI on a developing economy. This will be done in chapter 4 below. So what is planted today will be harvested tomorrow, if the soil has been adequately prepared yesterday on the basis of a conceptual framework to be provided on the day before yesterday.

Chapter 2 :
Policy Foundations, Some Historical Aspects

Instead of saying that a country is poor because it is poor," it can now be said on the basis of a comparison of the success stories and failures in the development record that" a country is poor because of poor policies (Meier 1995, p. 66).

2.1 Overview

Chapter 2 reviews the foundations of policies in developing economies related to the research subject. The theoretical chapters, this and the preceding one, are to provide a theoretical basis to examine the subject of this study. The following questions could be useful to guide the study to do that: On the basis of which policies and how can one justify FDI in conditions that countries with a developing economy are in? Is the foreign direct investment useful for countries with developing economy, everywhere, every time and forever based on the neoclassical self-regulating free market conditions? Is FDI the unique instrument for development and the key to solve the socio-economic problems for countries with a developing economy? Is foreign direct investment a useful solution for countries with a developing economy to achieve a sustained rate of growth? And, finally, chapter two analyses specific policies in an attempt to clarify the possible effects of FDI on countries with a developing economy.

In any case, it is a difficult task to frame a policy conception which takes account of the rapid socio-economic changes that are going in time and of the effects of a rapidly evolving international environment, particularly so after the 1990s. In the present chapter we nevertheless attempt to outline some policy guidelines. It seems that in successful countries there is, in general, a positive relation between following an economic theory and choosing a competent policy to guide economic development, and attracting foreign investment in particular (World investment report 1994, pp. I, II, XXV).

The chapter is divided into three sections. The first section considers the characteristics of neoclassical economic policies. These are all grouped under the heading of free market theory. Commonly they have a marked tendency to employ the international economic potential in order to achieve a sustained rate of growth. An example is provided by the policies that recommend capital transfers as the main means to growth and development (Table 2.4). This is characteristic of the extreme right-wing economic views about thesis subject. There is a tendency to categorize these as advocating a mechanism of external financing of the development process (Hauser 1986. p.12). These policies have induced the globalisation trend (Buckley 1995. p.104).

The second section sets forth alternative economic views. Their representatives are generally very careful about the international economic interactions that may lead on to puzzling

results, such as foreign investments. On the contrary, they focus more on the internal economic potential to achieve satisfactory sustained rates of growth. The second section also considers policies related to a closed economy. These are alternatives to liberal free market policies, such as protectionism and self-sufficiency policies (Yusuf and Stiglitz 2001. p. 229). Such policies bring about national and regional economic systems. These doctrines represent extreme left wing economic views. Their representatives are, as a rule, careful about the international economic interaction mechanism in general and sceptical about the results of capital transfers in particular. Given this, they focus more on domestic economic policies to induce economic progress in general and a sustained rate of growth in particular (Buckley 1995. p.106). Such inward directed policies become more important in unfavourable economic conditions and in conditions of uncertainty about future developments; in particular, when distribution is unequal and unemployment rises. Consequently, tariffs and non-tariff barriers necessarily emerge to protect national economies. Particularly old domestic industries and labour-intensive sectors on the one hand and infant modern industries on the other hand require protection. This is in line with the essential findings of the political economy of protectionism (Nurkse, 1955. pp. 104-105).

In such a system, tariffs can be interpreted as "prices" of a neoclassic system, which equilibrate demand and supply. In general, the relative policies differentiate between the demand for, and the supply of, protectionist measures, and derive the determinants of the resulting political economic equilibrium (Hauser 1986. p.169).

Finally, in section three, the Classical-Keynesian system is presented as a comprehensive policy. This is a flexible and multidimensional approach, considering man and society as entities. The Classical-Keynesian system is the political economy of Social Liberalism as is set forth in Bortis (1997, 2003).

To summarize, there are two groups of opposite and alternative economic policies. On the one extreme there are policies based on protectionism, nationalism, which may be combined with capitalist or socialist elements. At the other end there are policies associated with Liberalism which is individualistic and where the economic actions of individuals are coordinated by self-regulating markets. The former is inward looking and favours internalisation of economic activities, the later emphasises externalisation. The doctrine of Social Liberalism represents a middle-way between protectionism, nationalism and liberalism. This doctrine emphasises the – territorial - state as a precondition for a well-ordered society in which the social individuals may

prosper. The economic theory of Social Liberalism that is classical-Keynesian political economy simultaneously makes use of elements of the internal and of the external mechanism governing economic activity (Bortis 1997. pp. 190-98). Classical-Keynesian political economy represents a new way between the radical alternatives which takes a comprehensive view. This approach enables to set up flexible policies, of a middle-way type in principle, but also temporarily moving to the right or to the left, when needed.

Classical-Keynesian theory is robust and simple. It is also multidimensional, always looking at the economy and society as a whole. As such, policy conceptions based upon this theory can come to grips with a complex reality, which is not the case with the extreme doctrines. Given the absence of adequate theories for countries with a developing economy, there is hope that the classical-Keynesian system may prove useful for providing policy conceptions.

Both theoretical chapters (this and the former) and the empirical data presented in the next chapter aim at providing a policy view in line with the situation in developing countries to be able to assess the impact of foreign direct investment in whole.

However, this chapter and the next also include a comparative analytical study with distribution and employment as two main elements investigated. They examine the question: Is foreign direct investment a useful way for countries with developing economy to achieve a sustained rate of growth?

2.2 Introduction

Since the beginning of 20th century, economic progress, growth and economic development have been at the centre of economic discussions. The great depression, the destruction occasioned by the World Wars, the huge economic collapses, high rates of unemployment and poverty in developed economies made the situation in countries with developing economies worse than in the earlier period of colonialism. They felt the great level of backwardness harder to bear than in the past. The situation was improved somewhat by new features in international economic relations such as capital transfers.

After the Second World War, resource transfers have become more varied and universal through foreign aid and loans. This let developing countries hope that social and economic problems could be tackled more appropriately by external resources than in the past (Yusuf and

Stiglitz 2001, p. 234).

Consequently, the newly independent countries with developing economies became interested in external resources as the unique way of promoting growth and development, although simultaneously, there were opposite views on how to proceed and also about the effects (Trevino et al. 2002, p. 30).

Therefore, foreign resource transfers progressed in size and form gaining a continuously greater role every day, also under the American's umbrella of Truman's Plan to transfer foreign aid and loans (1945-1953). Consequently, a unique mobilization of capital took place, preceding any theoretical justification (Nurkse, 1955. p.120).

After the golden period in the 1950s-60s, developing countries had accumulated a huge debt. This led to ever rising resource outflows due to the servicing of the debt (interest payments and repayment of debt due). At the same time, a saturation of financial capital occurred in the developed countries. Moreover, at the beginning of the 1970s it became evident that markets were limited, that world effective demand fell short of productive capacities. Unemployment rose sharply in the developed countries. The search for new outlets for final products produced in the developing countries became more intensive and so did the needs to obtain cheap raw materials. This leads to a first hypothesis in relation with the saturation of financial resources: financial capital was now being mobilised for uneconomic reasons; this meant realising investment projects in developing countries without clearly establishing a macroeconomic rationale. Indeed, new multinational corporations (MNCs) emerged as agents of private foreign investment in developing economies. Foreign aid continually increased and the lending of commercial to countries with developing economies rose sharply. Even greater reliance has been placed on private international capital markets for the necessary resource flows to support developing economies. This type of assistance requires also increased financial integration of countries with developing economies with global capital markets under a hidden political relationship between the economic powers. With such integration, the operations of multinational corporations widened very strongly, accompanied by intense bargaining processes between multinationals and host governments. This leads to another hypotheses related to our subject: Capital transferring was more about solving problems of developed countries – new outlets for final products and increased access to cheap raw materials – rather than to promote development in countries with developing economies (Preston 1982. p. 35).

Then the oil problem came into being. The oil crisis of the early 1970s brought cost-push inflation and very high unemployment rates in the industrialised countries. The rise in oil prices and the consequent increase in the revenues of the oil-producing countries led to a flow of financial capital to the developed countries (Hauser 1986. p.12). Gradually, governmental aid and loans gave way to private capital especially on FDI (Table No 2.1, also see Ha-Joon Chang 2004. pp. 107-123).

The next change happened in the early 1980s, when the debt crisis deepened. Payment of interest and amortization declined sharply, mainly because of the high Latin American debt. At the same time, FDI was carried out increasingly by transnational corporations (TNCs). This represented a new dimension for foreign direct investment (Kennedy and Sandler 1997. and Trevino 1999). In 1990s, this trend amplified, affected by events such as the collapse of the USSR and Eastern bloc countries where more regional agreements, mutual integrations, and new international institutions had evolved.

According to Jean-Marc Fontaine (1992), the neoclassical free and open market policies have become the main mechanism to adapt developing economies to international interactions and to an outward oriented economic development during the time-period 1970s -1990s (on this see also Table 2.1). This was caused by the amount of capital transferred; these transfers have also continued during the time-period, 2000- 2004. Moreover, the share of FDI in comparison to the other capital movements was 1 to 5 in 1990. It grew to 1 to 3 after 1993, and it has been more than 1 to 2 since 1998. Table 2.1 clearly indicates the growing importance of FDI relative to other types of capital flows.

Table 2.1: Net resource inflows to developing countries, portfolio, FDI, equity, and debt, US $ billions 1970-2003

Year	Portfolio	FDI	FDI Rate Of Change Percent	Equity Flows	Long term Debt (1)	Total Resource	Rate of Change Percent	FDI to Total Resource ratio Percent
1970	0.0	2.2	-	2.1	6.6	10.9	-	20.2
1980	0.0	5.1	131.8	13.2	67.7	86.1	689.9	5.9
1989	3.4	23.2	354.7	19.3	36.7	82.6	-4.1	28.1
1990	3.2	24.5	5.6	29.2	43.7	100.6	21.8	24.4
1991	7.2	33.5	36.7	37.3	44.5	122.5	21.8	27.3
1992	11.0	43.6	30.1	31.6	59.7	145.9	19.1	29.9
1993	44.9	67.2	54.1	29.3	70.6	212.0	45.3	31.7
1994	32.7	83.7	24.6	32.4	58.1	206.9	-2.4	40.5
1995	32.9	95.5	14.1	32.6	77.0	237.2	14.6	40.3
1996	45.7	109.5	14.7	31.3	98.1	284.6	20.1	38.5
1997	22.6	171.1	56.3	193.7	105.3	299.0	5.1	57.2
1998	6.6	175.6	2.6	182.1	57.6	239.8	-19.8	73.2
1999	12.6	181.7	3.5	194.4	13.8	208.1	-13.2	87.3
2000	12.6	162.2	-10.8	174.8	-9.8	165.0	-21.7	98.3
2001	4.4	175.0	7.9	179.4	-1.2	178.2	8.0	98.2
2002	4.9	147.1	-15.9	152.0	7.3	159.3	-10.6	92.3
2003	14.3	135.2	- 9.1	149.5	44.3	193.8	21.7	69.8

Source: Global development finance 1970 - 2004
(1)-Net flows of long–term debt (excluding IMF)

Thus, international capital movements, particularly FDI, have had great role in shaping economic development of developed as well as developing countries at end of the 20th century and early in the 21st century. Moreover, FDI has played an increasing role in foreign finance.

In principle, governments desire to follow a clear, robust, successful and workable policy in the face of complex problems (Williamson 1993. p.1334 and John Weiss 1995. p. 259, and Yusuf and Stiglitz 2001. p. 234). Firstly, this is possible only if they provide the necessary substance and structure for theories and policies that they intend to use. However, they have benefited of these theories differently, depending on their different economic backgrounds, potentialities and abilities in different time periods and according the region where they live (Chang and Grabel 2004. p.123). Moreover, countries with a developing economy have never been in a position to shape the content of economic theories, and to formulate policies adapted to their situation, also with respect to FDI. In addition, they have never been in the active position in the international capital market as unique demander or monopoly supplier. These facts would clearly emerge if historical studies were undertaken.

Secondly according to Nurkse (1955, p.120) the role of the FDI became outstanding in

comparison with other resource transfers, but without any theoretical justification from the point of view of countries with a developing economy (Chang and Grabel, 2004, P107).

Thirdly, today most of the countries are eager to complement their domestic capital formation by seeking finance from abroad, whether this is in the form of public financial aid, loans, portfolio investment (PI) or foreign direct investment (FDI). However, this transfer of capital is not limited any more from rich to poor countries; today, this transfer consists of bilateral transactions. For example, developed economies have been the greatest FDI recipient countries. For example, they received 77.7 per cent of global FDI in 1991, 64.8 per cent in 1994, 74.1 per cent in 1998, and 84.1 percent in 2000 (Chang, and Grabel 2004. pp.108-109). From the point of view of neoclassical theory this has been a paradoxical phenomenon since capital has flown out of countries where it is scarce (Hauser 1986. p.12).

In addition, as is suggested by table 2.1, the total amount of capital transferred has risen more rapidly than important key components based on free and open market policies, that is FDI. This was accomplished in many developing economies since the 1950s, through IMF stabilisation policy and World Bank structural adjustment policy (Meier 1995. p. 576). Nevertheless, the net FDI inflows to developing economies increased from $ 2.2 billion in 1970, $ 5.1 billion in 1980, $ 24.5 billion in 1990 to $ 162.2 billion in 2000, and $147.1 billion in 2002, and $135.2 billion in 2003.

2.2.1 FDI Definition and the Reasons of Developing Economies to accept FDI

"Defined narrowly, foreign investment is the act of acquiring assets outside one's home country. These assets may be financial, such as bonds, bank deposits and equity shares or they may be so-called direct investment and involve the ownership of means of production such as factories and land" (John Weiss, 1995. p. 403).

FDI is considered to take place also if the ownership of equity shares provides control over the operation of a firm (Chang, and Grabel, 2004. p.106). Also according to Meier (1995. pp. 64-70) there are four major reasons and possibilities for developing economies to accept FDI as a strategic key to development. A couple of them could be explained at a macro economic level and the others are formed at a management and micro economic level (Meier, 1995. pp. 64-70).

First, FDI is required to compensate the low level of domestic savings, which was brought

into being by a "vicious circle of poverty" that emerges from a low level of real income, reflecting low productivity, which in turn is due to a lack of capital. This, in turn, is a result of the small capacity for saving and consequently investment that goes back to a low rate of real income (Nurkse, 1955. p. 4). So FDI is able to provide additional resources and to complete domestic capital deficits. National resources combined with external resources can break up the vicious circle of poverty and facilitate development, raise real income, favour a socially appropriate distribution of incomes and bring about a high level of employment. Therefore, FDI plays a complementary role for domestic resources.

The lack of foreign exchange is the second reason. Unfavourable terms of trade, a deficit in the balance of payment and current account and a decline in the capacity to export are some causes. All these causes could be the result of a chronically low amount of capital investment. In such conditions, there are no motivations to invest, because the purchasing power of the population is too small (Gupta and Islam, 1983, p.21 and Stoneman, 1975. pp.11-26). This represents the second aspect of the vicious circle of poverty theory (Nurkse, 1955. pp. 4, 5).

At this stage, a low level of incentives to invest in developing economies or a high level of incentives to invest in developed economies could become balanced through trade and capital movements. This would help developing economies to grow beyond their capacity (Salvadori, 2003, p.47). This is also a specific way of accumulating capital through imports, based on export earnings and capital movements, particularly FDI (Meier, 1995. p.64).

The third reason for FDI inflows is related to the need for social infrastructure and for the development of human resources (Salehi Isfahani, 2005. pp.117-147). This does not stimulate the economy in the short run, but is a management and social requirement, which will favourably influence the economy in the long run (Yusuf and Stiglitz 2001.p. 228). In fact, social foundations should facilitate the creative part of economy. Beyond an increase in the quantity of productive factors, it is necessary to improve the quality of the people as economic agents, and to continue to facilitate productive activities (Meier, 1995. p.65).

The fourth and last reason relates to the unique and selective preferences in societies and special aims. For example, there is the necessity to support the important old economic sectors and their improvement, because of their large share in GDP (gross domestic production). This requires a huge amount of investment and brings a lot of pressure on the governments. Examples are the oil industry, the raw materials, and agricultural and mining sectors of countries with a

developing economy. In difficult circumstances, these countries have to maintain or to improve their ability to remain competitive regarding quality and quantity in order to maintain or to expand market shares. For example, the oil exporting countries have recently (2005-2007) asked for new investment because of increased demand for oil and due more intensive competition for market shares. That is contrary to the past normal behaviour on the oil market, where shares were predetermined. Therefore, rapid changes in the market always create a need for urgent investments that, frequently, have to be undertaken by domestic means.

Therefore, if demand and production increase in industrial sectors, a direct or indirect pressure is created on raw material producers to increase investment. The financing of these investment leads to increased indebtedness, an additional pressure to sell on domestic or foreign markets to create domestic saving; rising imports create new outward dependency. Simultaneously, due to severe competition, not enough profits are generated to finance investment. This again leads to rising indebtedness. In such a situation, FDI is the only way out.

Consequently, low domestic savings, a deficit in the foreign trade balance and in the overall balance of payments, social infrastructure needs, the development of human-resource, sectors enjoying a specific preference and special social and political aims to be reached are the major reasons to attract FDI. More generally, the external debt also depends on infrastructure investment needs and special sectors require huge amounts of capital to reduce the backwardness gap, low interest rates, a high current account deficit, slow growth rates of national output, a high rate of unemployment, an unequal distribution of incomes which negatively affects the purchasing power, effective demand and output, rendering capital less productive. All these factors lead, in a neoclassical perspective, to the impression that capital is scarce and that FDI is required.

This could be expanded to the reasons that justify the developed economies eagerness to capital transferring to abroad. As Meier, states: "A country can have greater equity and greater output in the future only if it endures greater inequality in the present"(1995, p.65). Among the economic reasons the search for profitable investment opportunities by foreign financial capital is certainly most important. Multinationals and transnational enterprise may look abroad for lower costs of production, gain new markets or secure the supply of raw materials and energy resources. At this stage that should be remembered that attracting FDI is, at present, considered the most important and popular economic policy recommendation and the key to growth and

development. FDI goes along with liberalization of trade, privatisation, internationalisation, and globalisation. This is interesting because this hints at the eagerness of many countries, in particular those with developing economies, to use more proficient and compatible economic instruments based on different fundamental theories and policies (OECD Report, 1995, p18).

Consequently, focussing on the historical foundations of policies, which brought about capital transfers, firstly, helps countries with a developing economy to choose a suitable and compatible policy. This would eventually enable developing countries to experience the same level of prosperity at a certain historical stage as the now developed countries had at the same level of development (Chang and Grabel 2004. p.106). Second, this enables developing countries to realise their self-potential compatible with their capabilities, and to implement the necessary condition required for specific historical conditions. For example free market policies need conditions such as a free information network and less bureaucracy (Hauser 1986. p.14). Simultaneously with the necessary conditions for the implementation of policies, one should also recognize the costs and the benefits the recipient countries receive through FDI. By adopting robust and recognized policies, one may try to prepare the social foundations required to bring about continuous economic progress, such as fair cooperative relations between government, central bank, banks and firms. A further aspect emerges, when one compares the contrasting aspects of today's socio-economic reality with some situations that have prevailed in the past.

The complexity of the present socio-economic situation may require a new multidimensional combination of policies synthesising old policy prescriptions.

Although, there are positive relations between policies advocating FDI inflows and states of prosperity in some countries, there are considerable controversies as to the effects of FDI on countries with a developing economy (Hauser 1986. p.169). The effects of FDI would be favourable if developing economies could rely on a successful FDI policy approach, since sound policies are guides to successful applications. It is one of the purposes of this study to find out an appropriate FDI policy approach.

In the first, successful past policies are important, for example the development policy of Germany and Japan in the 19th century. Identifying such policies would enable policy makers to ask under which conditions a recipient country should allow the inflow of FDI such as to obtain a more substantial contribution to its development program. If the policy prescriptions were adapted to domestic conditions such an analysis would allow the developing country to obtain the

maximum benefits and minimum costs of foreign investment. This would bring about the highest potential contributions of foreign investment to the recipient country's economic development.

The next argument emerges from a comparison between policies and the goals of decision makers. Here the role of the economy is the core problem. In the political economy approach (Bortis 1997) the economy is essentially a means to reach social, political and cultural aims, among them individual and social justice. The political economy approach is thus of an ethical nature; (neoclassical) economics, however, relies on the self-regulating capacity of the market to co-ordinate the rational – profit and utility maximising - actions of individuals in a socially optimal way. Policy managers have to choose what must be sacrificed for what. For example, humanistic aims such as public health could be at cost of more profit and more output. It is possible to achieve what might be termed efficient equity, that is, a distribution of incomes and wealth broadly in line with social ethical standards on the one hand, and on the other hand, a high level of output and employment (Meier, 1995. p.66). Consequently, it is clear that today the vital problem for countries with a developing economy is not simply to attract FDI. The problem is with foreign finance management and in particular how FDI could be coordinated with domestic development policies (Buckley, 1995).

A considerable effort has been made to give the details and the basic issues related to FDI and to introduce a new synthesis to set forth how FDI could develop their long-term international potential to the benefit of all. For example there is this vital question: Is FDI an absolutely useful tool in all places and at all times as enthusiastic neoclassical economists argue? (OECD Report, 1995) In other words, what did FDI contribute to the economic development of developing economies in the current context of globalisation? (Hauser, 1986. p.169 and Buckley, 1995). Countries with a developing economy are wondering whether they will benefit in the same way from foreign investment as do the already developed countries (OECD, 1995. p.17 and Chang 2002. p.16).

In a field, which is changing quickly, and which has different dimensions, the effects of FDI on developing economies and its role in development is a crucial subject of this chapter. However, to deal with this issue, one has to take into account the goals of the developed economies, for example regarding markets for final products and tendencies to ensure the supply of primary resources. These issues will be discussed in this thesis.

2.2.2 Remarks on Development Policies

A policy should propose definite ways of action so as to make it a useful tool in the process of decision-making. The policies must therefore deal with a specific situation on the basis of a – probable - understanding and explanation of this situation provided by a theory. In addition, the policy must attempt to predict challenges, cover all effects of the relevant variables, and change all threats into fortune by a development plan (Papanek 1968. p.6 and Meier 1995. pp. 580-583). A policy should make special effort to generate and strengthen the fundamental elements involved, such as rate of savings to fill the gap of the current account, to balance the payments or past deficits. It must also establish the role of each element in economy and society as a whole, such as, the aims and means, for example, the highest possible level of employment and a socially appropriate distribution of incomes, and the role of domestic and foreign interactions. In details, it must for example, clarify the relation between import and export. Then, a policy must also deal with the relation between the traditional and the modern sector that is with the problem of dualism (W.A. Lewis). It is also necessary to determine the level of investment associated with different rates of growth and, importantly, the distribution of investment between sectors. Each of these dimensions can be determined in fair detail by simple and straightforward guides. This is to make assumptions about the role of variables in the economy while taking account of the cyclical movement of the economy (Papanek, 1968. p.6). The crucial point, however, emerges through the necessity to set up different kinds of policies depending on their components, and to relate these to the functioning of the economy as a whole. That is, a factor being endogenous or exogenous or of a supply side or demand side character affects the components. For example if the import requirements turn out to be higher than the acceptable overall import level, the composition of domestic production must be adjusted in order to provide an adequate amount of import substitutes or the real foreign resources may be combined with additional real capital through internal resources such as taxes, mortgages and internal borrowing, loans or the foreign resources, such as PI and FDI. (Papanek 1968, p.10). Then the policies must be able to adapt to a very wide range of activities (Atkinson et al, 1996. pp.57-58). As an instance, on the supply side, policies focus on measures such as tax cutting, cutting government intervention in a normally functioning market, when, consequently, the demand side policies would be in the opposite way. In the most cases, it is observed how markets work and what will happen to economic sectors and

industries if it is attempted to changes some parameter and variables, mostly through through government intervention. For example, if the government aims at improving the functioning of markets, the result may be contrary to what was expected if markets do not work as predicted by textbooks. If, in case of unemployment, wages are lowered, unemployment may increase further, because effective demand may decline.

As a result, policy principles must rest on sound and robust theory to form a solid guide for action; for example, if a resource gap occurs, should the balance of payments gap be adjusted through the mechanism of import substitution or through industrial policy to promote exports? The answer to this question will be very different in widely differing situations. However, at first there must be a discussion of the various theoretical approaches to select the most plausible approach on which policy is to be based.

Starting from this, one could make a long list of the characteristics of policies, their purposes and regional locations where to put them to use. All this is very important for performance (Meier 1995. pp.62-110). However, performance will differ due to a large number of practical details. For example, specific policies may have different advantages and disadvantages in different developing countries, including different theoretical and performance aspects and experiences. The advantages could include the ability to adopt a competitive market system, comprising the essential channels to make the market competitive; on the macroside there would be the possibility to adopt an incomes and an employment policy. The disadvantages could, on the international level, include the inability to export, and on the national level, the lack of the necessary potential to set up a reasonably well functioning tax system; the lack of savings and investment, a badly organised banking system may be associated to insufficient capacity to accumulate capital (Meier 1995. pp.188-199). Policies could be reviewed and grouped according to form and content as they have appeared historically.

Considering form, there are some characteristics that differentiate policies, for example according to the importance attached to the market, or according to the way supply and demand are formed in the short and long term. On the other hand, it is also necessary to distinguish the policies regarding their contents.

For example the different policies may be pursued with respect to some basic issue, for instance FDI. The aim of this section is to adapt facts and ideals aimed at and to harmonize internal and external elements to be able to formulate the best possible policy.

Obviously, those policies are successful that realise the goals set most closely. Successful policy makers have the ability to organize a framework and a policy mix such that the best possible use is made of inside capabilities and outside opportunities, for example to be successfully competitive in the world markets, or to use in an appropriate way offensive and defensive protectionist measures in the developed world (Papanek 1968. p.138). As a result, the policies must be formulated by paying attention to the internal and external elements that might affect the degree of success of policies. Hence the functions and results within a country must be complementary to the functions and results outside and vice versa. Although this bilateral priority is primary, it also could be prepare the ground for improved multilateral actions.

Studying policy alternatives is about identifying which policies work best under the particular conditions of developing economies. The conventional neoclassical hypothesis may lead to the wrong conclusions while similar policies cannot be expected to have similar results in different environments. The South- American industrializing countries represent perhaps the best example of unexpected results; there was a promising start, but, on the whole, development was disappointing. Consequently, to improve the situation it is vital to analyse comprehensively both internal and external factors. The example could be expanded to the protective economic policies related to the experiences of developing countries (Chang 2004. p.50). Those economies relying on western countries, with domestic factors influencing the effectiveness of their policies differentiated it from other experiences. Another important dimension concerns the complex relationship between macro and micro-economic and management policies. Overlooking the relationships between these policy levels, means neglecting a key factor in comparative exercises. Indeed, one of the necessary conditions for a successful policy performance is a clear vision how macro and micro policies are interrelated at the national and at the international level. New ways are being required to meet these demands. It is crucially important to consider that the success of policies might be affected by internal elements such as, in popular belief, market self-regulation, state intervention or the omniscience of the state (Freeman and Kagarlitsky 2004. pp. 241-244,184-185). Subsequently, as recent experience demonstrates, policy aims in developed and developing economies need to join with development plans, assisting the economic structure to cope with unexpected changes of international competition, transmitted by external elements (Sercovich 1999, p. 53). In the domain of international relations, that is in the relations between countries, the policy scope may consist of harmonization, coordination or joint assessment, or

benchmarking (Sercovich 1999, p. 53). Based on this aspect a salient feature of these three levels of cooperation is the declining need for top-down intervention and centralized execution (alternative views) inside and moving towards increased liberalization and privatisation. Finally it is clear that it is not possible in frame of a thesis to cover all relevant considerations, but it is hoped that the investigation of several aspects that have perhaps been unduly neglected may contribute to a more rigorous and comprehensive analysis.

2.2.3 Limits and Challenges

To formulate a sound and coherent policy represents a momentous challenge to policy makers, given the immensely complex socio-economic and political situation they are usually faced with. There is the functioning of the institutional system, the behaviour of the various social groups, and the relations with the outside world. And the complex states of affairs are constantly evolving. In a first step, policy makers have to consider the internal state of affairs of their country, the actual situation and its potential for development in a broad sense. Moreover, the external situation has to be considered, eventual threats have to be taken account of, and, on the positive side, co-operation has to be enhanced wherever possible. Subsequently, a broad cost-benefit analysis regarding the various dimension of the internal and external situation has to be set up in order to be able to frame a policy conception (Sercovich 1999, p. 52). For example, among the domestic economic potentials, there is the capacity to raise the tax rate, in order to fill some deficits, a budget deficit or a current account deficit.

Policy makers have primarily to manage the economically strategic domestic factors in accordance with changing outside conditions due to an evolving economic environment. For example, they have eventually to choose policies such as to manage the economy according to some global price and trade authority, for example WTO, based on the free trade doctrine, or to attract foreign resources. In a second step, they have to care about different social, economic and political problems facing the country, including aims and needs, for example, thinking to problems such as deficit of current account, unequal terms of trade and a negative current account balance, an unsatisfactory rate of savings, a low level of investment related to low rate of economic growth, and the desire to achieve a higher rate of employment and a more equal

distribution of income. Moreover, additional resources may be required to achieve export targets. These resources must eventually be covered by domestic or foreign debts (Papanek 1968. p 4). In a way, this would be another dimension of their policy challenge.

In a third step, policy makers have to think about the perspective of future changes, the general situation and its evolution, for example, the evolution in market situations, in the terms of trade and in the – probable - future value of currencies in terms of some major currency (Meier, 1995. pp. 579-583).

A few words also must be mentioned about the capital coefficient. Studies have indicated that the costs of capital requirements could greatly vary between countries because of very different fiscal policies associated with greatly diverging tax burdens. Given this, the relationship between growth and investment, close to those assumed in the models and in consequent policies, remains of course valid; increased taxation may, however, reduce investible resources and vice versa (Papanek, 1968. pp. 10-11).

Given the immense complexity of the circumstances in which policy making takes place, very robust theory is required to set up sensible policies.

2.2.4 General and Specific Grouping of Development Policies: A Brief Review

The theoretical characteristics of the major development policies could be divided in to two main groups, that is according to method and content. On the side of method, policy measures differ according to the level of investigation; there are macroeconomic, microeconomic and management approaches. The content of policies is defined through the objects considered, for instance: society, economy, and politics. Moreover , in the economic sphere policies may be related to the supply or to the demand side. There are also other types of groupings such as liberalism and neo-liberalism and their alternatives (Freeman and Kagarlitsky 2004. p.185). This gives rise to policy alternatives.

2.2.5 The Methodological Side: Macro, Micro-economic and Management Policies

There are variants of macro- and microeconomic policies and associated operational management policies to conceive and to implement development programs. In order to obtain better results it is necessary to assess the possible effects of policies through analysing differences in performances, aims and instruments, on the theoretical and on the practical level. In the preceding chapter theories and the principles they are based upon was briefly reviewed. Here we have a look at the policies, most importantly at the key variables affecting the choice of the decision makers. This is to be done by considering extreme positions, for example liberalization on the one hand, and protectionism on the other. Middle ways are also taken into account. And all this has to be related to the research subject that is FDI.

There are other crucial points to be mentioned here. First, development policies ought, in principle, to rely on a methodical, systematic and organized way of proceeding, which is ought to be based on a robust theory. Theories, in turn, always rest on a social philosophy, whether this is made explicit or not. In practice, however, governments and decision makers in developing or transition economies increasingly rely on the international policy experience without any theoretical foundation. They often do so in the face of unpredictably evolving international situations, advancing, in a way, into moving ground. Second, although information flows across borders more freely and faster than ever before, the variety and complexity of the information to be assessed also proliferates, leading to greater opacity rather than greater transparency**.** In addition, increasingly competitive markets may ultimately result in monopolies; this may have positive and negative effects on developing economies. For example, developing countries may apparently be fortunate to attract a great amounts of FDI; this, actually, also creates new and strong competitors that the domestic enterprises of developing countries cannot stand up to as this is the case in developed economies. Some statistical studies clearly show this has happened in the decades after World War II and during the 1990s and after that. This is aptly illustrated by Sercovich (1999) and Chang (2004). There is also a huge and growing network of often-overlapping international trade and investment agreements. “Since 1947, 98 regional trade agreements have been notified to GATT under Article XXIV, with a further 11 under the 1979 Enabling Clause, which applies to developing economies and more than a third of them just during 1990-94. Similarly, by July 1996, there were 1160 bilateral investment agreements under

way, two-thirds of which were effective since 1990 and 172 in 1995 alone" (Sercovich 1999. p. 55). This implies clearly how hard the developing countries breathe in gloomy climate of neoclassical trade world condition.

Third, in the ongoing globalisation process, capital and technology move more easily across borders. In such conditions countries compete more than in the past and are more careful to take decisions. They have, on the basis of policies, aimed at taking advantage of the accessible resources and attempted to set up appropriate institutional frameworks surrounding the markets, in order to raise continuously their competitive standards. Neoclassical economists argue that this liberal way of organising a society will enable the economy to adapt better to global competitive conditions. In this thesis it will be argued, however, that this exceeds the capabilities of developing economies, simply because of the fact that markets are not self-regulating.

Fourth, there is, at present, an increasingly protectionist trend in the world economy, contrary to the neoclassical conventional arguments over having multilateral cooperation by increasing globalisation of the world economy under free market conditions; specifically, developing economies set up new and more practical and effective ways of mutual collaboration, which, precisely, does not exclude some protection of infant industries. From this discussion, the question emerges whether unemployment be reduced or even eliminated and whether distribution will become more equal through FDI, if policies are based upon neoclassical theories.

2.2.6 Do Developing Countries need Special Policies?

How should the developing economies progress? This is a simple question; but the answers are complex. To start with, it may be noted that there are no policies commonly agreed upon. Then, natural and social conditions differ widely, and it is very difficult, if not impossible, to judge the degree of performance or the lack of performance of a policy on a theoretical and practical level.

Moreover, there is still room for argument; what reference point should be used if we are to judge the performances of developed economies against those of the developing economies. Also performances could be compared on the basis of the historical record of similar countries, too. Finally, a theoretical framework needs to be developed to explain data, if comparisons are to involve more than the presentation of figures.

One may also ask the question whether there are different ways of performance. For example, numerous possible factors can be used to explain the different FDI effects. This is because there are no clear divisions between economic factors pertaining to the supply and demand sides; moreover, macro and microeconomic and management aspects are interrelated; this means that relations between causes and effects are very difficult to establish. Table 2.2 below attempts to identify different policies, characterized by the dominant position of the market (the neoclassical vision) or alternative - political economy - views where social relations are put to the fore. Then a classification is made according to the extent of the divisions of labour, solidarity and cooperation between the economic actors, government authority, central bank, the independent banks and financial institutions and the relevant indicators of performance. Subsequently, these criteria have been put to use to attempt to evaluate performances in order to set out possible effects of FDI in chapter 3.

Table 2.2: Policies, General Conditions, Environment and Characteristics

Macroeconomic policies	
Supply side: Neoclassic Policies, with a tendency to apply the external development mechanism Monetary policies	Demand side: Alternatives policies, with a tendency to apply the internal development mechanism Fiscal policies; Instittutions
General conditions and indices	
Reduce state intervention, play on (take advantage of) international relations and external elements; example: FDI, more attention to the market structure & behaviour in the sphere of politics. Focus on individual property rights	Increase state intervention, play on (take advantage of) national relations and internal elements; example: Taxation, focus on social property rights, more attention to national political action, ownership and labour issues, and problems of income distribution move to the fore.
Trade Liberalization Structural adjustment Export-oriented industrial policies Stabilisation: Price stability Privatisation policy Globalisation	Protectionist policy: Independency policy Infant industries & Industrialization Import Substitution Policy Diversification Export-oriented p olicy
Microeconomic and Management policies	
Interest rate policy, Exchange rate policy Transaction costs	Coordination policy Benchmarking policy Harmonization Policy Anti-dumping policy Exchange-policy

2.3 The Neoclassical View: The Foundations of Liberalism

Neoclassical national and international economic policies have emerged from three fundamental sources. Firstly, there is Adam Smith's natural socio-economic system, with the ethical notion of *propriety* – a combination of self-interest *and* fellow feeling – governing natural prices. Full employment comes about automatically. Competition is required, but not necessarily perfect competition. In a way, the natural system is brought about by the invisible hand, which transforms individual economic actions, partly based on self-interest (partly by fellow feeling) into a social optimum. This idea has been taken up and elaborated by Walras in his General Equilibrium Model. Here perfect competition prevails and self-interest – constrained maximisation of utility and profits – dominates absolutely, with ethics relegated to the framework. It was Walras, not Adam Smith, who became fundamental to neoclassical economic theory and guided in the form of the Pareto-Optimum neoclassical economic policy.

A second source is Ricardo's classical theory of international trade based upon the principles of comparative cost and comparative advantage. In fact, if all countries specialize in the commodities in which they possess comparative cost advantages, export these goods and import those with a comparative disadvantage then an optimal allocation of world productive resources would result. Thirdly, Ohlin and Heckscher's neoclassical theory of international trade is based on Walras's neoclassical open and free market theory**. "**There are certain commodities that each nation can produce relatively [labour –intensive or capital-intensive] more efficiently, given its natural resources, labour force, and technological capabilities" (Kuttner 1991, p.116). Given this, the welfare of each individual country, as well as of the world as a whole, would be maximized. Consequently, any effort to protect a domestic economy involves sacrifices in the aggregate to national and international efficiency. An example is given by the English landlords in Ricardo's time. Ricardo advocated the abolition of tariffs protecting agriculture because England had a comparative advantage in industrial products, textiles in the main; as a consequence manufactured products should be exported and agricultural products imported. However, the landlord's strong political position led to the maintaining of protective tariffs in agriculture until 1846 (Kuttner, 1991, p.116). Today some politically or economically powerful groups in the world society are, once again, able to set up trade barriers; the barriers recently

(2005-2007) erected by the U.S.A and the EU against Chinese textiles are good examples of attempting to reap benefits at the expense of others.

As conventional wisdom tells us, these calls for regulation on free trade that enabled Ricardo's theory to be accepted. Also Smith's theory of propriety was altered into a theory of self-interest to justify capitalism. This insures freedom of world trade, given the self-regulating capacity of a competitive market system. Subsequently, Ohlin completed this, based on a new dimension of the law of division labour and specialisation of trade on a world scale. There are labour –intensive economies and capital-intensive economies. This justified the mobility of factors of production, specifically with capital flowing to the economies where capital is scarce, that is to economies where labour-intensive techniques of production predominate (Nurkse, 1955, pp. 104-105). Consequently, Smith and Ricardo and their neoclassical followers were seeking to optimally allocate the world's resource through free trade policy, which is a market–oriented strategy. This justified trade surpluses when factors of production were immobilised, for example to transfer capital to developing economies where capital was scarce. In this way, countries with a developing economy benefited from international economic relations in two ways: first, from comparative advantages of trade, originally based on labour values, subsequently on market prices, and second from resource transfers, relieving the scarcity of the produced factor of production, that is capital.

On the other side, each country would benefit from new foreign markets enabling it sell the goods produced in excess domestically; this echoes the classical version of Say's Law according to which each supply creates its own demand. An obvious example is England from Adam Smith's age until the end of the Second World War, selling manufactured products for primary products within the imperial trade system. In the view of the early classic economists international economic relations were essentially a trade of goods based on comparative cost advantages in terms of labour, hence productivity-oriented, and, implicitly based on market seeking. This view was gradually replaced by a system of capital transfers, which was efficiency–oriented, with profits moving to the fore, and led to a new type of division of labour and international specialisation

Consequently, liberal economists concluded that unquestionably the neoclassical economic policies are appropriate to deal with the situation prevailing in developing economies. In the neoclassical view, world economic productivity and efficiency can be enhanced by capital flows

in open markets, and recipients as well as donors will benefit from such a system: the recipients get an additional amount of a scarce factor, that is real capital which enhances productivity; donors get higher profit rates than on domestic investment which means more efficiency; thus capital flows lead to a 'win-win' situation. Finally, neoclassical economists emphasize that the recipient's potential welfare can always be increased by FDI, whereas the owner's potential welfare might be reduced at home, where it can be increased abroad by an official flow that could not be financed by domestic market terms (Nurkse, 1955, pp. 120-124).

However, there is evidence that the neoclassical mechanism did not work in the historical reality of developing economies. Several reasons account for this.

First, the now developed economies historically started with entirely different development policies, mainly associated with protectionism and colonialism (Chang 2002, pp.58-59 -139).

Secondly, today's developing economies are confronted with very complex and multidimensional problems which are entirely different from the challenges the developed countries had to face at the time when they started the process of economic development (John Weiss 1995, pp.79-80). This prevents the market from functioning normally, mainly because, in developing countries, the traditional market economy is gradually being transformed into a monetary production economy. Here, the social process of production and the political, legal, social and cultural institutional superstructure play a central role. This raises the problem of an appropriate institutional set-up, the role of institutions and the relations between them, for example between the government and the central bank. The way of life, that is the social culture, is important here, the capacity of people to live in society. Then there is the huge problem of setting up the social process of production, the financial sector and the markets. To run the social process of production and the institutional superstructure an appropriate education system is required.

In many developing countries, there are serious deficiencies in this complex technical-institutional system. For example, there may be gaps in the social process of production at the inter-industry or the vertically integrated level. Technically important primary, intermediate or final products are not available in sufficient quantity or not at all, and cannot be imported, perhaps for political reasons. There may be also gaps in the institutional superstructure; specifically, this means that in developing countries persons and clans dominate and frequently take the place of institutions. On the socio-economic side there are very great social and

economic inequalities, income distribution may be very unequal and is, as a rule, associated with mass unemployment; or the monetary or financial system may be badly organised.

In addition, following List, it may be exceedingly difficult for developing countries to build up industries if the economy is open and exposed to international competition; the reason is of course economies of scale: in developing countries unit costs are, as a rule, higher in all industries and sectors than is the case in advanced industrialised countries. In such a situation, infant industries would need protection.

Finally, there are gaps in economic theory, for example, a coherent theoretical framework, different from the neoclassical one, justifying the transfer of resources, for example FDI, from south to North countries. All these suggest that extremely solid theoretical tools are required to deal with extremely complex and frequently confused situations as prevail in countries with a developing economy.

2.3.1 Background

Freedom of choice is the main meaning of liberty, which enables us to distinguish and to criticize theories, policies and their related strategies. This includes the search for sustainable and robust theoretical foundations in economics that is principles. Not only neoclassical policies, but also its alternative economic policies such as protectionism systems are based on such principles. These could be considered as extreme points of the vector that allows different intermediate views. As a result, there are different points of view between the two extreme views. This does not mean that political economists opposed to neoclassical economic theory are against trade or FDI flows. For example, the US and Japanese trade policies are not contrary to the trade policy of India, China, Cuba and Argentina; these countries also exhibit a similar attitude to the FDI issue. One can even go further to argue that the neoclassical FDI policies dominating today, had been adopted by the now industrialised countries when they were in the early stages of development. In fact, "…are the developed countries trying to kick away the ladder by insisting that developing countries adopt policies and institutions that were not the ones that they had used in order to get developed?" (Chang 2004, p.139).

2.3.2 Founders of International Economics

Although many economists believed that the neoclassical theory of international trade and investment has filled in a vacuum (Kuttner, 1991 p. 6), neoclassical theory and policy of international economic relations are based upon traditional – classical – theories, the history of which goes back to more than two hundred years (see chapter 1 above). Smith's principles, that is, propriety, including self interest, the division of labour, specialization, free trade and the invisible hand, Ricardo's principle of comparative cost advantage, and Heckscher-Ohlin's principle of comparative efficiency advantage, are still fundamental elements in the neoclassical theory of international trade and investment.

The theory of international economics is based upon the inheritance of Adam Smith and David Ricardo. Basic principles are the allocation of resources through the equalization of profit rates, and specialization based on labour values; the principle of comparative cost advantage emerges in relation with the principle of diminishing returns; the concept of the limited size of the market is important in relation with the international version of Say's Law: goods produced in excess of domestic needs are to be exported, whereby supply creates its own demand. In relation with FDI, the principle of the equalisation of profit rates is of importance. This principle can be given a classical or a neoclassical interpretation. In the classical view, capital flows into those sectors of production where realised profit rates exceed the natural (equilibrium) profit rate, and vice versa. In the neoclassical view, the marginal productivity of capital (the rate of profits) will be higher in regions or countries where capital is scarce, attracting thus real capital, and the other way round. This view also underlies the international exchange mechanism associated with a free and open market system and also covers the issue of capital mobility, represented in the neoclassical capital transfer theory of Ohlin (Nurkse, 1955, p.121). Heckscher-Ohlin's interpreted all these components of neoclassical international economics in a new version of the international trade model; here, the principle of comparative advantage of efficiency is based on the mobility of the factors of production, especially capital (Ohlin et al 1977, pp.11-13). This model represents the basis for the discussion of international trade issues, including problems associated to capital movements. These neoclassical principles also lead on to advocate unrestricted FDI inflows.

However, according to Joan Robinson, there are considerable differences between classical and neoclassical theories of international trade (Robinson 1962, p. 5). Initially, it seems that the

classical view is based on social fairness to solve the socio-economic problems, while neoclassical economics is based on purely individual self-interest. In Smith's exchange system, individual self-interest is limited by the fellow feeling which embodies social benefits and ethics, associated to the great problems of political economy, such as the production of wealth and its distribution; the latter is particularly emphasised by Ricardo who, in fact, considered distribution a social problem, with an ethical element entering the determination of the natural wage rate; the employment problem has been systematically taken up much later by Keynes (Bortis, 1997, pp.76-77).

Ricardo's thoughts were focused on solving social problems in a political economy manner, and not just on economic lines. This gives rise to important the differences between classical and neoclassical views on fundamtals in international trade theory. Ricardo's classical concepts are based on labour values and on the international immobility of the factors of production (labour and capital). However, the new neoclassical policies are based on competitive markets and the mobility of the factors of production. Morever, the original classical theories were based on the exchange of goods with the labour value mechanism providing rational and objectively given terms of trade, allowing all the countries to participate in international trade and to benefit from it. The neoclassical theory, however, led in practice to a very restricted kind of international trade and of international division of labour. In fact, the highly industrialised countries produced technologically advanced products, with labour productivity dramatically increasing. This in term lead on to high wages and even higher profits. On the other hand, developing had to concentrate on the production of primary goods, with terms of trade being volatile. It is only very recently that the terms of trade seem to turn in favour of primary products and hence of developing countries. However, the benefits of high prices for raw materials and energy resources accrue to relatively few people. A problem of distribution thus arises, which, as will be seen in chapter 4, has feedbacks on employment.

Hence classical political economy, later complemented by Keynesian theory to become classical-Keynesian political economy considers the great socio-economic problems, such as, distribution, employment, and welfare. Neoclassical theory, however, advocating the free play of market ended up in capitalist reality, with unemployment exercising a pressure on wages, causing profits to rise in the highly developed countries; here, productivity and efficiency increased as did the level of gross national production (GNP). On the other hand, international trade – industrial

goods and services exchanged against primaries - lead to similar results in the developing countries. Here, however, the level of GNP and, above all, of GNP per capital was much lower, with disastrous effects on social welfare.

Subsequently, in this section we first deal with the evolution of polices, particularly those related to foreign direct investment. Next, is to distinguish differences between the form and structure of different policies for example aims and ways of implementing policies. This point will be emphasized from the point of view of the developing economies. For example, the goal of a developed economy for FDI is a market-intensive policy or diversification of rate of returns by different policies to make efficiency based on increasing positive terms of trade or based on efficiency- seeking policy; while, on the other hand, the developing economies are interested in foreign finance, partically FDI, to improve low-productivity production processes and a huge potential, but unsatisfied demand. In fact, developing economies need to fill the gap between saving and investment; at the same time developing countries tend export goods with low value-added, while being forced to import high-technology goods, so as to be able to substitute traditional through advanced techniques of production. "…investment is recognized for what it is: a source of extra capital, a contribution to a healthy external balance , a basis for increased productivity, additional employment , effective competition, rational production, technology transfer, and a source of managerial know-how" (Chang and Grabel 2004, p. 136).

2.3.3 The Underlying Characteristics of Neoclassical Policies

Among the major groups of policies, some key characteristics of neoclassical policies are reviewed here. In the first place, the market is self-regulating and co-ordinates the rational actions of individuals – profit and utility maximisation – in a socially meaningful way (Walras's General Equilibrium is also a Pareto-Optimum). Individualistic liberalism is thus based on the principles of self-interest. This implies that individuals seeking their economic self-interest will benefit society more than they would if they tried to benefit society directly (Papanek 1968, p. 40). Second, there is the new world division of labour, specialization and the international optimisation in the allocation of resources, based on mobile resources within the framework of globalisation (Ohlin et al, 1977). Third, allocation of resources is brought about by market prices

which, in principle, are formed under competitive conditions. "Foreign investment is fundamentally a means of improving the distribution and use of the world's productive resources"(Nurkse 1955, p.130) These factors of production are associated with corresponding marginal productivities: the larger the factor quantities, the lower the marginal productivities. Fourth, the self-regulating competitive markets imply the maximisation of profits and the minimisation of costs. Given this, functional distribution and employment will be socially optimal too (Bhagawati 1977). Distribution as regulated by the marginal principle is associated to efficiency, based on the logic of specialization and the principle of self-interest. Hence, if each producer gets to do, what he does best, the resulting distribution of wealth is also efficient, and therefore implicitly just (Kuttner 1991, pp.114-115). Fifth, as a rule, the state should minimize interventions in the economy. Sixth, there is now a huge and freely moving stream of information. This frequently raises the problem of assessing the quality of individual pieces of information. This reduces the significance of the standard neoclassical assumption of free access to information (Bardhan 2001, p. 269). Seventh, external economic resources are seen as a welcome contribution to increase welfare. Specifically, foreign direct investment (FDI) is considered an engine of growth. Finally, to have durable peace is an essential condition to make orderly economic activities possible; security and peace are conditions of extraordinary importance in countries with a developing economy (Kuttner 1991, p. 10). This is of course a condition of general validity that must also hold if non-neoclassical policies are pursued. In the neoclassical view, these principles and preconditions represent the logical foundations to create productivity, efficiency and progress in developing economies.

2.3.4 The Neoclassical Policies, Changes and New Developments

A first characteristic of neoclassical policies is provided by some underlying macroeconomic and microeconomic principles. For example, self-interest, rationality, individualism, world division of labour, specialization, free information flow and last but not least, the principle of comparative cost advantage. In principle, markets are free and open and there is capital mobility. Given this, the principle of the invisible hand is extended from the national to the international level; in fact, the world economy is considered self-regulating (Kuttner, 1991, p. 6). Obviously, perfect capital

mobility, if realised, would benefit the borrowing countries. In principle, this system provides equal opportunities for individuals to maximize their utilities and contributes to shifting world economic activity on ever higher levels. In a competitive situation economic agents are eager to invest, produce and exchange their goods, services and capitals according to their self interest; specifically, international capital transfers associated to investment abroad are induced by specialization in line with the division of labour on a world level (Ohlin, et al, 1977, pp. 483-487). The second theoretical feature underlying neoclassical policies is the equilibrium notion. Walras set out to bring to the open the implications of Adam Smith's invisible hand. He showed that with consumers and producers maximising utility and profits under their resprective budget restrictions, a general equilibrium on all markets could exist. This general equilibrium was also a social (Pareto) optimum. It is well known that with Walras the equilibrium is not established by the market but by the auctioneer. A very important question now arises: Can competitive markets bring about a tendency towards equilibrium if there is, initially, a disequilibrium situation. Walras was very optimistic on this and he in fact thought there was a *natural* tendency towards equilibrium. This very important postulate is, and has remained the most important feature of neoclassical economic theory which, in turn, underlies neoclassical policies. (At this stage, we may already remark that it is very likely that a strong tendency towards an equilibrium does not exist at all, even in ideal, that is competitive conditions. This is the outcome of the capital theoretic debate briefly sketched in Bortis 1997 (chapter 5). Most importantly, there are no regular – well-behaved - associations between factor prices and factor quantities, specifically between interest and profit rates on the one hand and quantities of capital on the other. This will be confirmed empirically in the next chapter, and taken for granted in the theoretical chapter 4. In fact, the capital theoretic debate constitutes the fundamental theoretical critique of neoclassical economic theory, preparing the way for putting to the fore the classical-Keynesian system of political economy.

The third characteristic of the neoclassical policy principles is the Marshallian's supply and demand mechanism. Through his partial equilibrium analysis Marshall rendered in fact Walras general equilibrium model operable. Walras, however, always remains in the background. Marshall in fact explicitly states that in his Principles "the general theory of the equilibrium of demand and supply is a Fundamental Idea running through the frames of all the various parts of the central problem of Distribution and Exchange" (Marshall 1972, p. viii).

The fourth and the fifth characteristics have emerged from the great crisis of the 1930s and the two World Wars, that is from the time-period 1914 -1945: large scale capital transferring and government intervention in economic activities, greatly varying between countries. After the Second World War Keynesian concepts, such as, government intervention through management of the economy to ensure a high level of employment, the role of effective demand and money in this management, the promotion of investment; these specific measures were inserted into a wider framework of industrialisation and modernisation, which became the hallmark of the new economic development plans. Given their Keynesian biais, the demand side dominated in these development plans. However, the previously dominating supply-side theory was equally accepted to incorporate the movement of labour and capital under the theory of international economics. A fair globalisation was accepted as a necessary means to adjust economic conditions to the newly emerging socially minded liberalism, represented on a theoretical level by the IS-LM diagram. All these elements, complemented by the Heckscher-Ohlin theory of comparative advantage, gradually gave rise to a new economic phenomenon that was termed foreign direct investment (Nurkse 1955, p.121). This great change gained momentum in the 1960s and 1970s. The sixth element were the multinational enterprises that strongly emerged in the 1980's. Capitalism now crossed the domestic market on a broader basis than was the case in the past. Multinational enterprises extended competitive markets to a maximum size, in fact to the world market, and the world economy changed into village size. In the 1990s, transferring resources became increasingly common and reached its climax in the 1990's. Seventh, the next phenomenon consisted in transnational corporations (TNCs) entering the world arena. In the main, this happened following up the collapse of the Soviet Union (1990) when globalisation intensified. All these elements are affecting us today. It is the logical consequence of the unfolding of open market economies (Streeten, 1991, p.87). With the TNCs the division of labour and the allocation of resources really became a world-wide phenomenon.

Great economists like Smith, Ricardo, Walras, Marshall, Heckscher, Ohlin and Keynes have shaped the theoretical underpinnings of the broadly liberal economics policies that have pursued until now. However, at the end of 20th century, and at the beginning of the 21st century, the world is confronted with substantial changes; these also affect economic theory, still dominated by the neoclassical approach, and the policy principles derived from theory (Kuttner 1991, pp. 115-16). The economic globalisation reality with all its characteristics, advanced

technology and sophisticated information technology has facilitated modern life in many respects, including many facets of today's modern economic life. Large scale transfers and allocation of resources is taking place, international joint ventures are going on, diversely strong labour unions attempt to maintain and to improve working conditions, the private sector grows and the role of governments is reduced. At present, all this is considered satisfying and acceptable by policy makers around the world. One also has to be patient to wait for the ultimate effects of September 11, 2001, on the future of the world economy. Specifically, there is a prediction that there will be increasing government intervention in developing countries. However, some basic questions still remain in spite of the changes and reforms that have going on in open market economies over long periods of time. In fact, there are unchanging questions, even though world has changed.

How could the developing economies improve their capacity to derive increased advantages from foreign direct investment through economic policies based upon liberal open and free market economies? (Kuttner 1991, p.12).

How the desire of all nations to maximize their welfare could be reconciled with the FDI based on a coherent system of rules, even if those rules are not the rules of laissez-faire ? (Kuttner 1991, p. 115)

What are the effects of FDI in developing economies when policies are based on neoclassical theory?

How could FDI be useful for developing economies in a global framework, when markets are free and open?

Can developing countries succeed in managing their development programmes through relying on FDI?

Based on classical-Keynesian political economy, we shall attempt to give tentative anwers to these questions in chapter 4 below.

2.3.5 Neoclassical Policies and Capital Movements, Particularly FDI: A General Overview

Liberal economic policies have come into being in the late 18th century. In spite of many social,economic and political alterations, revolutions and reforms, this doctrine has remained, in form and content, the main theoretical foundation for shaping economic policies worldwide (Salvadori 2003, pp.42-45). The neoclassical doctrine has also provided the major theoretical foundation of economic growth and development theories and has stabilised the debates in this field since the early 20th century and continues to provide the basis for development policy at present. The first important innovation regarding content occurred at the beginning of 20th century in relation with the phenomenon of capital mobility. Attempts to understand this phenomenon led on to elaborating a theory of international capital movements, which started to play an important role in economic growth and development debates (Nurkse 1955, p. 122).

The emerging mobility of capital, particularly of FDI, around 1900 was new phenomenon at that time, which helped the neoclassical orthodoxy reemerge (in fact, all along the great depression in the last quarter of the 19th century serious doubts about the self-regulating capacity of market economies had arisen). International capital movements in the early of 20th century and the associated theory had became the main component of neoclassical economic growth theory and policy (Nurkes, 1955 p. 5). Regarding bilateral relations, the neoclassical theory of international trade has progressed since World War I, and the international capital movement's approach varied. In the late of 1960s, it was dominant policy paradigm, even after Keynesian revolution (Kirckpatrick and Maharaj 1992, p. 93). Actually, Neoclassical policy makers have accepted many adjustments in front of the new situation what was raised by Keynes and Keynesian conjecture too (Nurkse 1955, pp. 123-124).

Subsequently, moderately neoclassical policies were gradually changed into increasingly fundamentalist neo-liberal economic policies, as dominant policy in 1980s, when, country-specific policies lost ground in favour of a unique global market with deregulation increasing (Chang and Grabel, 2004 P. 150-153). These changes even affected even relatively closed economies. Indeed, the desire to mobilise additional resources, especially FDI, has induced closed economies to abandon the internal employment and growth mechanism, based on domestic demand. Instead there was a shift towards adoping the external development mechanism. For example, US trade policy after the World War II, China after 1970s and Russia

after 1990s gradually became increasingly oriented towards outside markets (OECD report 1995 and Chang and Grabel, 2004 p.142). Here is the place to group the main reasons of choosing the policies, external activities or internal policies.

Simultaneously, some new phenomena also were growing in importance, for example, world and regional institutions such as the International Monetary Fund (IMF) with its stabilization policy, World Bank with structural adjustment programs policy and regional agreements such as Organization for Economic Cooperation & Development (OECD). In this context, the emphasis on adopting a more open and less regulatory economic structure continued in the 1980s (Kirkpatrick and Maharaj, 1992, p. 93). In this situation FDI has become the essential component of development plans. The comparative table (2.1) clearly shows this.

Subsequently, FDI became increasingly important through globalization policies based on neo-liberal ideas (Freeman and Kagarlitsky 2004, pp. 41- 42-120. Real and financial capital was seeking the highest returns (Freeman and Kagarlitsky 2004, p.185 & Chapter 3 below, table no 3.6.a. Comparative rates of interest). Given this, capital transfers around the world increased dramatically and government interventions into the economy declined (Chang and Grabel 2004, p. 135). All this was justified in the neo-liberal view. Indeed, the composition of international trade had to change in order to take advantage of comparative cost difference on the world level; this implied huge structural adjustments in developed, and, above all, in developing countries (Mosley 1992, pp.40-45 and Freeman and Kagarlitsky 2004, pp. 120-185).

Subsequently, transnational corporations (TNCs), a new form of foreign direct investment, changed the shape international economics; indeed, a worldwide division of labour to produce one good – cars for instance – emerged. Given this, a new growth and development model (the new globalisation) was born in the late 1980s. It has been argued that this was a natural need for western neo-liberal capitalism to survive (Yusuf and Stiglitz, 2001, p 235). Therefore, the changes went on under pressure, above all in the developing countries. Indeed, neoclassical policies does not work in situations of profound structural changes, since in such situations great uncertainty prevails, above all in developing economies (Meier 1995, pp. 581-583). In any case, the advantages of TNCs, above all in terms of larger profits, are reaped by the developed economies. Indeed, these countries keep the technical know-how and realise larger profits, since low paid work to produce components of goods is carried out in underdeveloped countries.

An important question arises in this context. Why indeed have policies based on

neoclassical theory been unable to perform reasonably well in economic crises. The great depression of the 1930s is certainly the most telling example. More recently, we may mention the oil price crises of the 1970s and the subsequent sharp rise in unemployment in industrialised and developing countries. One may add here the Asian monetary crises in the late 1980s and in the l990s, the economic effects of the Persian gulf wars (1991 and 2003d). In this thesis we suggest that neoclassical theory is, by its being an equilibrium theory based on exchange, not able to deal with crises situations, real and monetary. To deal with monetary and real crises we need a monetary theory of production as is exhibited by classical-Keynesian political economy (Bortis 1997, pp. 204-20).

2.3.6 Neoclassical Macro and Micro Policies: A Brief Review

Neoclassical macro policies, which include, for example, international trade liberalization policies, should be opposed to its alternative, the pure policy of protectionism. In this view, liberalization policies are enhanced by the trend to increasing globalisation, and their depends on the behavioural reaction of the countries involved to the lowering of economic protection. The response of domestic producers to liberalization of the trade regime is the main point in the standard treatment of the protection issue. "The standard model can be made to generate a hypothetical situation in which the costs of protection and self-sufficiency loom large . . . Faced with the alternatives of strict adherence to the pure model yielding small quantitative effects or adding to it epicycles that make free trade look quantitatively better, most authors have chosen the latter" (Diaz Alejandro, quoted in Kirkpatrick and Maharaj 1992, p.100). As a conventional definition "liberalization is used here in the sense of a removal of control on the access to internationally traded goods and foreign exchange. Use of relatively strict trade controls to restrict the demand for foreign exchange, has been a common policy response to balance of payment difficulties in developing economies, and one which has been severely criticized as leading to various forms of inefficiency in resource allocation" (John Weiss 1995, p.79). In other words, the neoclassical mechanism removes barriers to bring about an improved allocation of resources and, consequently, a better level of efficiency through international trade. However, it emerges from empirical evidence that for developing countries domestic producers are faced with

inefficiencies of trade liberalization. Bhagwati and Srinivasan state: "contrary to the enthusiasm of many proponents of liberalised regimes, there is no systematic evidence on their side either of dynamic efficiency . . . and no general conclusion seems warranted" (quoted in Kirkpatrick and Maharaj 1992, p.102). Consequently, there are strongly contradictory claims here. For example, "a considerable body of evidence has accumulated on the technical and allocative inefficiencies resulting from tariffs and other protectionist measures…" (Kirkpatrick and Maharaj 1992, p. 99, see also Table 2.5), while proponents of protectionism would argue that the efficiency losses of trade liberalization arising at given output levels are more than offset by increases in output in developing countries where infant industries figure prominently (Kirkpatrick and Maharaj 1992, pp. 100-101).

As to the micro and management level, neoclassical economists also argue that the liberalization of trade results in gains in terms of an improved allocation of resources and of technical efficiency. The extent of these gains will depend upon the behavioural reaction of firms to the lowering of protection (John Weiss 1995, pp.94-97). For example, as cited in Mendoza, Kirkpatrick and Maharaj (1992) believe "that the existing theories and empirical evidence supporting trade liberalization are ambiguous and inconsistent. They claim that this indeterminacy stems from the uncertainty of the behaviour of firms toward the more open trade policies so that more research must be made at the micro-level to determine how the firms actually respond to the policy changes. They add, that the reaction of firms will be "conditioned" by the existing structure of the industry" (Mendoza, 1994, p. 4). Also, it has been pointed out "that the main contributions of an outward-oriented trade policy to efficiency may arise from the larger total market available when exports are not discouraged, allowing for both increased capacity utilization and economies of scale arising from specialization"(Trabajo 1994, p. 4).

The dramatic experience of the Great Depression, with a mass unemployment, and of World War II had cast very serious doubts on the self-regulating capacity of the market. And on the theoretical level the Keynesian revolution had occurred. This led to largely abandoning neoclassical theory and policy. In the first two decades after of World War II social welfare systems were built up in the developed economies. Most countries created protective barriers to international competition, especially those countries which hoped to grow and to develop on the basis of the internal mechanism. They used tariffs, quantitative import restrictions and, if necessary, exchange rate adjustments. Nevertheless, in the developed countries growth was

considerable, and employment levels were high. This led to a considerable increase in the volume of international trade: rising national incomes led to higher import demand in the industrial countries, and this meant larger exports for all developed countries. Hence, an orderly and flexible protectionism, if leading to high levels of economic activity in all countries, may actually enhance the volume of international trade. Moreover, foreign resources – aids and official loans – moved from developed to the developing economic countries. This led to an export surplus in the developed economic countries, stimulating thus additionally effective demand, output and employment here. On the other hand, the developing economic countries could, through an import surplus, dispose of more goods and services than they themselves produced, also because interest payments and repayments of debt were not a problem still in the 1960s. Nevertheless, exports associated with the external employment mechanism were seen as a vehicle to raise the level of economic activity and thus of material welfare. This was accompanied by import substitution policies.

As a result, export- oriented industrial policy stance came to be seen as a necessary vehicle for improved industrial performance and rapid growth in the countries with a developing economy. The protective measures were often reinforced by a domestic market intervention policy in the form of selective credit policies, licensing and price controls. However, the somewhat anarchic character of the protective policies was gradually perceived as an obstacle to growth and development. Given this, trade liberalization policies started to re-emerge again in the late 1960s. Neoclassical trade liberalization policy thus became the major element of economic growth and development plans. Consequently, the neoclassical orthodoxy emerged as the dominant paradigm. Policy makers have been encouraged to abandon protectionist policies. An important instance was the switch from import substitution policy to a trade-oriented policy. These changing views even influenced closed economies (for example China started to develop an interest in market and trade since the 1970s).

In the majority of reform plans, quantitative restrictions in the economy have been greatly reduced. For example, government intervention on economic activities, such as control on foreign exchange and the regulation of markets have been reduced at the same time when widespread socio-economic revolutions come into being, such as the green, white or even yellow revolution in different regions of the third world.

However, the liberalization trend was hampered when the depression following up the Oil

crises (1970-1973) set in. As a result, protectionism regained in importance, accompanied by some other types of policy such as fiscal policy, coordination policy, benchmarking policy, harmonization policy and finally anti-dumping policy (Table 2.2). All this brought the extreme fragility of neoclassical theory, based on the postulate of self-regulation, to the open. This continued until the 1980s. In the meantime, however, Keynesian, which had provided theoretical support for some protection and state intervention, had been pushed into the background, on the ground that Keynesian theory could not explain the inflation that had occurred in the 1970s following up the oil-price shock. An increase in the quantity of money, so the argument, did not lead to lower interest rates, more investment and hence to higher levels of employment, but caused inflation. On the basis of this way of reasoning, neoclassical monetarism started to dominate the scene very quickly. This provided the theoretical basis for more liberal policies, which started to be, implemented around 1980. Since then, the trade liberalisation policy, based upon neoclassical economic theory, became a key component of the World Bank's structural adjustment policy and International Monetary Fund's (IMF) stabilisation policy. For example during the period 1979-89, the World Bank, often in conjunction with the IMF, supported liberal trade policy reforms. For example, adjustment loans containing substantial proposals for trade policy reform have been supported in 44 countries through the 1980s (Thomas and Nash 1991.p 235). Free and open trade did not become universal, but reforms aiming at opening economies to the world market were carried in a growing number of countries in the 1980s. It was generally believed that economies could be opened to the world market without any disruptions of domestic activities, that critics had predicted (Thomas and Nash 1991.p 235 and John Weiss 1995, p. 94). Given this, during the 1980s, neoclassical policies, trade and foreign exchange liberalization policies became central elements in economic development reform programmes. As John Weiss reported (1995, Table 4.1), for the total sample of 51 countries, Table 2.3, trade policy reform was followed in almost 80 per cent of all programmes; in the highly indebted middle-income countries, the share increased to 90 per cent with conditions in various policy areas as they existed in the 1980s (John Weiss 1995, Table 4.1). In table 2.3 countries are classified according to the feature of the trade policy they chose after the reform. This classification includes, first, the tight control group of countries, with a definite control of quantitative restrictions that cover more than 50 per cent of imports. Second, there is the significant control group of countries, having set up a control system that covers between 15 and

50 per cent of imports. Third, we have the 'relatively open' group; the countries in question established a control system that covers either 5 to 15 per cent of imports or less than 5 per cent, with maximum tariffs and surcharges that exceed 50 per cent. Fourth is the 'open group' that has control system that covers quantitative restrictions of less than 5 per cent of imports and tariffs and other charges that do not exceed 50 per cent of the value of the imports in question. By these definitions, 28 countries were under tight or significant control prior to reform, while only 11 remained in these two groups after reform. Even for these 11 countries, the share of imports subject to licensing fell significantly. A system of government allocation of foreign exchange constituted the main form of control in nine cases in the pre-reform period and in only two after the reforms (John Weiss 1995, p.96, Table 4.1).

Table 2.3: Trade reform in the 1980s: selected economies

Selected economies	Before reform (%)			After reform (%)		
	Year	Tariff range a	QR coverage b	Year	Tariff range a	QR coverage b
Tight control						
India	1987	0-295	> 90	1990	0-295	70
Nepal	1985	5-100	> 90	1989	5-100	> 50
Tanzania	1987	6-100	90	1990	0-60	> 50
Significant Control						
Bangladesh	1984	0-300	51	1990	0-100	24 d
Cameroon	1988	0-100	> 90	1991	0-100	15-50
Malawi	1987	0-40	85	1991	0-45	17
Morocco	1982	0-45	>90	1989	0-45	22 d
Nigeria	1985	5-100	92d	1989	0-200	21d
Pakistan	1988	10-225	80d	1991	0-95	21d
Tunisia	1986	5-236	76	1990	0-43	30
Zambia	1984	0-100	> 90	1990	15-50	15-50
Relatively open						
Brazil	1985	81c	34 d	1991	0-65	1d
Colombia	1984	61c	93 d	1991	0-63	14d
Cote d'Ivoire	1983	2-30	15-50	1987	5-30	7d
Ecuador	1984	0-290	38 d	1991	5-35	15d
Indonesia	1984	0-60	32	1990	0-40	15d
Jamaica	1984	0-75	50	1988	0-60	7
Kenya	1987	0-125	58	1991	0-100	6
Malaysia	1985	14c	5	1989	n.a	5
Peru	1989	0-117	100	1991	15-25	5
Philippines	1984	0-50	36	1989	10-50	8d
Senegal	1985	15-45	15d	1991	15-45	6d
Sri Lanka	1986	0-100	13	1990	5-50	9d
Thailand	1981	0-100	6	1990	0-100	8d
Trinidad & Tobago	1988	5-35	15-50	1991	5-45	0
Venezuela	1988	0-80	65	1991	0-20	10
Zaire	1982	0-50	> 90	1986	0-50	8
Open						
Argentina	1986	0-100	60	1991	0-22	4d
Bolivia	1984	0-60	90	1988	5-10	2
Chile	1984	0-35	0	1988	15	0
Costa Rica	1985	0-220	1	1990	1-40	1
Gambia	1985	0-60	> 50	1991	0-23	1
Ghana	1985	0-100	100	1988	0-25	0
South Korea	1984	26c	15d	1990	1-50	4
Mexico	1984	0-100	38	1988	0-20	2
Uruguay	1982	0- 75	0	1985	0-45	0

Source: John Weiss 1995, P.96 Table 4.1 trade reform in the 1980s

a. Surcharges are not included.

b. Proportion of imports subject to quantitative restrictions.

c. As a rang of tariffs is not available the un-weighted average is given.

d. Proportion of tariffs code items subject to quantitative restrictions.

In addition, the policies that should be adopted cover a very wide range of activities, including a large degree of differences in treatments. For example Kirkpatrick and Maharaj pointed out that "the proportion of World Bank structural adjustment loans (SALs) contained one or more conditions concerning various policy areas"(1992, p.96). However, problems emerge when the policy prescriptions based on neoclassical free market theory did not fit to the socio-economic conditions of developing economies. For example, in the early 1990s, tariffs remained relatively high and only in a few cases (for example, Mexico, Chile and Bolivia) tariffs have been lowered and rendered uniform; nevertheless, the competitive situation continued to remain far from free market conditions (John Weiss 1995, p.94). The data also implicitly show that the economic and institutional preconditions were largely inadequate in view of introducing a complete competitive market system. For example, the percentage of total amount of loans to support the exchange rate, the financial sector and energy policies are minimized while the percentage of the total number of loans for trade policies, fiscal policy, public enterprises, budget/ public expenditures, and agricultural policy obtain the maximum share. Given this, the countries with a developing economy were not capable to adapt their institutional foundations to the national and international dimensions of the new free market policies. These policies were, in fact, based on pure neoclassical theory picturing ideal situations, and did not take account of the socio-economic realities of the developing countries.

Table 2.4: Content of World Bank Structural adjustment lending operations, 1980-7

percentage of total number of loans :

Line	Different type of Policies	Sub Saharan Africa(13)	Highly indebted middle-income countries(22)	Other developing countries(16)	All countries* (51)
1	Exchange rate	30.8	18.2	0.0	15.7
2	Trade policies	76.9	90.0	62.5	78.4
3	Fiscal policy	61.5	72.7	56.3	64.7
4	Budget/ Public Expenditures	69.2	50.0	37.5	51.0
5	Public enterprises	61.5	54.5	43.8	52.9
6	Financial sector	38.5	36.4	43.8	39.2
7	Industrial policy	53.8	9.1	25.0	25.5
8	Energy policy	7.7	13.6	50.0	23.5
9	Agricultural policy	76.9	40.9	37.5	49.0
10	Other	23.1	9.1	12.5	13.7

Source: Kirkpatrick and Maharaj 1992, p.94 Table 4.1.
*Numbers in parentheses are total numbers of loans.

The data of table 2.5 confirm that the motivation programs that encouraged developing economies to reform through the specific areas of market price trade policies were not absolutely successful. For example during the period, structural adjustment loans (SALs) were received by 40 countries. The majority of these countries had negligible or less significant implementation of the free market policies, while only a few implemented the market and trade policies significantly (Table 2. 5).

Table 2.5: Number of countries where reforms took place:

Area of reform	Significant	Less Significant	Negligible	Total	Not Present	Present	Total
Overall import policy *	19	10	11	40	-	-	-
QRs on non-competitive imports	12	16	12	40	-	-	-
Protective QRs	12	17	11	40	-	-	-
Tariff level	7	20	13	40	-	-	-
Tariff dispersion	8	22	10	40	-	-	-
Protection level	13	26	1	40	-	-	-
Schedule of future reduction	6	29	5	40	-	-	-
Protection studies	-	-	-	-	28	12	40
Overall export policy*	15	14	11	40	-	-	-
Exchange rate**	-	-	-	-	38	2	40
Export promotion***	-	-	-	-	33	7	40
Imports for exports	17	15	8	40	-	-	-

Source: Kirkpatrick and Maharaj 1992, p.94 Table 4.2.
Note: The assessments refer to proposals by the World Bank. They do not necessarily refer to policy implementation.
*Judgement on the significance of the overall reform proposals.
**Often these were not explicit conditions, but constituted understanding, frequently made under the programme.
***Includes such schemes as export credits, insurance, guarantees, and institutional development.

As a result, because of table 2.5 and other evidence at table 2.6, such as "the record of implementation based on 51 adjustment loans (both SALs and Sector SALs) in 15 developing economies shows an important feature of different policies. These demonstrate the relatively low degree of full implementation in the area of neoclassical policies. The nine groups of policies indicate the policy reforms that were identified in the period considered. These suggest that the implementation of policy reforms in the area of trade may be more difficult than in other areas." (Kirkpatrick and Maharaj 1992, pp. 94-96). For example, "the percentage grade [of loans used] for trade reforms is among the three lowest figures, both during and after the loan period" (Kirkpatrick and Maharaj 1992, p.94.). Table 2.6 was established on the basis of an approximate

classification of policies according to their degree of implementation.

Table 2.6: Implementation of conditionality for 1980s

		Percentage of conditions fully implemented	
Row	Policies	During the loan period	Current situation
1	Exchange rate	70.0	62.5
2	Trade policies	54.9	63.4
	Import QRs)*	62.8	69.0
	Import duties	61.5	72.7
	Import / export finance	20.0	42.9
	Export incentives	60.6	62.5
	Other trade policies	33.3	41.1
3	Fiscal policy	53.2	69.8
	Tax policy	46.2	86.7
4	Budget / public expenditure	68.0	71.7
5	Public enterprise reforms (incl. restructuring)	61.3	70.0
6	Financial sector	71.4	73.5
7	Industrial policy (excl. restructuring)	53.3	42.9
8	Energy policy	79.2	83.3
	Energy pricing	84.6	100.0
9	Agricultural policy	57.1	58.1
	Agricultural pricing	64.3	61.5
-	All conditions,Total	60.3	67.5
-	All conditions, SALs	68.3	73.5
-	All conditions, SECALs	50.9	60.0
-	All conditions, SSA countries	52.4	62.2
-	All conditions, HICs	66.9	73.2
-	All conditions, other developing countries	52.8	56.0

Source: Kirkpatrick and Maharaj 1992, p.94
*Quantitative restrictions (QRs)

2.3.7 Conclusion

In relation to our subject, FDI has been the object of the majority of neoclassical policies, for example trade liberalisation policy. Sometimes, foreign direct investment promotes liberalisation policies; in other instances, FDI is influenced through such policies, as has been discussed above. This mechanism works well, if the markets work well. For example, "[in] 1990, 109 developing countries are listed by the IMF as having restrictions on capital movements and 34 are listed as having separate exchange rates. Over the period between 1975 and 1990 whilst the number of developed economies rose from three to nine, the number of developing economies with no restrictions rose only from 20 to 21" (Mathieson and Rojas-Suarez 1993, p.5 quoted in Weiss, 1995, p. 97). This happened at a time when the effects of capital liberalizations were not yet clear for developing countries on the basis of the available evidence. Moreover, capital liberalisation

led to an increase in capital transactions in the 1990s, but a robust theoretical rationale to justify these larger transactions was lacking. Contrarily, there are also many developing economies that maintain some restrictions on the access to foreign exchange for capital transactions. An example is Mexico, where the liberalizations on capital movements are not considered to be the right policy to be pursued. According to John Weiss, at the same time the problem of 'capital flight' grew more important in developing economies, which means that domestic savings flow out of an economy. The capital liberalization plans in Argentina, Chile and Uruguay are examples of the deregulation of domestic financial markets during the 1970s; there have been some successful experiences at this time like liberalization in Mexico in the late 1980s (Weiss 1995, p. 97). According to a comparative study, World Investment Report 2001:

> FDI statistical data for the time period from 1985 to 2000 revealed "that FDI reaches many more countries in a substantial manner than in the past. [It is a fine comparative period because the dissolution of the socialist system which, with western collaboration, has resulted in a profound change in the world economy, with the conditions changing again after September 11, 2001.] More than 50 countries (24 of which are developing economies) have an inward FDI stock of more than $10 billion; compared with only 17 countries 15 years ago [in 1985] (7 of them were developing economies). The picture for outward FDI is similar: the number of countries with stocks exceeding $10 billion rose from 10 to 33 (including 12 developing countries, compared to 8 countries in 1985) over the same period. In terms of flows, the number of countries receiving an annual average of more than $1 billion rose from 17 (6 of which were developing economies) in the mid-1980s to 51 (23 of which were developing economies) at the end of the 1990s" (Transnational Corporations, Vol.11, No. 1 April 2002, p.82).

In addition, Table 2.7 also shows aggregate data on average growth of exports, imports and GDP for the four groups of countries in Table 2.5 for the 1980s (periods covered differ between countries). However, the results in Table 2.7 do not indicate convincingly that the open or more extensive reformers have performed better in terms of either income growth or the balance of payments.

Table 2.7: Average trade and GNP growth: four groups of trade reformers in the 1980s

Groups [1]	Annual export Growth [2]	Annual import Growth [2]	Annual growth GDP [3]	Number of countries for which merchandise trade balance improved
Tight control (3)	7.8	6.0	4.6	2
Significant control(8)	5.3	4.9	2.8	5
Relatively open(16)	7.0	6.7	2.8	10
Open (9)	5.0	9.6	4.7	1

Source: Weiss 1995, p.98 Table 4.2.
1. Number of countries in each group is in brackets.
2. Simple average for growth of goods and non-factor services in US $ dollars
3. Simple average for real GDP growth

Moreover, the average results for all three indicators are not significantly higher for the more open economies in comparison to the results of economic systems with tight or significant control. Differences between averages are small and statistically insignificant for GDP growth, but are higher and statistically significant for growth of exports and imports; average annual export growth for the more open economies is nearly two percentage points higher and average annual import growth nearly four percentage points higher than for the controlled economies. However, contrary to John Weiss (1995, p. 98), this did not show more rapid growth in trade in a more liberalized environment and it also does not exhibit that imports have responded more rapidly than exports in all samples of open economies (Weiss 1995, p. 98). Nevertheless, the rapid growth of imports in the more open economies points to possible dangers of too much opening an economy, above all a developing economy. In fact, rapidly growing imports indicate that an economy is, in the sense of List, not yet prepared to face superior foreign competition. Indeed, with imports growing more rapidly than exports an import surplus will invariably come into being. In a monetary production economy a persistent import surplus inevitably results in reduced effective demand, less employment and increased foreign indebtedness.

As a result, according to Weiss, “These liberalizations of the capital account ultimately proved unsustainable and had to be reversed. [. . .] ” (Weiss 1995, p. 97).

2.4 Alternatives Policies

"It is recognized that powerful local actors may indeed be worse at distorting development aims than powerful international actors" (Sugden and Wilson, p.112).

2.4.1 Introduction

In the first section of this chapter, the basic concept of the neoclassical free market policies has been considered. Section 2 focuses on the explanation and analysis of alternatives policies, including protectionist and nationalist ideas as well as Classical - Keynesian synthesis policy. The first part of section two is devoted to protectionist and nationalist ideas. The second part of this section very roughly sketsches Classical - Keynesian policy. The purpose of this part is to introduce the debates on the interaction between the behaviour of individual and collectives and the institutional system, made up of individualistic and social institutions; this interaction is a basic feature of Bortis (1997).

The purpose of this section is to highlight somewhat the differences between neoclassical policies and alternatives policies. Specifically, some features of the currently dominating free market doctrine has to be examined, since this doctrine has fundamental effects on economic policy making in countries with a developing economy.

The first difference between neoclassical and altrnative theory emerged with the Keynesian revolution. Endogenous money and banking moved to the fore to replace the simple neoclassical market for new capital goods regulated by the rate of interest. The second difference is given by the role of the government. In the Keynesian era effective demand and government intervention to manage the economy moved to the fore.

Following up the emergence of Smith-Walras free market theories, a wave of people, opposing and supporting neoclassical doctrine, have attempted to analyse the effects of this theory. The supporters of neoclassical theory emphasised maximizing capital accumulation and growth through free domestic and international trade, without governments intervening in the economy. Economists opposed to neoclassical theory, nationalists, socialists and protectionists went into an entirely different direction. Most prominently, Friedrich List argued that short-term gains made through international trade are not very important. The crucial point was to develop the productive forces of a country. Most importantly this means protecting infant industries with

still high average costs against more advanced foreign industries where average costs are already lower. Given this, List also argued that differing situations of the various countries should be taken account of and that, therefore, there is no unique way to progress. Policies should reflect the characteristics of each country, given by the degree of development, technologies in use, the formation of the labour force, the availability of highly qualified labour, the position on domestic and foreign final product market and the access to natural resources, which, incidentally is becoming increasingly important at present.

We have already mentioned List's theory of protecting infant industries in countries that are not yet ready to compete on international markets. However, List also gives surprisingly flexible advice for countries with various natural and institutional differences. For example, he advises tariffs for powerful big countries with active people based on their natural abilities, since such countries would primarily rely on domestic markets. The United States until the First World War are an obvious example. However, tariffs may be irrational for small countries because their resources are not sufficient and diversified to be independent. Free and unhampered international trade is therefore indispensable for these countries. Switzerland would be a modern case in point.

Another remarkable idea in List’s discussion is his emphasis on the effects of differences in mentality on economic activities. He believes that tariffs has had an unexpected adverse effect in Latin American countries; protected industries did in fact not progress substantially, protection thus resulted in stagnation and frequently in an easy life for the producers. However, in the United States with exceptionally active and dynamic people in production and finance, leading on to a steady flow of progress in technology and organisation, protection had a very positive result (List 1983). While insisting on retaining and improving commercial relations, List supported formation of international (costums) unions between smaller and less dynamic countries in order to enhance competition and technical and organisational dynamism.

2.4.2 Protective Policies

Protectionism is viewed as an extreme alternative to neoclassical free trade policy. Direct and indirect tariffs, subsidies, quantitative restraints on imports, government intervention by means of fiscal and monetary policies, and recently some major non-economic barriers, are some of the

instrument countries dispose of in order to protect the national economy (Hauser 1986, p.196, and Kuttner 1991, pp.119-120). There are some supplementary characteristics making protective and national policies differ from other policies. Export promotion, important substitution and industrialization are all important features of Alexander Hamilton's nationalistic economic policy and Friedrich List's Infant industry protection policy (Nurkse1955, p.104). M.T. K. Amir Kabir (1807-1852), Iranian prime Minster (1849-51), was another person who had an understanding for the necessity to protect infant industries from international competition (Chapter 3, Iran case study). The protective measures are often reinforced by domestic market policy interventions in the form of selective credit policy such as, licensing and price control. This also puts to the fore the role of profit and rent incomes accruing to domestic persons and institutions at the expense of foreign interests (Hauser 1986, p. 26). For example, a high-tech country has large value-added in production, services and trade. It achieves more output per unit of domestic resources (labour and capital), consequently productivity and efficiency are high, the terms of trade favourable; as a result, such a country gets richer in the long run compared to countries producing primary and standard industrial goods. As a rule, a high-tech economy with a large Research and Development sector is able to shape the development of technology to some extent and is in stronger position to face unexpected situations. A technologically advanced country is, as a rule, able to stay ahead competitively, through a free trade policy based on domestic and foreign capabilities (Hauser 1986, pp. 25-30).

Protection is expected to be effective in sustaining a maximum rate of employment and to bring about a reasonably equal distribution of incomes by controlling capital movement. For example, developing economies, with structurally low labour productivities and little ability to modernisation, have to compete mainly with big industries supported by developed economies on free markets if capital is allowed to move freely. For example, in 1980 Canadian restrictions on apparel imports, protected 7.5 per cent of the industrial jobs. In 1977, US tariffs on apparel preserved nearly 90,000 jobs which was equivalent to 10 per cent of the industry's employment (Hauser1986, p. 26). On the other hand, some liberal economists believe that over a longer period, protection can accelerate the substitution of capital for labour and thereby reduce industrial employment. This capital deepening, together with relatively slow demand growth, accounts for two- thirds or more of the long-run decline in employment (Hauser 1986, p. 27).

In addition, when the size of markets is not sufficiently large, protection and prevention of

foreign capital inflows will affect the market size. Nurkse advances this argument for a country with large domestic capabilities in relation with a 'big push' in capital accumulation:

> A wave of capital investments in a number of different industries can economically succeed while any substantial application of capital by an individual entrepreneur in any particular industry may be blocked or discouraged by the limitations of the pre-existing market . . Through the application of capital over a wide range of activities, the general level of economic activity is raised and the size of the market enlarged. (Nurkse 1955, pp. 13-14)

2.4.3 The Variation of Protective Policies

In chapter I above it has been suggested that protectionist policies have been systematically put to use in mercantilist times already. The point was to protect small industry and to export much and import little. Subsequently, the protectionist argument was further enriched through the growth debate. The discussion about balanced and unbalanced growth resulted in policy differences. This starts with List's infant industry, nationalist and protectionist policies and, according to Meier, continues with Hirschman:

> Hirschman, [following up Friedrich List's infant industry, nationalist and protectionist policy], however, advocated unbalanced growth in order to maximize induced decision making and to take advantage of forward and backward linkages in the production process. Unlike the neoclassical economists who assumed a smoothly working market-price system, some of the early development economists adopted a more structuralist approach to development problems. Structuralist analysis attempted to identify specific rigidities, lags, shortages and surpluses, low elasticities of supply and demand, and other characteristics of the structure of developing countries that affect economic adjustments to development policy. The structuralist view also was pessimistic about the responsiveness of agents to price signals and incentives. Instead of neoclassical flexibility and substitutability, the structuralist view emphasized low elasticities of supply and market imperfections that limit the mobility of factors and the responsiveness of agents (Meier 1995, p.87).

In this context protectionism emerges as a means of getting out of the rut, a means of stepping up the rate of growth when the external forces of advance through trade expansion and foreign capital are sluggish or inoperative.

2.5 Classical - Keynesian Flexible Policy

"Capital formation is not entirely a matter of capital supply, although this is no doubt the more important part of the problem" (Nurkse 1955, p. 4).

It has already been suggested in chapter 1 above that the foundations of the Classical - Keynesian policies considerably differ from neoclassical free market policies (see on this Bortis 1997, chapters 3 and 6). The first difference is associated to the goals. Classical-Keynesian political economy is essentially normative. In a Keynesian vein it is part of the moral sciences. The basic policy aim is to achieve the Common Good as closely as is humanly possible. In the socio-economic sphere the most important component of the Common Good are a high level of employment and a reasonably fair distribution of incomes. The social process of production, the financial and the commercial sectors make up the material basis of a society which produces the social surplus to be used to build up a political, legal, social and cultural superstructure (Bortis 1997, ch. 3).

The classical-Keynesian policy view is sharply opposed to the neoclassical policy goals. These emerge from Walras's general equilibrium theory. This theory is based upon the marginal principle (Schumpeter). Competition and rational behaviour, utility maximisation of consumers and profit maximisation of producers, render possible a general equilibrium, which is also a social optimum, that is a Pareto-optimum. Hence markets co-ordinate individual rationalities in a optimal way which is also socially optimal: "it is impossible to make some individual better off without making some other individual worse off" (Meier 1995, p. 541). With the market as a self-regulating mechanism neoclassical economic policy therefore essentially becomes competition policy. In the neoclassical view, factor and final goods markets, that is the market system, stands at the centre of society, with the political, legal, social and cultural institutions forming the framework.

The second point relates to the nature of mechanisms involved and to the economic equilibrium concept. Neoclassical theories are based on individual behavioural equilibria, which reflect the rational profit and utility maximising behaviour of economic agents. "[In the neoclassical view] behaviour is fundamental and the system - the market system, for instance - is merely an automatic natural mechanism of secondary importance, which causelessly coordinates the action of individuals" (Bortis 1997, p.84). This stands in striking contrast to the classical-

Keynesian system equilibria, which are associated with the functioning of the socioeconomic system in a political economy way, putting to the fore the functing of the institutional system, that is the material basis and the institutional superstructure, as a whole. Again, according to Bortis:

> The function of the system is primary and fundamental and the behaviour of individuals is secondary, the interplay of social and individualistic institutions produces certain equilibrium outcomes; the variables governed by the entire institutional system are normal variables. For example, Sraffa's model of production, value and distribution shows how the (normal) prices of production are governed by the conditions of production and the social regulation of distribution, or the super-multiplier relation implies that the whole socioeconomic system (all institutions) comes in to determine the normal level of employment. [The] system equilibrium is determined once income distribution regulated. By definition, normal magnitudes-prices or employment levels, for example - are persistent because institutions represent steady social and individual behaviour associated with the pursuit of social and individual aims. Here no automatic tendency towards an equilibrium exists, which means that ethically grounded policy efforts are required to improve existing situations. (Bortis 1997, pp. 83-84)

There are, third, great differences in the nature of economic policies because internal and external potentials are put to use differently. Classical-Keynesian policies allow decision makers, considering the existing facilities based on priorities, to employ both internal elements, such as managing government expenditures, and external elements such as taking advantage of the international facilities by allowing the free markets inside. However, the neoclassic policies rely on a unique mechanism, the market mechanism, to deal with internal and external elements in the same way; in fact, in ideal conditions, all prices and quantities are governed by competitive markets.

Fourth, an essential difference between the various theoretical approaches is given by the time-period within which policies are implemented. In the traditional classical (Ricardian) theories the equilibrium position is determined based by long-term elements, such as labour values and the natural wage, implying that the distribution of income is institutionally regulated by the surplus principle. According to neoclassical all the great problems – value, distribution, employment in the main – are regulated on markets; short- and medium-term equilibria, with profit rates differing between sectors of production, are set to the fore; the consideration of long-period equilibria, implying a uniform rate of profits in all sectors of production, has been

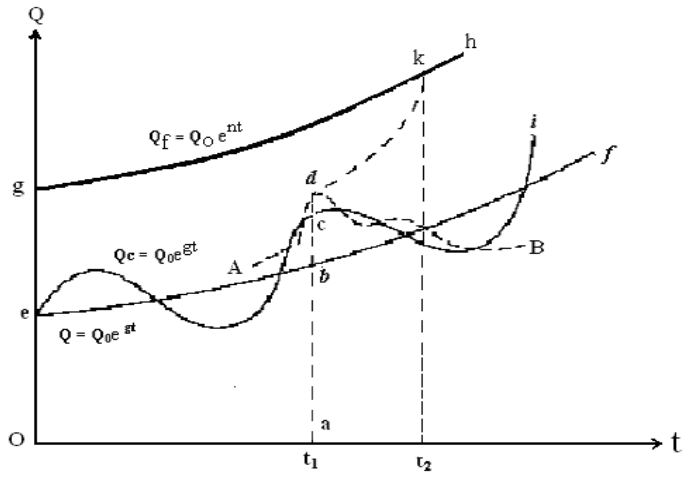
abandoned since the capital-theory in the 1960s (the result of this debate was there are no well-behaved relationships between factor quantitities and factor prices).

Keynesian theories are also of a short-term nature, with the capital stock given and with only the income effect of investment being relevant. Post Keynesians, Kalecki in the main, have worked out a theory of cyclical growth which is represented in Bortis 1997 (pp. 204-20). Both Keynes's and Kalecki's theories are on the behavioural level, whereby behaviour is co-ordinated by the economic system through effective demand. Long-period classical-Keynesian political economy deals, in the first place, with the functioning of the socio-economic system, that is with the institutional-technical system made up of the material basis and the institutional superstructure; the institutional system is completed once the distribution of incomes is regulated, that is the money wage level, the normal mark-up and the normal profit rate (Bortis 1997, ch. 4, specifically pp. 158-75). As already suggested, distribution appears, in a Ricardian vein, as the principal and most fundamental problem in political economy.

Classical-Keynesian political provides the basis for long-, medium- and short-term policies. Long-term policies could be called system-policy; the aim would be to build up a harmonious institutional system. In the short- and in the medium term conventional Keynesian and post Keynesian fiscal and monetary policies could be applied.

Now, the institutional system and the behaviour of individuals within the system stand in a specific relationship to each other. To be clear about this relationship is an essential precondition for analysing the interrelationship between FDI and employment and distribution in chapter 4 below. "[In fact, any moment, long-period magnitudes governed by the system is superseded by medium- and short-term behavioural outcomes" (Bortis 1997, p. 84). This point can be illustrated by the help of figure2.1.

Figure 2.1: The socioeconomic system of outcomes



Source: Bortis 1997, p. 84, Figure 1.

Bortis puts the issue as follows: "What can be directly observed is the whole of output Q (ad at t_1) which results from short-period entrepreneurial behaviour based upon short- period expectations: expected effective demand [that] leads entrepreneurs to produce corresponding output quantities. Hence to use existing capacities to certain, degree; the system governs a short-period equilibrium position determined by autonomous expenditures and the Keynesian multiplier. Abstracting from varying degrees of capacity utilization, capacity output *QC (ac* at t_1) obtains, i.e. the normal output that could be produced with existing capacities. Capacity output is governed by the past investment (accumulation) behaviour of entrepreneurs; this we denote medium-term behaviour because of the gradual revision of investment plans that takes place on the basis of comparisons between expected and realized results. Opposed to the behavioural outcomes is the outcome of the functioning of the institutional system, *i.e.* normal output Q (ab at t_1) to which correspond normal prices (see chapter 4, pp. 175-80) both of which cannot be observed directly. If now total output is above (long-period) normal output, as is the case at period t1, then the short-period deviation *cd* and the medium-period deviation *bc* have to be subtracted, in order that the long-period trend output ab may be obtained. Contrariwise, if total output is below the long-period trend the short- and medium-period deviations have to be added to output actually observed so as to get trend output. Hence the 'trend', line *ef* is an *invisible*

demarcation line telling us that *ab* is that part of output governed by long-period forces and that bd is determined by medium- and short-period factors. Similarly, long run normal prices never appear in a pure form. These are always accompanied, so to speak, by deviations from normal prices as brought about by cyclical movements of an economy or by short-term vagaries of the market. The same reasoning also applies to independent (predetermined) variables and parameters: exports, government expenditures, leakages out of income, the capital-output ratio, the import coefficient, the coefficients of production and profit rates may deviate temporarily from their respective (institutionally governed) long-period values which are constant or change but slowly. [. . .] The normal output line is *ef*. Long-period variables (normal employment or normal prices for instance), which represent outcomes of the socioeconomic system, cannot be observed directly since the persistently acting causal forces act simultaneously with medium and short-period forces to fully determine specific phenomena" (Bortis 1997, pp.84-86).

Broadly speaking, long-period classical-Keynesian system policy aims at shifting the long-term trend upwards, that is in the direction of full employment. In chapter 4 we shall see that this can be done through the internal employment mechanism, the external employment mechanism or a combination of both. FDI may play an important auxiliary role in this process of social and economic development.

Finally, classical-Keynesian political economy and neoclassical economics profoundly differ as to the nature of the underlying approach. Classical-Keynesian poliical economy, set forth in Bortis 1997, is a moral science; the fundamental social ethical value to be pursued is the Common Good, and the principles of Subsidiarity and Solidarity are fundamental to the doctrine of Social Liberalism. Social relations and cooperation are of primary importance. In neoclassical economics, as is based on Liberalism, self-interest associated to rational behaviour, competition and allocation of resources are set to the fore. In a way, while classical-Keynesian political economy would contribute to prepare the soil for the improvement of society, neoclassical economics is already about reaping the yield.

Chapter 3 :
The Real Situation, Foreign Direct Investment in Historical Reality

Today the crucial issue for developing countries and the dynamic non-members economies is not simply one of attracting FDI pressing as the foreign-exchange constraint is for some of them. It is how to develop their long-term international competitive strength and how FDI can contribute to that development in the current context of globalisation (Buckley, 1995).

3.1 Flows of FDI in the Twentieth Century - a Historical Statistical Picture

In this chapter we first present some statistical data on the flows of foreign direct investment in the twentieth century. In doing so it is attempted to bring to the open the changing character of foreign direct investment and, more importantly, the changing geopolitical situations in which FDI occurred. In the second section the historical-empirical evidence regarding FDI in Iran is considered. The historical-empirical facts presented in this chapter, together with the theoretical aspects set forth in the previous chapters, will be interpreted by means of an alternative theoretical framework to be presented in the next section. Here the economic theory of Social Liberalism that is classical-Keynesian political economy will be presented. Indeed, a global and comprehensive view is required to assess the impact of FDI on a country with a developing economy.

3.1.1 FDI Policy Trends and Issues

The basic principle underlying the doctrine of the free market economy is self-regulation: a high degree of competition leads, in principle, to a full utilisation of available resources; most importantly there will be full employment of labour. Moreover, the doctrine suggests that governments should abandon their old role as a producer so important for countries with a developing economy. Instead the government should facilitate the coming into being of private enterprise and concentrate on setting up an appropriate framework, legal and political most importantly. This leads to a shift away from government-owned to privately owned enterprises, from a regulated to a deregulated economy, to lower trade barriers and to reductions of price controls, what Streeten defined as 'State Minimalism' (1991 p. 235). Therefore, the private sector is encouraged and empowered to manage investment and, thereby, to take strategic economic decisions. This implies that the allocation of scarce resources under free and competitive market conditions would lead on an optimal situation. Given this, the market price is an indicator of marginal productivity and marginal efficiency. Technical progress results in a rise of productivity or a reduction of costs. The latter will shift supply curves on goods markets to the right. This, however, requires an expansion of productive capacities and, consequently, new investment

which, in turn, results in economic growth. Since competitive economies always tend towards full employment equilibrium economic growth will be beneficial to all. For example, technical progress and growth will also lead to higher marginal productivities of labour to which money wages may adjust (Kappel et al, 2005. pp. 27-53).

Hence technical progress and growth bring about an extension of markets. However, as Adam Smith already perceived, the rate of growth also depends on the size of markets. In an international situation market sizes crucially depend on the degree of competition: the nearer the marginal revenue is to the price, the larger will be the market. Therefore, productivity and efficiency will be enhanced through increased competition brought about through an opening of markets as occurs through international free trade. This is a strong argument to create large free trade areas and even to establish global markets. The mobility of capital will enhance economic growth. Indeed, with real capital moving into areas where capital is scarce and, consequently, the marginal productivity of capital and profits are both high as is precisely the case in countries with a developing economy. Growth will, therefore, be higher in these countries. Hence, global competitive market will, in principle, create a tendency towards equal development levels. The movements of real capital, that is FDIs, are supposed to play a central role in this process (OECD Report 1995a, p. 7).

On the other hand, and as a result of this, the amount of foreign direct investment flows to countries with a developing economy depends on openness of their economies. In this context, the proper functioning or even the viability of their national economic systems depends on an internationally recognised legal framework guaranteeing equality before the law for all individuals. Moreover, individual citizens should be willing to work hard and to respect agreements without continual monitoring by their partners or even by foreign countries (Cable and Henderson, 1994 p. 2). Given a certain institutional set-up, a country may be very attractive for one company while being simultaneously unattractive for another. For this reason the motives of economically developed countries or of the international economic actors to become economically active in some country, their perceptions and tolerances of risk associated with different countries may differ substantially. For example countries with a developed economy may either aim at conquering new markets or to obtaining resources (raw materials or energy resources), but they are always exposed to greatly differing amounts of risk, political, monetary or competitive.

In addition, economic policies are changing in the course of time; however, changes are very frequently in appearance only; policies appear under new names and in a new form, but the contents and the results obtained remain essentially the same. The economic policies pursued reflect, as a rule, the basic principles of dominating economic theory. Indeed, liberal policies based upon neoclassical economic theory have dominated through time, although they may have differed in complexity and varying shape. This may allow each type of neoclassical policy to appear having been successful, at least partly, for some period of time. These policies may include market liberalization policies, specialization policy, industrial policy, export policy, adjustment policies and privatisation policy. On the other hand, developed countries are said to have performed differently from countries with a developing economy, precisely because the economic policies pursued had been based upon alternative theories. For example, while the former has focused on participating in the process of Globalisation, in order to increase their shares in the world markets, the latter has been focusing on attempting to solve their social and economic problems. Moreover, it is frequently difficult to compare public industrial policies in developed or in developing countries, for instance when the government privatises the ownership of companies in the telecommunications (telephone) or in the health sector (hospital and medical treatment services) in the course of economic reforms. However, the same reform has, as a rule, a different meaning and leads on to different results for a country with a developed economy than for one with a developing economy. For example, there may be great differences between the aims of privatisation as pursued in England and those pursued in Argentina, and the results of privatisation will, as a consequence greatly differ (Streeten, 1995, pp. 222-224). The former may have privatised in order to increase the sales revenues of their companies resulting from a new and stronger position in the world economy, the latter's aims may have been to build a stronger private sector to enhance economic development, to create additional employment and, as a result of economic growth, to bring about more justice in income distribution. However, developing countries may attempt to abandon domestically based industrial strategies and adopt import-substitution and/or export-oriented policies; in this case, these countries privatise to obtain a stronger position on the world markets through increasing the competitive strength of their economies and to bring about more efficiency, imitating thus the economic policies of the developed countries (Jomo, 2002, p.125). As rule, then developing countries attempt to bring about adjustment in their economies in order to stabilise them to get a more even economic

development. Developed countries, however, pursue a globalisation policy, frequently in the form of the economic hit (Perkins, 2004) or the cooperating economics that are beginning to bear fruit (Kojima, 1978). Based on this theory some developing economic countries have experienced a dramatic liberalization process to become one the main recipients for FDI, whereby "In South Korea and Taiwan the Invisible Hand is guided by a strong Visible Arm" (Streeten 1995, p.235).

The presently existing theories and policies in general and of FDI specifically, do not seem solid enough to set up performable models of economic development in these fields. The new economic and political conditions require new theories and policies (Cable and Henderson, pp.179-189). Facing changing economic and political conditions, countries with a developing economy need new policies. Alternative policy responses have to challenge the presently pursued policies based on conventional theories. In fact, a new way of thinking is required first, because as Keynes always emphasized, in the long run it is ideas that shape socio-economic and political conditions, not vested interests (Keynes 1973/1936, pp. 383-84). Also, in a Keynesian vein, the basic economic problems of modern monetary production economies are employment and distribution; "One of the biggest problems in development policy is how to provide productive and remunerative jobs for the rapidly increasing labour forces of the developing countries. It is not enough to provide high – wage jobs for a small group of workers, but the need is for satisfying jobs for large and growing numbers"(Streeten, 1995 p.13). For Keynes indeed, the possibility to have a job is, because of the purchasing power argument, associated to a fair and socially just distribution of incomes. Employment and a fair distribution are the main social and economic elements for a natural way of life enabling the society and individuals to prosper. "In a Keynesian global order, foreign trade needs to be a compromise between more or less open commerce and the imperatives of domestic full employment "(Kuttner 1991, p.38).

In the form of a brief review, chapter 3 offers a selective survey of FDI trends in international economic activities and explores the conventional economic analysis of these trends. It includes two sections: The first section (3.1) develops a general empirical view of international FDI trends, and in the second section (3.2) the historical-empirical situation of Iran is considered.

The essential theme taken up in section (3.1) is the analysis of the historical-empirical situation of World FDI, which constitutes a main component of the new international economic system. This will enable us to provide tentative answers to questions like these:

- To what extent theories and policies are able to elucidate international FDI mechanisms?
- How does FDI affect countries with a developing economy?
- To what extent is FDI useful for countries with developing economy?
- The probable impacts of FDI on employment and distribution are the main elements used to try to answer these basic questions.

In the remainder of this section, indicators and criterions related to our hypotheses will be explained, as well as the variables and the methodology that we use to test them. We will discuss the data relating to differing situations, offer statistical results, and discuss the implications for specific countries, above all those trying to increase FDI flows.

A historical and geographical picture of FDI flows, in a statistical framework of the world economy is provided here, with regions, countries and economic sectors also being considered. The indices included are FDI trends, share of FDI in GDP, total investment and its possible effects on quantity and quality of employment, distribution of income and structure of wage and rate of poverty and per capita income. Taken together these data allow examining, in a very tentative way though, FDI results and its possible effects on countries with a developing economy. Next there is an analysis of the results, followed by some tentative conclusions. Subsequently, the second section (3.2) of this chapter is devoted to a comparative statistical analysis of the Iran's economy; in fact, a case study of Iran is presented. Iran's economy is dependent on oil revenues, and is a recipient of FDI. The remainder of this section contains a brief description of the historical FDI flows, and of its probable effects in Iran.

The data have been selected in a way to cover three differing periods of time. First, there is the period before the 1970s, which includes the economic 'golden age' of the 1950s and 1960s. The second period extends from the1970s to the 1990s, including the oil-crises years 1970-1973, the East Asian depression 1982 -1983, and the collapse of the socialist economic systems 1990-1992; it is in this period that global flows of FDI grew at an unprecedented rate, almost 30 percent per year on average, until 1999 (World Investment Report 2004). The third period considered is from 2001 to 2005 which will shift us to a new position, depending more on the international situation, such as the new globalisation trend, which has begun under a military shadow, terrorism and military terror, the crucial events are September 11, 2001, and the

subsequent intervention in Iraq. As a consequence, FDI flows have declined since 2001.

The data presented include both countries with a developed economy and those with a developing economy in Asia, North America, Latin America, Africa and Europe, in fact all countries that have been encouraged to liberalize the flows of FDI. The analysis is also expanded to bring out quality dimensions. It will be attempted to study the distribution effects of FDI in countries with developing economy through the study of the quantity and quality of the FDI share in the world GDP. Quantity transfers are examined so as to obtain an approximate picture of FDI flows on the world level. From these data it will emerge that FDI has become an increasingly important factor in the growth and economic development, above all for the eight industrialised countries. For example, the share of FDI in total capital inflows to countries with a developing economy increased from 28 percent in 1991 to 56 percent in 1998 (Table 3.1.9). A similar development took place in the eight industrialized countries. For example, FDI made up over 85 percent of total capital inflows to these countries in 1999 (Liu 2002, pp. 579-602).

Regarding the quality dimension, one may attempt to explain, for example, the effect of FDI on the structure of employment and on distribution of income in general and in the long term; or the investment volume determines the level of employment and distribution of income in the short run. One might also consider whether FDI flows to labour-intensive or capital – intensive industries. The geographical FDI flow is other point. For example, the areas, which benefited from FDI inflows are very different, and the reasons why they have benefited may be far from what neoclassical economic theories have predicted. The example is the conflict over market shares between different producers located in different geographic regions, South and North countries for instance. In such situation the higher volumes of FDI were attracted by higher developed economic and political powers. Such outcomes may differ greatly from those predicted by neoclassical free market theory which would assert that FDI flows to regions where the scarcity of capital is most pronounced. The geographic distribution of FDI and different rates of interests in the various regions of the world economy could illustrate the contradiction between the theory and the empirical situation. For example, present US incomes from foreign investment changed greatly by regional origin compared to those in 1950; at the same time, the relative regional development levels did not probably change substantially (Table 3.1.4).

3.1.2 Hypotheses

FDI is one of the modern economic factors that have played an increasingly important role, especially in the second half of the 20th century. Therefore, effects of foreign direct investment and its role have been considered as one of the important elements related to economic development by many studies in economy and political economy. There are many reasons why countries with a developing economy have been eager to attract foreign direct investments, but there are doubts if this has been beneficial everywhere and at any time.

The neoclassical theory and the related policies rely on free and competitive markets. Economic advisers to developing countries have emphasized time and again, that countries with a developing economy benefit most if they establish open and free markets to attract FDI in order to fill in the vacuum of capital, technology, management, skills and modern sciences. On the top of this, there are also benefits for countries with a developed economy in general, and Transnational Corporations (TNCs) and their shareholders in particular, that is abundance of raw materials, natural resources, large quantities of low wage labour, low taxes and a simple system of business and trade law and last but very importantly, access to expanded old markets and the possibility to enter into new markets with a large demand for everything, a real paradise for free market advocates in the earth, which reflect, in fact, the high degree of deregulation prevailing in today's economies. This last outcome supports the findings of a few disaggregated studies on developing economies, which have found significant positive spillovers from FDI to output of TNCs. It also provides evidence in favour of the idea that FDI seems to be one of the main forces influencing economic performance in developing countries. Furthermore, the positive causal relationship between FDI and employment and distribution suggests that FDI leads to economic growth and this could indicate that the integration of developing economic countries into the world economy is being fostered by free market conditions and subsequently through FDI. However, what motivates research in this field is the other side of the coin, that is the unsatisfactory results of so-called self-regulating market outcomes and FDI. However, regarding FDI and self-regulating markets, the research has been trying to find out, what the real effects of FDI on developing economic countries might be in selected cases, especially when the theoretical groundwork underlying economic policies has not been spelled out clearly. Given this, what was

discussed theoretically in the previous two chapters and will be discussed from a practical and empirical perspective here. This discussion is based on an empirical investigation through using various evidence related to FDI, specifically employment and distribution data; the aim is to somewhat clarify questions as the probable effects of FDI on developing economies. For example, the effects of FDI on the level of productivity, efficiency and on the rate of growth in the different sectors of a developing economic country are broadly discussed in this chapter to find probable answers to questions such as:

Is FDI benefiting developing countries as well as their partners that is private or public foreign investors? More specifically, does FDI lead on to a higher level of employment and to a fair distribution of incomes in the developing countries? And have the developed economies found new markets, raw material and energy resource and cheap workers?

Is FDI complementary to domestic investment or are there substitution effects?

Moreover, why do, in contradiction to the prediction of neoclassical economic theory, FDI flows go to a large extent to some developed countries rather than to developing countries?

There are a number of similar questions to clarify, as are related to neoclassic theory concepts and to the associated economic policies. These questions are about the empirical and practical effects of FDI in a supposed free market situation.

What, finally, are the implications of FDI for growth, employment and distribution? This is the central question. Tentative answers will be provided in this and, above all, in the next chapter.

Now let us turn to a review of historical statistics to examine some probable effects of FDI flows. In this section, in a way, the history of FDI through its geographical distribution, including world regions, individual countries and, at last, the economic sectors are considered. The contribution (costs and benefits) of FDI to specific developed and developing countries, and their economic sectors, the agricultural and raw materials, manufacturing, and the service sector will be broadly examined here.

3.1.3 General Review of the Historical Statistics

The world economy has gone through deep structural changes since the early 20th century (Streeten 1995, pp. 5-7). These have shaped the foreign capital flows in structure and size. Various time periods may be distinguished. These periods include great events, which have brought about fundamental changes: First, there is World War I (1914-1918). This momentous event changed the position of empires and their shares in colonies, real and financial capital and resources. The growing importance of foreign investment emerges from comparing the situation towards the end of the 19th century with that prevailing at the beginning of the 20th century. In this time-period Great Britain, France and Germany had been the major investor countries with 6 US$ billion in 1874, rising to 33 US$ billion in 1914. This represented three quarters of world foreign investment amounting to US $ 44 billion – this figures are put into perspective by a broad estimate of British GNP, making up about 10 billion US $ in 1914. However, according to the UN Department of Economic Affairs 1949, the rise on investment was, in the main, the result of the reinvestment of rents, profits and other returns. It was not the result of new investments. Yet, the amount invested doubled by each 13 years on the average. The relative position of the investors is set out in Table 3.1.1. The other investors included were Russia and Japan. The latter invested at China; moreover, Portugal invested in Brazil and Sweden in Russia. The U.S. was one of the recipient countries with a foreign investment inflow of about U.S. $ 6.8 billion (Nasre Esphani, 1969, pp. 287-291). The main aim of foreign investment in developing regions had been to facilitate the access to cheaper labour and to raw materials and energy resources, for example to bring about an increased production of the Iron industries through building railways. This is a crucial point: The Western countries did not build up manufacturing industries overseas, which would have favoured the coming into being of new competitors. The colonies and the dependent regions had in fact a double function for the early industrialised Western countries: first, these countries were a source of primary products required as inputs for Western manufacturing industry and, second, they provided outlets for final manufacturing products produced in the Western industrial countries. Hence, in fact primaries were exchanged against manufactures. This reflected a specific world division of labour brought into being by Great Britain following up the Industrial Revolution. Despite the fact that heavy investment took place in economically

underdeveloped and somehow dependent countries, only about 30 percent of total FDI was invested in countries with a developing economy and more than 60 percent was invested in Europe and in the U.S. and North America (Table 3.1.1).

Table 3.1.1: Total long term Foreign Investment until 1913-1914

Investor Country	Million US$	Recipient area	Million US$
Britannia	18000	Africa	4700
France	9000	Asia	6000
Germany	5000	China	1600
U.S.	3500	Europe	12000
Belgium, Netherlands and Swiss	5500	North America	10500
Others	2200	U.S.	6800
Total	43200	South America	8500
		Australia	2300
		Total	44000

Source : Nasre Esphani,Asadolah 1969,P 288, Tables 26-27

After World War I (1914-1918) the structure of political power changed profoundly as well as the international role of the great powers, and this had effects on the structure and size of capital movements too. For example, the Ottoman Empire fell down. Great Britain became a debtor nation and had to find new investment opportunities. New democratic Germany had to pay reparations but had to borrow instead. The United States became a creditor nation with New York emerging as the new financial centre of the world. Gradually, world economic leadership shifted from Great Britain to the United States.

The second great event was the economic crisis 1929-1932, in fact the Great Depression. International trade collapsed and unemployment increased dramatically, above all in Germany and in the United States. This led economic activities to uncertain conditions on a world level, and made the great powers even thirstier to suck out wealth from colonies and dependent regions overseas. Simultaneously, doubts about the future of capitalism grew, and economic theories and their performances were questioned. *The Years of High Theory 1926 – 1939* (Shackle 1967) brought revolutions in economic theory: Keynes' *General Theory of Employment, Interest and Money,* Sraffa's critique of Marshall and the subsequent revival of the classical theory of value and distribution, Harrods Keynesian growth theory demonstrating the complete instability of capitalism when autonomous expenditures are absent. Contrary to the period before the First World War, direct foreign investment, except the Oil industries, sharply decreased in the interwar

period, especially during the great depression 1929-1932 (World Investment Report 1994). In addition, "as far as direct foreign investment is concerned, before World War I, more than 50 per cent of the world investments were in the primary sector, in other words, in agriculture and raw materials. 20 percent were in railroads, 15 percent in manufacturing and 10 percent in services" (Hegewisch, 1986, p.49). Given this, according to various international organization reports, foreign investment has had a very limited effect on the economic development of the – developing - host countries because foreign investment did not take place in those sectors of the economy that had a productive role in countries with developing economy, consumption and investment goods industries for example (Nasre Esphani, 1969, p. 291). As a result, FDI has lost the important role it held in the past. Moreover, investment volumes changed greatly. Clearly, this was a result of the economic slowdown, which led to a shrinking of the size of markets. For example, direct foreign investment data for England and the U.S. illustrate the enormous fluctuations that occurred between the two World Wars (Table 3.1.2).

Table 3.1.2: Average Yearly English and U.S. investment
million U.S. $ (1919-1938)

Countries/Years	1919-1923	1924-1928	1929-1931	1932-1938
U.S.	531	1142	595	28
England	516	578	399	143

Source: Nasre Esphani,Asadolah 1969, P 290 Table 28

The third great event was the Second World War (1939-45). The breakdown of the European economies created an entirely new situation. The World War and the experience of the great depression with its unemployment, poverty and misery prepared the way for a new way to think about economic problems. Following up the Keynesian revolution, economic theory became truly macroeconomic. This meant a shift from the neoclassical exchange model to a monetary theory of production with price changes being eclipsed by quantity adjustments (Sundrum 1991, pp.13-14). On the political level, the Second World War prepared the emergence of huge power blocks, the Socialist East and the Capitalist West. Given this, and the absence of robust and comprehensive economic theories, the political motives were to become all important to shape the flows of direct foreign investment. As a result of the World War, America became the first foreign investor, and FDI increased again, but it had, probably, no sensible positive effect on countries with developing economies in the immediate war period. This is indicated by the fact

that, in 1950, the bulk of U.S. direct investment went to countries with a developed economy and some of it was invested in already developed economic sectors of countries with a developing economy (Table 3.1.3). Foreign investments were made for profits, not to promote development.

Table 3.1.3: Diversity of U.S. FDI in regions and main economic sectors (1950) Million US $

Regions / Sectors	Canada	Latin America*	Western Europe	Eastern Europe	Others Countries	Total	Percentage to Total
Industry	1897	780	933	9	214	3831	32.5
Oil	418	1408	424	296	844	3390	28.7
Infrastructure affiliates	284	1042	27	18	54	1425	12.1
Mine	334	628	21	88	57	1129	9.6
Trade	239	243	186	13	81	762	6.5
Agriculture	21	520	1	9	39	589	5.0
Insurance	313	71	37	0.5	3	425	3.6
Others	72	45	92	1	27	236	2.0
Total	3579	4735	1720	435	1317	11788	100.0
Percentage to total	30.4	40.1	14.6	3.7	11.2	100.0	

Source: Nasre Esphani, A. 1969, Table 29, P.303
*Most of this amount was invested in Venezuela's oil sector (U.S. $ 981 million).

In addition, it emerges that differences in ratio of investment income to investment did not motivate investors to invest more in regions were this ratio was higher. In fact, this ratio was three times higher for developing regions than for Western Europe and two times more than in Canada and Latin American, but the capital has had a tendency to go back to countries with developed economies (Table 3.1.4). This is particularly true of industry. The data of this table strikingly confirm the suggestion made above: Foreign investment did not primarily go to developing countries to promote development, but to extract raw materials and oil which, as basic inputs, favour economic development in the already developed economies. Indeed, the world division of labour between producers of primary goods and producers of manufactures was carried on by US in 1950, what was set up by England and Western Europe early 19th century. "[In fact, in] the 1950s, the main U.S. goal for global monetary relations was the restoration of full currency convertibility, for that was the precondition to free flows of capital and commerce" (Kuttner 1991 p. 55).

Table 3.1.4: Net investment's incomes and difference rate of income to investment ratio at different regions and sectors, (1950) U.S $ Million

Regions / Sectors	Canada	Latin America	Western Europe	Eastern Europe	Others Countries	Total Income	Percentage
Industry	1	6	6	0.5	1	14.5	1.1
Oil	3	262	9	75	212	561	43.3
Infrastructure affiliates	211	55	69	1	22	358	27.7
Mine	31	64	1	12	3	111	8.6
Trade	9	33	0.5	0.5	1	44	3.4
Agriculture	1	76	0.5	4	11	92.5	7.1
Insurance	17	17	21	3	14	72	5.6
Others	21	9	4	2	5	41	3.2
Total Income	294	522	111	98	269	1294	100.0
Total Investment	3579	4735	1720	435	1317	11788	
Income to Investment ratio	8.2 %	11 %	6.5 %	22.5 %	20.4 %	11 %	

Source: Nasre Esphani,Asadolah 1969, Table 32, P.306

Fourth, there was the unpredictable upswing in the world economy, in fact, the golden economic period of the 1950s and 1960s. The new economic policies based upon Keynesian ideas certainly contributed to this upswing. The notion that, in principle, effective demand governed output and employment through the multiplier principle was basic for employment policies. Moreover, foreign investment gained importance again, probably because of the high employment levels prevailing in these years. Foreign investment was seen as vehicle for transferring real capital, technology and management skills to the recipient countries.

According to Hegewisch "after World War II, there was a dramatic change that put manufacturing as the main investment sector, both in [economically] developed and developing countries." (1986, p. 49). This dramatic process evolved in several aspects: First, it changed the geo-economic locations of capital movements. For example, " investment was mainly directed towards developing countries rich in natural resources and with a relatively high per-capita income" (Hegewisch 1986, p. 49). Second, investment was mainly shifted to specific economic sectors, focussing, for example, on a group of industries required to complete the investors interests related to industries with an advanced technology, or to low-technology industries producing goods needed by the partner for some economic or political reasons. For example, "the manufacturing sector encompassed both developed and developing nations. Investments were made mainly in food, chemicals and capital goods. In the service sector, investments were mainly

centred in banks, insurances and, to a lesser degree, tourism, advertising, marketing and distribution. In the extraction sector, investment went basically to the petroleum industry, copper and bauxite" (Hegewisch 1986, p. 50). Thirdly, there is a tendency for income and profits to move to donor countries. Moreover, according to Hegewisch, "there is a reallocation of investment that comes out of, but goes mainly to, developed countries" (1986, p. 50). In a traditional mercantilist way these countries also continued to accumulate capital at a rate above average, the reason being that they concentrated on producing goods embodying advanced technologies. "[This] differs from the situation prevailing before World War II where most investments went to the exploitation of raw materials in developing countries" (Hegewisch, 1986, P. 51). This is the reason why the quantity of direct foreign investment taking place in countries with a developing economy was very limited compared to indirect investment in the shape of bank loans, for example. Consequently:

> The importance of international direct investment in the net financial flow to developing countries has gradually declined, giving way to a rapid expansion of international indirect investment through bank loans and credit lines for imports. While in the period of 1968-1970 direct investment accounted for 22.1 per cent of the total capital imports of the developing countries, for 1978-1980 this figure dropped down to 13.9 per cent. It is evident that too much was financed via debt and very little through capital contributions (Hegewisch 1986, p. 51).

A fifth period to be considered is the cold war age that started after the end of World War II, lasting, in fact, from the late 1940s until the early 1990s. A political and economic struggle took place, between the capitalist West (the US and Western Europe) and the socialist East (the Soviet Union and Eastern Europe). This resulted in considerable stability of the international economic and political structures, and, as a consequence, FDI greatly expanded.

Sixth, the Cold War period encompasses the Oil crises in the1970s and 1980s as important events, which induced the capital flight from Oil producer countries to developed economies and from developing economies to developed economies (Varman 1991, p. 4). "Between 1974 and 1977, oil-exporting nations generated surpluses of $ 173 billion, nearly all of which was deposited in grateful western banks" (Kuttner 1991, p.71).

Table 3.1.5: World Capital movement, 1970-1980 (U$ Billions) No. 1

years	Net direct investment	Net portfolio Investment	Other net Investment*	Net capital Movement
1970	2.10	0.17	n.a	n.a
1971	2.48	0.41	5.47	8.36
1972	1.60	0.46	6.00	8.06
1973	4.44	0.02	6.55	11.01
1974	2.20	-0.19	5.22	7.23
1975	3.67	0.40	3.33	7.40
1976	1.76	0.83	10.81	13.41
1977	3.14	0.25	16.21	19.61
1978	5.57	0.55	11.23	17.35
1979	8.33	0.80	-2.64	6.49
1980	6.61	0.58	3.85	11.05

Source: World investment Reports 1972, 1990
*Other net investment is included: Private loans, official loans and grants

Table 3.1.6: World Capital movement, 1981-1990 (US $ Billions) No.2

Years	Net direct investment	Net portfolio Investment	Other net Investment	Net capital Movement
1981	12.72	2.34	36.81	51.87
1982	10.73	6.78	4.11	21.62
1983	8.57	8.38	-9.13	7.81
1984	8.88	2.79	-20.79	- 9.12
1985	8.97	9.30	-17.28	0.99
1986	9.31	1.45	9.94	20.70
1987	14.51	5.59	14.40	34.51
1988	18.73	2.54	-0.22	21.06
1989	15.50	12.87	-10.19	18.19
1990	18.37	17.39	12.01	47.77

Source: World investment Reports 1982, 1994
*Other net investment are included: Private loans, official loans and grants

Seventh, FDI has accelerated in the 1990s up based on the Transnational Corporations (TNCs) carrying out international production activities to lower production costs. This represents a new feature of quantitative dimension of the capitalist world economy. Indeed, the global expansion of investment flows was driven by more than 60,000 Transnational Corporations (TNCs) with over 800,000 affiliates abroad. And qualitatively, cross-border mergers and acquisitions (M&As) that remain the main motivation behind FDI, grew much faster than at any time in the past (World Investment Report 2002 Overview, p. 77).

Table 3.1.7: World Capital movement, 1991-2000 (U$ Billions) No. 3

Years	Net direct Investment	Net portfolio Investment	Other net Investment*	Net capital Movement
1991	31.28	36.89	55.61	123.77
1992	35.50	51.08	32.70	119.28
1993	56.81	113.61	11.45	181.87
1994	82.73	105.63	-35.78	152.58
1995	97.04	41.24	55.02	193.31
1996	115.86	80.81	15.41	212.08
1997	142.65	66.80	-60.39	149.06
1998	131.02	36.73	-103.41	64.33
1999	116.65	8.03	-57.99	66.70
2000	123.25	44.20	-22.09	145.35

Source: World investment Reports 1992, 2002,
*Other net investments were included: Private loans, official loans and grants

Eighth, there is the collapse of the Soviet Union in 1991 and of the Socialist economies. The ensuing market oriented reforms have strongly reinforced liberalism which now definitely became hard line neo-liberalism (Staehr 2001, p. 156). Capitalism became institutionalised worldwide and the new American hegemony started from the early 1990s (Kuttner 1991, pp. 54-82, and Chudnovsky 2002. pp. 121-124). On the economic side the situation evolved differently, however. First, Europe became gradually the single market of considerable strength, with now the Euro rising in value relative to the dollar. Secondly, China made an enormous economic progress based on a very numerous and cheap labour force, enormous human resources and a rapidly advancing technology; even in research and development China relies more and more on her own forces. The consolidation of China and Russia, and, perhaps, increased co-operation between the two countries could be a further factor that could contribute to accelerate the relative decline in US economic hegemony, which has lasted for about 50 years. As a consequence, this might be followed by the gradual emergence of a polycentric world economy (Cable and Henderson 1994. p. 2). The notable features emerging in early 21st century are trade based on Transnational Corporations (TNCs), Mergers and Acquisitions (M&As) and Foreign Direct Investment (FDI). These features are associated to a free market approach with monopolistic competition involving large enterprises competing on a global level. In this new situation trade and military intervention might emerge as two faces of a coin. These conditions are clearly different from Adam Smith and Léon Walras's vision of a free-market economy with competition

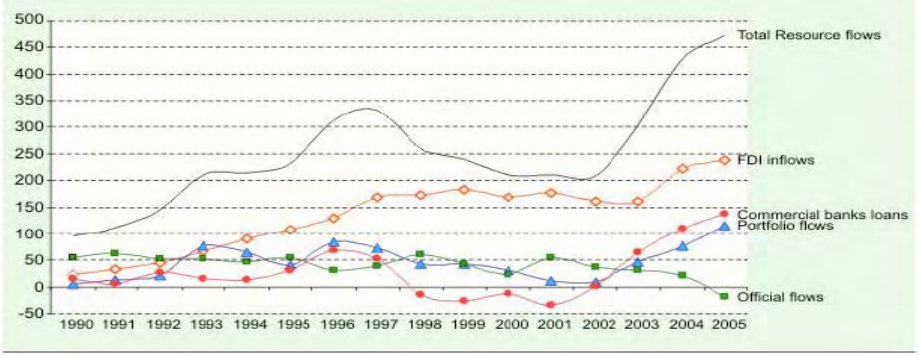
between small and medium-sized enterprises. Consequently, instead of having trade relation based on the principles of comparative costs and of exchanges of surplus production at high employment levels, we have an unrestricted struggle for market shares and thus for work places in a situation of high unemployment levels worldwide. Given this, trade wars in view of maintaining and, possibly, enlarging market shares, might, in some instances at least, be accompanied by military wars, and, on the economic level, by the next great depression. This might end up in a strengthening of the monopoly system, perhaps more appropriately, oligopoly system, with misery and unemployment increasing, and this without any economic and social purpose, the only aim being the maximisation of profits (Perkins 2005, p. 120). Joint ventures, integrations and mergers, are, presently, new aspects of the new puzzle. On the other hand FDI plays a central role in the new situation in its emerging as the appropriate tool to accelerate the growth and development process.

The last but important – normative - point is of course the level of government interventions in order to promote cooperation, equal opportunities, above in terms of access to employment, and the creation of as much scope of freedom for individuals as is humanly possible. This classical-Keynesian vision should prepare the ground for domestic and foreign investment to contribute to economic development, above in the developing countries. Such themes will be taken up in chapter 4 below.

3.1.4 Global FDI Trends

At present, economic life is more and more shaped by theories emphasizing an external development mechanism and economic policies rely upon making use of the international abilities of economic actors; for example, enterprises, even small and medium are encouraged to become active internationally. This strengthens the role of FDI, which continues to expand rapidly, quantitatively and qualitatively (embodying new technologies) through neoclassical self-regulating market condition. Indeed, according to actually dominating economic theory FDI has become the main tool of economic growth and development (figures 3.1. below).

Figure 3.1.1: Total net resource flows[a] to developing countries[b] by type of flow, 1990-2005
(Billions of dollars)



Source: World Investment Report 2006, Figure I.3.
a Defined as net liability transactions or original maturity of greater than one year.
b The World Bank's classification of developing countries is used here. It differs from UNCTAD's classification in that it includes new EU member States from Central and Eastern Europe and excludes high-income countries such as the Republic of Korea and Singapore.

Simultaneously, FDI changes the size and the structure of world economic activities in such conditions. And changes are very severe indeed, above all in countries with a developing economy. For example, qualitative changes are, as a rule, associated with a transition from labour-intensive to capital-intensive methods of production; under free markets conditions this may lead on to more unemployment if there is no increase in demand. In addition, the size of FDI certainly had an influence upon the extent of world economic activity. Several points, which are going to be discussed, affect this trend and direct it towards a kind of oligopoly, or even monopoly situation, different from theoretical neoclassic ideals.

The first is the new terms in international economic relations; in fact, "economic integration agreement" (EIAs) immediately emerged more after the Second World War to protect the free market economy. EIAs have emerged in various forms and contents, and during the time, the numbers of agreements have increased enormously, while the world trade atmosphere continuing to change in to protect international investment stocks, increase liberalisation access to markets, such as WTO, GATT. OEPC.

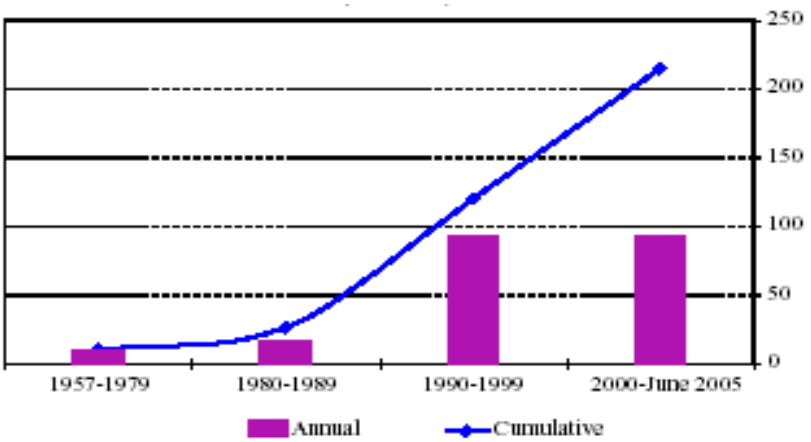
EIAs are in form generally divided into two groups; the first group, according to United Nations Report, is ". . . the category of multilateral economic integration and investment agreements (EIIAs), notably WTO agreements" [and the second group is] . . . bilateral investment

treaties (BITs) ", [that are agreements] "negotiated between two countries to protect and promote investment of investors of one party in the territory of the other party"(2006b, p. 2). Regarding content, these treaties are, also according to a United Nations Report, divided in tow groups: These treaties are "vary[ing] enormously and range from agreements that provide only for economic cooperation to agreements that create a common market. Such agreements may be bilateral, regional, interregional, multilateral or supranational. They may involve countries at the same or at different levels of economic development, [and second are treaties] "seek[ing] to facilitate international trade and cross-border movements of the factors of production [goods, services, capital, people or information and] international investment agreements (IIAs). [And] the new generation of IIAs has witnessed some innovations in BIT practice and thus there is greater variation among these agreements than in the past" (UNCTAD 2006b, p. 3). This distinction could be also expanded to policies. In fact, regarding double taxation treaties (DTTs), we find the following in an UNCTAD report:

> In 2004, 84 new treaties were concluded between 79 countries. . . . Nevertheless, the total number of DTTs increased to reach 2,559 by the end of 2004. . . . Unlike BITs, the top 10 economies in terms of number of DTTs signed are all developed economies. About 39 per cent of all DTTs were concluded between developed and developing countries. DTTs among developed countries accounted for 29 per cent. Another 19 per cent involved [transition economies], the remaining 13% were concluded among developing economies. . . . The number of such agreements has been growing steadily and, by April 2005, it exceeded 212. The large majority of these agreements, about 87 percent, were concluded since the 1990s. In 2004 and early 2005, at least 32 new agreements were concluded and about 66 others were under negotiation or consultation. [Thus, while the rate at which new BITs are being concluded has been slowing, the rate at which new regional trade and investment agreements have been concluded has been increasing. Initially, most of these treaties were between countries in the same region.] Since 1990s, however, countries located in different regions began to conclude agreements with one another, with the result that interregional agreements now account for 44 per cent of the total preferential trade and investment agreements (Figure 3.1.2) (WIR 2005, pp. 28-29).

From figure 3.1.2. below the impressive growth of trade and investment agreements since the breakdown of the socialist economies in Central and Eastern Europe clearly emerges.

Figure 3.1.2: The growth of trade and investment agreements, other than BITs, 1957-June 2005 (Number)



Source: UNCTAD, 2006 (http://www.unctad.org/iia)

The next important point is related to the largely unproductive, complex and sophisticated role of markets in developing countries. According to the UNCTAD Series reports 2006:

> International investment rules are becoming increasingly sophisticated and complex in content. The greater level of sophistication and complexity, however, does not necessarily imply a greater degree of stringency. For example, the greater complexity may, at times, be the result of an effort to define an obligation with greater specificity and thereby to clarify its scope and application. . . . For example, Canada and the United States subsequently modified the language of their BITs and other investment agreements to clarify the meaning of "fair and equitable treatment" and the concept of indirect expropriation. (UNCTAD 2006b, pp. 10-11)

In fact, a new development potential related to our discussion emerges from the new condition that countries with developing economies are in. In fact, the majority of BITs as of the end of 2004, 40 percent of all BITs were between developed and developing economies, while 25 per cent were between developing economies. Another 10 percent were between developing and transitional economies. Thus, developing countries were one or both parties to 75 per cent of all BITs. Furthermore, a clear trend toward increased South-South cooperation is evident. For example, in 2004, the largest number of BITs signed was between developing countries. Specifically, 28 of the 73 new BITs were between developing countries. This trend reflects both a greater emphasis on South-South cooperation on investment and an increase in the quantity of outward foreign direct investment flows from developing countries (UNCTAD 2006b, pp. 8-12).

In addition, according to the World investment report: "Reflecting the growing competition for FDI (as well as the need to stimulate investment generally), significant reductions in corporate income tax rates, were noted in many countries. While policy changes overall are in the direction of more liberalization and deregulation, there are some differences between regions" (2005. p. 26). According to UNCTAD's findings, about 20 economies reduced their corporate income tax rates during 2004 (Table 3.1.8).

Table 3.1.8: Changes in corporate income tax rates in selected economies, 2004 (Percent)

Economy	1 January 2004	1 January 2005
Decrease		
Albania	25.00	23.00
Austria	34.00	25.00
Barbados	33.00	30.00
Bulgaria	19.50	15.00
Czech Republic	28.00	26.00
Denmark	30.00	28.00
Finland	29.00	26.00
France	34.33	33.83
Greece	35.00	32.00
Israel	36.00	34.00
Japan	42.05	40.69
Korea, Republic of	29.70	27.50
Latvia	19.00	15.00
Mexico	33.00	30.00
Netherlands	34.50	31.50
Romania	25.00	16.00
Singapore	22.00	20.00
Switzerland	24.10	21.30
Turkey	33.00	30.00
Uruguay	35.00	30.00
Increase		
Germany	38.29	38.31
India	35.875	36.5925
Viet Nam	26.00	28.00

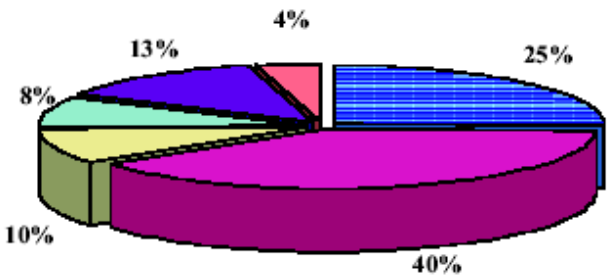
Source: World Investment Report 2005, Table I.15. p.26

Once more, according to the World investment report:

> Some new BITs also address a broader set of issues, including not only specific economic aspects such as investment in financial services, but also other issues where greater policy space for host-country regulation may be sought. In this regard, language is sometimes included to clarify that the investment protection and liberalization provisions cannot be pursued at the expense of the protection of key public policy objectives such as health, safety, the environment and the promotion of internationally recognized labour rights. Finally, some recent BITs have made significant innovations regarding investor-State dispute settlement procedures, in an effort to secure greater transparency in arbitral proceedings, including open hearings, publication of related legal documents and the possibility for representatives of civil society to submit "*amicus curiae*" (i.e. "friends of the court") briefs to arbitral tribunals. (2005, p. 27)

An additional related point is the trend of economic integration agreements (EIAs). "This trend is a manifestation of the globalisation strategies being pursued by more and more countries in response to the increasing global competition for resources and markets facing national economies" (UNCTAD 2006b. p.31). Of course, the choice of partners within and between regions responds to a variety of economic and political motivations depending also on the characteristics of the countries involved. Approximately, out of a total of 300 economic integration agreements (EIAs) "87% of these economic international investment agreements (EIIAs) have been concluded since 1990 (41% since 2000), and the other 13% between 1945 and 1989 (figure 3.1.3). Initially, EIIAs between countries in the same geographical region dominated the scene, and, until the late 1980s, economic integration through EIIAs remained confined mainly to interregional processes, albeit with important exceptions. 48 Since the early 1990s, however, countries and groups located in different regions began to sign EIIAs with one another, with the result that interregional EIIAs now account for 44% of the total 218 EIIAs (87 of which have been concluded since 1990) [see figure 3.1.3]" (UNCTAD 2006, pp. 32-33).

Figure 3.1.3: Total BITs concluded, end 2004, by country group (Percentage)



Source: UNCTAD 2006 (http://www.unctad.org/iia) Figure I.12.

25%Between developing countries
40%Between developed and developing countries
10%Between developing countries and countries of SEE&CIS
8%Between developed countries
13%Between developed and countries of SEE&CIS
4%Between countries of SEE&CIS

The second phenomenon is Transnational Corporation (TNCs), which is a result of the developed economies decisions to facilitate the economic cooperation with developing economies based on the notion of self-regulating markets. This cooperation takes mainly place in the sphere of production. The division of labour *within* an enterprise is now shifted on a worldwide level. "The location of TNC activity instead increasingly reflects three developments: policy liberalization, technical progress and evolving corporate strategies . . .Trade and investment liberalization allows TNCs to specialize more and to search for competitive locations. TNCs have greater freedom to choose locations and the functions they transfer. Between 1991 and 2000, a total of 1,185 regulatory changes were introduced in national FDI regimes, of which 1,121 (95 per cent) were in the direction of creating a more favourable environment for FDI. …During 2000 alone, 69 countries made 150 regulatory changes, of which 147 (98 per cent) were more favourable to foreign investors" (World Investment Report 2001 Overview, p.91).

"The growing spread and mobility of TNCs are making local conditions more, not less, important. The increased freedom for factors and functions to move does not mean that international production spreads equally to all locations. Mobile factors only go and "stick" in places where efficient complementary factors exist. Thus, FDI tends to be fairly concentrated geographically within countries, responding to the agglomeration economies that also influence domestic firms. These economies relate to proximity to markets and factors of production, and the availability of specialized skills, innovatory capabilities, suppliers and institutions. Intensifying competition forces firms to specialize more in their core competencies and rely more heavily on links with external partners (suppliers, buyers or even competitors) than in the past. These networking possibilities often induce TNCs to set up operations in close proximity to (competent) clusters of related firms" (World Investment Report 2001, Overview, p. 93).

"Indeed, the global expansion of investment flows is driven by about 77,000, transnational corporations [60,000 in 2002] with at least 770,000 foreign affiliates [over 800,000 affiliates abroad in 2002]. Therefore, they are becoming a force in the world FDI market affecting the structure and size of world economic activities, with outward FDI stock of already U.S. $ 59 billion (2002), they are building up their own international trade systems. [Now in 2005, for example]…More than 20,000 of the TNCs originate in developing countries. Consequently, FDI has grown faster than domestic investment (gross fixed capital formation), and FDI stock continues to rise. Thus the share of international production in world output, as measured by the

share of value added of foreign affiliates in world GDP, is rising and is estimated to have been 10% in 2005, compared to 7% in 1990" (World Investment Reports. 2006, p. 10 and World Investment Report 2001, p. 77).

Therefore, all this does not lead us to conclude that FDI works in the neoclassical way in the real world. In fact, the activities of TNCs all point to the fact that the social process of production, and the division of labour within this process, stands at the center of economic theory. In chapter 4 we shall touch upon some important issues related to the effects of FDI as are carried out by TNCs. Here, we add two passages which tell us something upon the considerable significance FDI carried out by TNCs have acquired since the breakdown of the socialist economies. In fact, "… a dollar of FDI stock from any home country [based on self-regulation market theory] leads to the same amount of international production every where, and based on past estimates of the relationship between FDI stock and foreign sales, employment and value added, respectively, TNCs based in developing countries and in South-East Europe and the CIS are estimated to have accounted for about $2.6 trillion in sales, employed 7.4 million workers and generated more than $500 billion in value added outside their home countries in 2005" (World Investment Report 2006, p. 10). Moreover, "[in] 2004 (the most recent year for which data are available), the world's 100 largest TNCs accounted for 11%, 16% and 12%, respectively, of the estimated foreign assets, sales and employment of all TNCs operating in the world, which gives an indication of the major role they play in international production. Given that their activities increased significantly, with total assets and sales increasing by 10%, 2004 proved to be a new record year (table I.13). The ratio of foreign activities to total activities also increased in 2004, with the exception of employment, which remained at almost the same level. . . . Overall, the rankings in the first quartile of the top 100 list in 2004 have remained relatively stable in the past few years, with General Electric, Vodafone and Ford Motor heading the list. These three TNCs had about $877 billion in foreign assets, corresponding to nearly 19% of the total foreign assets of the top 100 TNCs (annex table A.I.11). There was no change in the top 10 companies in 2004. In 2004, 85 of the top 100 TNCs had their headquarters in the Triad, the United States dominating the list with 25 entries. Five countries (the United States, the United Kingdom, Japan, France and Germany) accounted for 73 of the top 100 firms, while 53 entries were from the EU. In 2004, there were five companies from developing economies (China, Hong Kong (China), Malaysia, the Republic of Korea and Singapore), the largest number ever from this group, among

the top 100" (World Investment Report 2006, pp.30-31).

Table 3.1.9: Snapshot of the world's 100 largest TNCs, 2003, 2004
(Billions of dollars, thousands of employees and per cent)

Variable	2003	2004	% Change
Assets			
Foreign	3 993	4 728	18.41
Total	8 023	8 852	10.33
Foreign as % of total	49.8	53.4	3.6 [a]
Sales			
Foreign	3 003	3 407	13.45
Total	5 551	6 102	9.93
Foreign as % of total	54.1	55.8	1.7 [a]
Employment			
Foreign	7 242	7 379	1.89
Total	14 626	14 850	1.53
Foreign as % of total	49.5	49.7	0.2 [a]

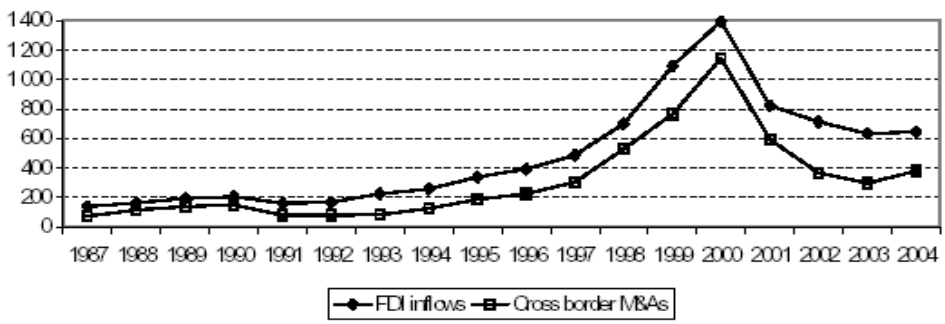
World Investment Report, 2006. Table I.13. p. 31

Cross-border mergers and acquisitions (M&As) is the third, phenomenon which affects the global FDI trend. M&As have increased in both, the value and number "Since the late 1980s; these started to pick up in 2004 following up three years of decline"(World Investment Report 2006, p. 31). Moreover: "Both the value and number of cross-border M&As rose in 2005, to $716 billion (an 88% increase) and to 6,134 (a 20% increase) respectively – levels close to those of 1999, the first year of the latest cross-border M&A boom- this is because of the growing role of international corporations in the world economy" (World Investment Report, 2006, p. 13). This increasing trend has advantages and disadvantages, which, however, are very difficult to disentagle in an unregulated free market reality. There are intricate relation between the various factor that have to be taken account of. For example, TNCs create workplaces and lead to exports, but what are the quality of the workplaces created and the effects of these on social life. In addition, a comparative review of the FDI trend and the growth trend of cross-border M&As, set out in figure 3.1.2, demonstrates a very close relationship between FDI trends and cross-border M&As growth. This association between FDI and cross-border M&As, implies that FDI emerges and operate, as the main component of the new neoclassical (neo-liberal) economic policies on the world level, where the cross-border M&As have now appeared. In addition remarkably enough, "cross-border M&As rose more markedly at the domestic and regional levels

than at the global level. For instance, between companies of the EU-15 such deals increased in value by 57% to $99 billion, accounting for 57% of the value of all cross-border deals in that region in 2004 as compared with 52% in 2003" (World investment Report 2005, p. 9) … and "the value and number of M&As in 2005 were comparable to the averages in 1999-2001, as were the number of mega deals" (World investment Report 2006, p 15). This clearly limited the small domestic economic space in developing countries to function normally and destroyed many jobs.

Table 3.1.10 below shows the trend of growth of M&As. This trend implicitly involved monopoly condition that allows anti economic behaviour and inequality to grow-up in international economic relations, according to World Investment Report: "Takeovers, favourable conditions in financial and stock markets prompted the growth of cross-border M&As. However, data on FDI flows and stocks should be interpreted with caution, taking into account a number of issues related to FDI statistics. . . . FDI flows are expected to represent funds for expenditure on capital formation in host economies. But in reality not all of the flows shown in FDI data represent external financial resources for investment, because they may have originated in that country itself in the first place (round-tripping), or because they are intended mainly for FDI in some other country (trans-shipping). [And as a result] a rise in global FDI flows, for instance, does not necessarily mean increased productive capacities in host economies" (2006, p.10).

Figure 3.1.4: FDI Inflows and Importance of cross-border M&As, 1987-2004 (Billions of U.S. $)



Source: UNCTAD, FDI/TNC database and cross-border M&A data base 2005, (www.unctad.org/fdistatistics).

Table 3.1.10: Cross-border M&As with values of over $1 billion, 1987-2004

Year	Number of deals	Percentage of total	Value ($ billion)	Percentage of total
1987	14	1.6	30.0	40.3
1988	22	1.5	49.6	42.9
1989	26	1.2	59.5	42.4
1990	33	1.3	60.9	40.4
1991	7	0.2	20.4	25.2
1992	10	0.4	21.3	26.8
1993	14	0.5	23.5	28.3
1994	24	0.7	50.9	40.1
1995	36	0.8	80.4	43.1
1996	43	0.9	94.0	41.4
1997	64	1.3	129.2	42.4
1998	86	1.5	329.7	62.0
1999	114	1.6	522.0	68.1
2000	175	2.2	866.2	75.7
2001	113	1.9	378.1	63.7
2002	81	1.8	213.9	57.8
2003	56	1.2	141.1	47.5
2004	75	1.5	199.8	52.5
2005	141	2.3	454.2	63.4

Source: World Investment Report 2006, p 13, Table I.3.

As a result, FDI flows associated to TNCs and M&As bring about an unfavourable situation, in the developing economies in the main. The World investment Report states on this: "In general, in developed countries, the sectoral distribution of FDI by private equity firms is more or less equal between manufacturing and services sectors, but, unlike FDI overall or total cross-border M&As, the primary sector does not seem to be a significant target. In developing countries, the focus is more on services (80% of the total value) " (2006, p 19). However, given this situation, conflicts have emerged because of differences in structure, size, capabilities and socio-economic goals and policy performances between different developed and developing economies. As a result it could be said that, specifically in developing countries, the FDI, ILAs, TNCs and M&As have become substitutes for the domestic capabilities and capital, domestic economic contracts and domestic corporations, investors, inventors, scientists and even groups of skilled and simple workers.

An additional point related to the subject is given by the differences that are observed in world distribution of income and the level of standards of living in a time period when the

amounts of FDI have dramatically increased since earlier 20th century (Tables 3.1.7 & 3.1.11).

Table 3.1.11: World Population Millions, World P.L.I.E.P[1] less than $1 and $ 2 per a day

Indicators / Year	1980	1990	2002	2005
World Population millions	4 430	5282	6199	6465
World $P.L.I.EP_1$ less than $1 per a day millions	1452 (2)	1218	1011 (3)	-
Percentages World P.L.I.EP less than $1 per a day to Population Ratio	32.77	23.06	16.31	-
World P.L.I.EP less than $2 per a day millions	2419 (2)	2691	2732 (3)	-
Population, PLIEP less than $2 per a day Ratio (%)	54.60	50.95	44.07	-
World GDP Millions US $ (Current)	10 818 514	21 898 479	32 570 901	44 673 628
Developed economies GDP Millions US $ (Current) (Percentages World GDP to Developed economies)	8 153 621 (75.37)	17 245 298 (78.75)	25 306 952 (77.70)	33 260467 (74.45)
China GDP Millions US $ (Current)	301 508	382 996	1 270 664	2 224 811
Percentages World GDP to China GDP	2.79	1.75	3.90	4.98
Inward FDI flows as a percentage of Gross Fixed Capital Formation: World /Developed economies	2.23 /2.53	4.23 /4.26	9.15(4) / 21.63	9.45 / 8.01
Inward FDI flows as a percentage of Gross Fixed Capital Formation China	0.06	3.52	10.41	9.17

Source: World Development Indicators, the World Bank. 2004, Tablets 1d and 1f P3 World investment report 2006,
1 People living in extreme poverty millions
2 data are for 1981
3 data are for 2001
4 The highest rate of the Inward FDI flows as a percentage of World Gross Fixed Capital Formation was 20.0

The table shows the fraction of the world Population living with less than $ 1 and $ 2 per day, World and Developed economies GDP proportions and World and Developed economies Inward FDI flows as a percentage of Gross Fixed Capital Formation in three decades. Such indicators, like poverty indexes, can provide important information on the degree to which development goals have been reached. At first sight, it seems that, social inequality has been reduced during the last three decades. But in a comparative view, it is probable that inequality has not been reduced; indeed, if the growth in world population, the rate of inflation, the great gap between developed and developing economies share in GDP, the insignificant decreasing size of people living with less than $1 per a day compared with the increasing size of peoples living with less than $ 2 per day and the extraordinary rising growth of the chinese economy, are taken into account, the picture changes (table 3.1.11). For those living with less than one or two dollars per person and per day growth rates apply to a much lower basis which means that, as is very likely, the absolute differences between poor and rich has increased. While World Inward FDI flows as a percentage of Gross Fixed Capital Formation has expanded during decades.

As a result, according to World bank staff calculations: “Inequality has increased in many

countries, with or without growth: [Based on observations in] Fifty-nine countries with comparable $1 or $2 a day poverty data measured at two points in time (with a gap of at least 10 years) over the last two decades show that growth and changes in income distribution can reinforce or offset their effects on poverty reduction. In 26 cases income growth was accompanied by increased inequality, and in 20 more income distribution worsened as average incomes fell" (World development indicators 2007 World Bank p.2).

In addition the distribution picture should be completed with comparative income analysis. In table 3.1.12 population and income percentages of developed and developing countries are compared. The picture is clearly one of widening gaps between rich and poor. Indeed, countries with a developing economy had 80.0, 82.0 and 84.0 percentages shares in World Population and 32.0, 29.0 and 19.0 percentages of shares in world incomes, for the years, 1970, 1980 and 2000 respectively. On the other hand, countries with a developed economy with percentage shares in the world population of 20.0, 18.0 and 16.0, had increasing shares in world income, with 68.0, 71.0, and 81.0 percent in the years 1970, 1980 and 2000 respectively.

Table 3.1.12: Share of world income,1970, 1980 and 2000 (percentage)

Regions Years	Percentages of developed economies Population	Developed Economies Income	Rest of the World Population	Rest of the world income
1970	20.0	68.0	80.0	32.0
1980	18.0	71.0	82.0	29.0
2000	16.0	81.0	84.0	19.0

Source: World Development Indicators, the World Bank. 2004, Tablets 1d and 1f P3

Of crucial importance is the fact unequalities have increased strongly in the 1980s and 1990s, precisely at a time when FDI volumes have grown dramatically. This fact will be insisted upon at other places. An attempt to tentatively explain it will be undertaken will be undertaken in chapter 4 below.

3.1.5 The Regional Aspect of FDI Flows

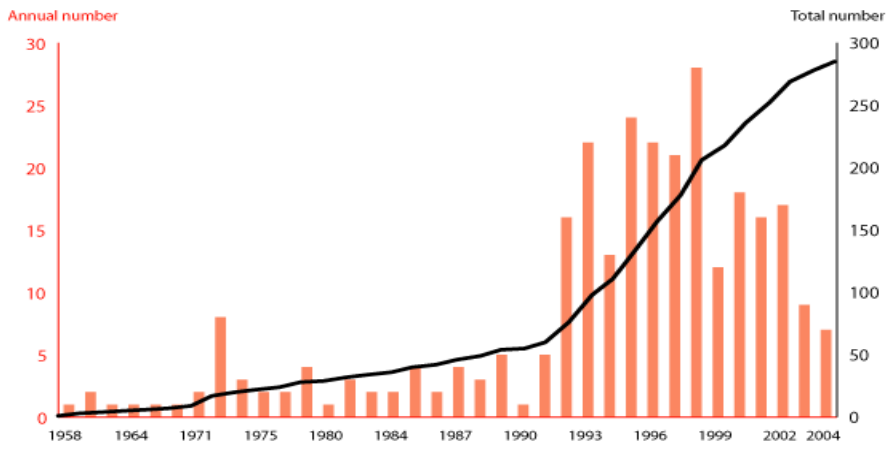
This section attempts to present some empirical aspects regarding regional integration in relation with FDI. Moreover, it is attempted to highlight the role of regional free-trade areas in attracting

FDI and the probable effects of foreign direct investment on developing countries. Considering FDI flows here aims at setting out contradictions in regional distribution of FDI resulting from economic agreements and alliances and from the implications of neoclassical free market theory. Specifically, the geographical distribution of FDI flows has changed markedly before and after the World Wars, during the cold war and since the new American economic hegemony from the 1990s onwards. These regional and geographic considerations attempt to set out the distribution of FDI flows to different economic regions, that is, North and South, groups of countries with a developed and a developing economy, groups of countries being members of different agreements also are included, such as a number of Asian countries, particularly six progressive economies, Hong Kong, Korea, Malaysia, Singapore, Taiwan and Thailand, the Dynamic Asian Economies (DAEs), and the Dynamic Non-Member Economies (DNMEs); moreover, our considerations extend to Europa, Latin America, Argentina, Brazil, Chile and Mexico, and some African countries with a developing economy, such as Algeria, South Africa, Egypt, Morocco, Tunisia and Libya; furthermore, we consider countries with a developed economy linked through various agreements regarding FDI, that is OECD Member countries such as Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, the Netherlands, New Zealand, Norway, Spain, Switzerland, the United Kingdom and the United States. In addition, non-oil exporters, raw material and primary producer countries and oil producers "Organization of Petroleum Exporting Countries" (OPEC), are also examples of such agreements and alliances. On the top of this there are the developed countries of North and the developing countries of the South. However, all these countries affect, as a rule, trend of FDI distribution through maintaining and controlling the domestic situation by making grouping agreements, unnatural barriers and difficulties for non-member countries and by supporting particularly the member countries. This is a kind of protectioism, which is not in line with the free-trade princples of neoclassic theories. For example, according to UNCTAD Series Report:

> Since the 1990s, the universe of agreements has expanded enormously, although the rate of growth is different for different types of agreements. By the end of 2004, the number of BITs had reached 2,392. Nevertheless, the rate of increase in the number of bilateral investment treaties (BITs) concluded has been in decline since 1996, when 209 agreements were concluded in one year. By contrast, 73 BITs were concluded in 2004, the smallest number since 1990 (UNCTAD 2006, p. 5), (Figure 3.1.5).

According to world Bank 2005: Global economic prospects 2005: "regional trade agreements are proliferating, there are more than 250 regional trade agreements in force –six times as many as two decades ago. A bout a third of global trade takes place between countries that some form of reciprocal regional trade agreement" (World Development Indicators 2006).

Figure 3.1.5: Growth of regional trade agreements 1958 - 2004 (Number)



Source: World Development Indicators 2006

It is very important to note, that economic integration agreements (EIAs), present new challenges for policymakers. Indeed, all international investment agreements (IIAs) limit the regular space within which countries can pursue their economic development policies. Such agreements may be bilateral, regional, interregional, multilateral or supranational. The new generation of IIAs also presents new challenges for policymakers. Therefore, FDI is now free to move on the borders; moreover, in free and competitive markets system a new type of monopoly appears because of agreements and alliances between enterprises. In addition, based on the logic mentioned above, the great importance of foreign trade to countries with a developing economy may also have been concealed by a second factor; in fact, the global FDI flows invested in countries with a developing economy returned largely in to countries with developed economies, notably the United States and Europe (Transnational Corporations Report 2002, p. 79). The Inward FDI Potential index gives details about this claim (World Investment Report 2005, p. 24).

Table 3.1.13: Top 25 Economies by the Inward FDI Potential Index, 1990, 2002, 2003

Economy	1990	2002	2003
United States	1	1	1
Norway	5	2	2
United Kingdom	3	3	3
Canada	2	5	4
Singapore	15	4	5
Sweden	6	7	6
Qatar	19	6	7
Germany	4	10	8
Belgium and Luxembourg	10	8	9
Ireland	27	9	10
Netherlands	8	11	11
France	7	15	12
Finland	9	12	13
Iceland	14	14	14
Hong Kong, China	20	13	15
Japan	13	16	16
Switzerland	11	18	17
Denmark	16	17	18
Australia	12	21	19
Korea, Republic of	21	19	20
Taiwan Province of China	22	20	21
United Arab Emirates	26	22	22
Israel	31	23	23
Austria	18	24	24
Spain	24	25	25

Source: World investment report 2005, Table I.11.

Actually, the ranking of the 25 top countries regarding the Inward FDI Potential Index, in 1990, in 2002, and in 2003, has been approximately fixed and changing but slowly. This shows how this group has the power to monopolise FDI movements. Complementarily, the average annual flow of FDI going to developing countries has increased in real terms since the 1980s, but the share of these countries in the world total of FDI flows has decreased.

On the one hand, this suggests that the various regions have benefited from FDI in a very unbalanced way (Table 3.1.14), and explains, on the other hand, that the share of countries with a developing economy having FDI outflows substantially increased from 1970 to 2004 (World Investment Report 2001 Overview, p. 79 and World investment Report 2004, p. 18). According to the World Investment Report, "annual FDI outflows from [countries with a] developing economy have grown faster over the past 15 years (in 2003), than those from developed countries. Negligible until the beginning of the 1990s outward FDI from developing countries accounted for over one-tenth of the world total stock and some 6% of world total flows in 2003

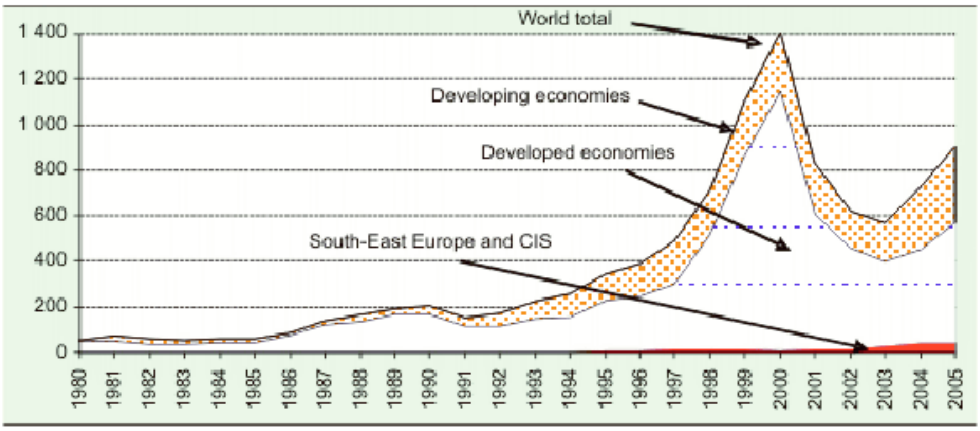
($ 0.9 trillion and $ 36 billion, respectively)" (World Investment Report 2004, p.18). To explain facts like these needs a very robust theoretical framework, which will be presented in the next chapter.

Table 3.1.14: Net Foreign Direct Investment in developing regions (1990-2004) billions $

Regions / Years	1990	1997	1998	1999	2000	2001	2002	2003
East Asia and pacific	10.	62	58	50	44	48	55	57
East Europe and Central Asia	1.0	23	26	28	29	32	33	26
Latin America and the Caribbean	7.5	67	74	88	77	70	45	37
Middle East and North Africa	-	6	7	3	2	6	3	2
South Asia	0.5	5	4	3	3	5	4	5
Sub-Saharan Africa	0.5	8	7	9	6	14	8	9
Total	19.5	171	176	182	162	175	147	135

Sources: World Bank, GDP, various years, 2003, 2004 and *Business Week* (November, 2000, Table 3.1.4)

Figure 3.1.6: FDI inflows, global and by groups of economies, 1980-2005, (Billions of dollars)



Source: World Investment Report 2006. p.4 Figure I.1.

3.1.6 FDI Flows to Specific Countries

Government's officials in developing countries have been taught that their countries need foreign assistance, especially capital, to achieve their growth objectives; methodically and increasingly, this foreign capital must be provided in a sustained way and increasingly by a negative balance on current account, portfolio investment, FDI and private and public aid. A historical comparative analysis should be able to explain difficulties encountered by such processes; first why FDI inflows were, in practice, generally directed to specific countries and, secondly, how a great size of FDI was allocated to specific countries, contrary to what was predicted by neoclassical theory. The World Investment Report 2001 compares the world inward and outward FDI in 2000, which was a unique year for FDI, and in 1985.

> [The results] reveal that FDI reaches many more countries in a substantial manner than in the past. More than 50 countries (24 of which are [economically] developing countries) have an inward stock of more than $10 billion, compared with only 17 countries 15 years ago (7 of them with economically developing countries). The picture for outward FDI is similar: the number of countries with stocks exceeding $10 billion rose from 10 to 33 (now including 12 developing countries, compared to 8 in 1985) over the same period. In terms of flows, the number of countries receiving an annual average of more than $1 billion rose from 17 (6 of which were developing countries) in the mid-1980s to 51 (23 of which were developing countries) at the end of the 1990s. In the case of outflows, 33 countries (11 developing countries) invested more than $1 billion at the end of the 1990s, compared to 13 countries (only one developing country) in the mid-1980s. Despite its reach, however, FDI is unevenly distributed. The world's top 30 host countries account for 95 per cent of total world FDI inflows and 90 per cent of stocks in the end of 1990s. The top 30 home countries account for around 99 per cent of outward FDI flows and stocks, mainly industrialised economies. (World Investment Report 2001, p. XV). FDI grew by 18 per cent in 2000, faster than other economic aggregates like world production, capital formation and trade, reaching a record $1.3 trillion (World Investment Report 2001, p. XVII).

FDI flows have, however declined in 2001 until 2004. Moreover:

> Within the developed world, the Triad the European Union (EU), the United States and Japan accounted for 71 per cent of world inflows and 82 per cent of outflows in 2000. Within the Triad, the EU has gained both as a recipient and source of FDI. Record inflows ($617 billion) were stimulated by further progress in regional integration, while the United States and other western European countries remain its

> main partners outside the region. …The United States remained the world's largest FDI recipient country as inflows reached $281 billion, out flows with $139 billion decreased by 2 percent. Japan saw its inflows in 2000 drop by 36 percent from the previous year to $8 billion, partly due to the prolonged slow-down of the country's economic growth, but also perhaps indicative of the fact that, in spite of its welcoming FDI policies, other factors deter investment inflows. In contrast, outflows from Japan rebounded to $33 billion, the highest level in ten years (World Investment Report 2001.p.XIII). It is interesting to note that "80% of total FDI went to only 10 countries while 100 countries (some in the developing countries) received just $100 million FDI in average each year in the 2000" (Business Week, November, 2000). "FDI flows to developing countries fell in 2003 for the second consecutive year. Net FDI flows are estimated to have been $135 billion in 2003, a decline of 9 percent from 2002 and 26 percent from the peak level reached in 1999 (table 3.1). As a proportion of developing countries' GDP, FDI continued to decline-from 2.3 percent in 2002 to about 1.9 percent in 2003 (figure 3.1). This decline is a marked contrast to the sharp improvement in portfolio equity and debt flows in 2003-and it is taking place at a time when global FDI is rising. FDI flows rose 6 percent in 2003 to an estimated $690 billion, mostly because of the substantial surge in flows to the United States (figure 3.2).2 As a result, developing countries' share in global Fill dropped to 19.6 percent in 2003 from 22.6 percent in 2002 (World Investment Report, 2004). The difference between inflows to developed countries and developing countries shrank to $147 billion – a significant narrowing of the gap compared with previous years. The United States was the largest recipient in 2004, ahead of the United Kingdom and China as well as Luxembourg, the top FDI recipients in 2003. FDI flows rose 6 percent in 2003 to an estimated $690 billion, mostly because of the substantial surge in flows to the United States (figure 3.2).2 As a result, developing countries' share in global Fill dropped to 19.6 percent in 2003 from 22.6 percent in 2002. The downturn in FDI flows to developing countries reflects a sharp decline in flows to a few countries (World Investment Report, 2004 p.33).

Although foreign direct investment to developing countries has increased, first it is interesting to mention that the distribution of FDI clearly could not be explained by neoclassical theory which postulates that FDI flows to developing countries where capital is scarce should be relatively higher and growing faster than the FDI amounts moving to developed countries. Second according to Prasad, Rajan and Subramanian:

> over the period 1970-2004, as well as over shorter periods, the net amount of foreign capital flowing to relatively high growth developing countries has been smaller than that flowing to the medium- and low-growth groups. During 2000-04, the pattern is truly perverse, with China, India, high-growth, and medium-growth countries all *exporting* significant amounts of capital, while low-growth countries receive significant amounts. That capital flows to developing countries do not follow growth has been dubbed the allocation puzzle by Gourinchas and Jeanne. The puzzle deepens when we examine net FDI flows. During the most recent period (2000-04), even net

> FDI flows do not follow growth. By and large, however, they do, with the fastest-growing group of non-industrial countries receiving the most FDI over the period 1970-2004, and China receiving substantial amount. This suggests that fast- growing countries do have better investment opportunities, which is why they attract more FDI. Yet they do not use more foreign capital overall and, in the case of China, they export capital on net. In short, the apparent perversity of overall foreign financing is even more dramatic when one examines the allocation of capital across developing countries.(Prasard, et al. 2007, p.17)

As a result it seems that the growth of FDI is more closely related to a positive balance on current account of developed countries than to the negative balance on current account of developing countries. Again solid theory is required to explain phenomena like these. This will be done in chapter 4 below.

Table 3.1.15: World Trend FDI inflows and out flows, 1982-2004 (Billions U.S. $, value at current prices)

Item / Year	1982	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
World FDI inflows	59	208	331.1	384.9	477.9	692.5	1075.0	1270.8	823.8	716	633	648
World FDI out flows	28	239	355.3	391.6	466.0	711.9	1005.8	1149.9	711.4	652	617	730
World GDP	10 898.5	21 899.5	29 418.3	30 047.4	29 906.1	29 697.8	30814.2	31624.5	31362.8	32570.9	36 526.1	40960.4
FDI inflows developed Economies	91.6*	176.4	203.5	219.7	271.4	483.2	829.8	1005.2	589.4	547.8	442.2	418.8
FDI inflows developing economies	19.8*	34.7	113.3	152.5	187.4	188.4	222.0	240.2	209.4	155.5	166.3	283.0
FDI out flows developed economies	88.3*	226.2	305.8	332.9	396.9	672.0	945.7	1046.3	660.6	600.0	577.3	745.9
FDI out flows developing Economies	5.4*	16.9	49.0	57.6	65.7	37.7	58.0	99.5	47.4	47.8	29.0	117.3

Source: UNCTAD, World Investment Reports, 1997, 2001, 2005, 2006 and 2007: Promoting Linkages, tables B.1and B.2, pp. 291 and 296 and
* Annual average 1983-1988

Table 3.1.16: FDI Flows as a percentage of gross fixed capital formation (GFCF)

(Per cent) 2002-2004

Regions / FDI flows/Years	Inward			Outward		
	2002	2003	2004	2002	2003	2004
World	10.6	8.3	7.5	9.7	8.2	8.7
Developed economies	10.9	7.9	6.1	12.0	10.3	10.3
Europe	22.9	16.1	8.6	21.2	17.5	12.0
North America	4.5	2.9	4.4	7.8	6.4	12.0
Other developed countries	2.5	1.6	4.2	3.8	3.9	3.9
U.S	3.7	2.8	4.2	7.0	5.9	10.1
Developing economies	9.5	8.8	10.5	2.8	1.6	4.2
Africa	13.0	15.0	12.5	-	1.1	2.4
Latin America and the Caribbean	15.4	12.9	15.5	2.3	3.2	3.9
Asia and Oceania	7.7	7.3	9.1	3.1	1.3	4.4
Asia	7.7	7.3	9.1	3.1	1.3	4.4
China	10.4	8.6	10.1	0.5	-	0.2
Iran I.R	1.4	1.2	1.0	0.1	- 0.9	- 0.2
Oceania	0.6	16.5	5.2	0.5	0.9	0.1

Source: UNCTAD, World Investment Reports, 1997, 2001,2005, 2007: Annex Tables

Table 3.1.17: FDI Stocks as a percentage of GDP,

(Per cent) 1990, 2000, and 2004

Regions/ FDI stocks	Inward			Out ward		
	1990	2000	2004	1990	2000	2004
World	8.4	18.3	21.7	8.7	19.7	24.0
Developed economies	8.2	16.3	20.5	9.6	21.5	27.3
Europe	10.8	26.5	32.0	12.0	38.4	42.5
North America	8.0	14.0	14.0	8.1	14.8	18.8
Other developed countries	2.8	4.0	7.9	6.9	7.1	10.2
U.S.	6.9	12.9	12.6	7.5	13.5	17.2
Developing economies	9.8	26.2	26.4	4.3	13.6	12.7
Africa	12.7	26.5	27.8	4.8	8.5	6.2
Latin America and the Caribbean	10.5	24.7	34.1	5.5	10.3	13.1
Asia and Oceania	8.7	26.9	23.2	3.6	16.0	13.4
Asia	8.7	26.9	23.2	3.6	16.0	13.4
China	5.8	17.9	14.9	1.3	2.6	2.4
Iran IR.	2.2	2.4	2.4	-	0.4	-
Oceania	28.9	30.3	21.2	5.8	3.2	3.2

Source: UNCTAD, World Investment Reports, 1997, 2001,2005, 2007: Annex Tables

3.1.7 Sectoral FDI Flows

FDI changes the trend of the sectoral distribution of investment in the world economy on the one hand (a new world division of labour comes into being) and, on the other hand, changes the distribution of investment inside the countries (a new spatial division of labour emerges) and between the economic sectors (specialisation pattern change); as a result, changes the distribution of income, between areas of a country, between urban areas, between urban and rural, between the classes of workers and property owners, and so on. This, in turn, alters the levels of the quality and quantity of employment and brings about human and fiscal migrations at the national and the international level, and finally affects the degree of poverty.

This section precisely attempts to evaluate the structural changes brought about by foreign investment and gives hints about whom might benefit from FDI. The crucial question is: How does FDI affect income distribution and employment in different economic sectors? In other words it answers the ambiguities about the current FDI distribution mechanism, which was initiated by the dominating economically developed countries. The striking example is the geographical distribution of FDI in China. Table 3.l.18 is evidence for the unequal rate of FDI attracted in China by regions; in fact, FDI concentrated on the Eastern regions, while the Central and the Western regions received relatively small amounts of FDI. This leads to social problems such as emigration, unemployment, unbalanced growth and an economic gap between regions.

Table 3.1.18: Geographical distribution of FDI in chain by region [a] 1989-1998

Year	FDI inflows ($100 million)			FDI inflows per person ($)		
	Eastern region	Central region	Western region	Eastern region	Central region	Western region
1989	28.12	1.17	1.22	5.54	0.46	0.28
1990	29.72	1.22	0.72	5.91	0.45	0.16
1991	38.88	1.68	0.68	7.78	0.61	0.16
1992	97.94	7.25	1.96	19.75	2.64	0.46
1993	236.83	23.80	10.14	48.40	8.79	2.38
1994	290.89	25.99	14.03	59.93	9.71	3.32
1995	324.58	33.24	11.42	67.45	12.57	2.73
1996	365.20	39.21	8.13	76.58	15.01	1.97
1997	385.65	47.90	11.68	81.76	18.55	2.86
1998	394.96	44.21	9.42	86.73	17.52	2.39
Total[b]	2 193 (88%)	226 (9%)	69 (3%)	45.98	8.63	1.67

Source: Transnational Corporations, Vol. 11, No. 1 (April 2002), p3, Table 1.
a. The geographical grouping of the provinces is as follows: eastern regions: Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian , Shangdonh, Guangdong and Guangxi; central region: Shangxi, Neimenggu, Jilin , Heilongjian, Anhui, Jianxi, Henan, Hubei and Hunan; Western region: Sichuan , Guizhou, Yunnan, Shanxi, Gansu, Qinghai, Ningxia and Xinjiang
b. The bottom row shows the total FDI inflows and percentages and average per capita FDI

3.1.7.1 The International Situation

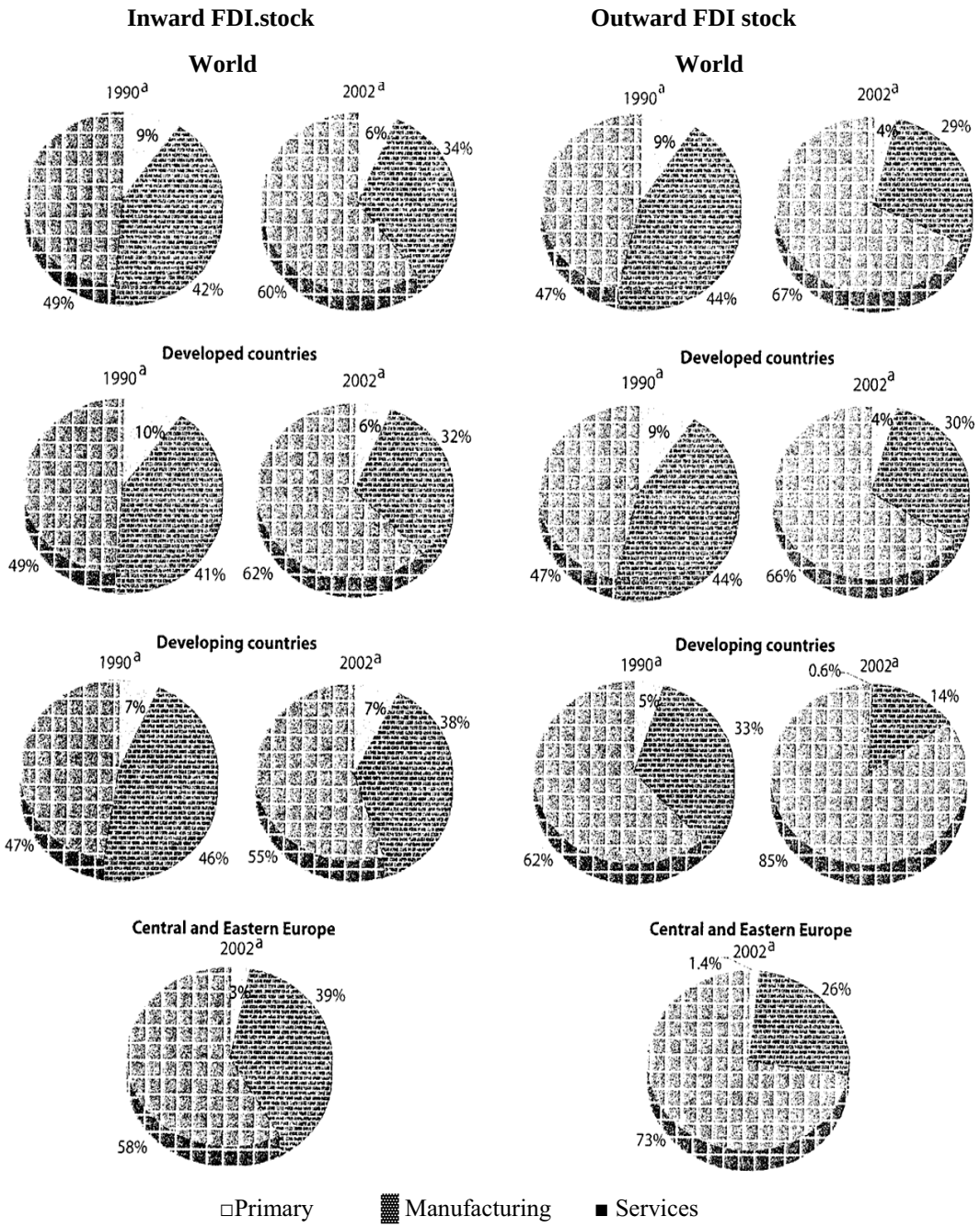
FDI contribution has grown over the time in all three economic sectors, primary, manufacturing and services until 2001. In addition the FDI's contribution to capital formation and investment has grown over the time in all-economic sectors (figure 3.1.7). These are the positive points. However, the flows of FDI according to needs, goals and necessities has been in benefit of the developed economies, the main FDI home countries, through world labour division, specialization and allocation of resources; FDI simply moved to regions and countries where profit opportunities were most favourable. Moreover, other indicators are employed to compare FDI effects, TNCs activities and the significant presence of cross border M&As in various sectors and in different countries. According to World Investment Reports, "[to] a large extent, policy-makers sought to target a large volume of FDI on the assumption that it would make a vital contribution to economic development. This led to the view, shared by a number of experts, that … in recent years the region's FDI policies have focused almost exclusively on attracting FDI, with no concern for selecting or channelling it according to national developmental priorities" (2005 p. 69).

The changing tendencies of foreign direct investors regarding economic sectors are also considered in different levels. Moreover, indicators such as the size of FDI, the number of TNCs and the increasing trend of M&As phenomena in various sectors enable the researcher to

conclude that the FDI sectoral distribution mechanism at national and at the international level was, not surprisingly, primarily shaped by economic factors rather than by social considerations. For example, preferred target countries are those with large markets and corresponding profit opportunities. Consequently, the size of FDI flows into the various economic sectors goes along neoclassical profit-maximising ways and related policies which are entirely different from fair distribution of income and employment considerations. For instance E.J Borensztein, Gregorio, and Lee, suggested that FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than domestic investment. However, the higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital. Thus, FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies is available in the host economy (Borensztein, et al.1998, pp. 115-135), which of course, could not be fit with expectations and the aims of developing economies based on the neoclassical self-regulating theories. For example, on the national level, according to World Investment Report, "significant Chinese investments are planned in natural resources, mainly in Latin America, steel in Brazil in particular, and real estate, in the Russian Federation" (2005, p. 62). However, a contrary and shifting trend was experienced in Latin America; again according to World Investment Report:

> The sectoral distribution of FDI in Latin America varies by sub region and country, and is changing. The services sector has lost importance as a recipient of FDI in Argentina and Brazil since 2001. In Brazil, it was overtaken by the manufacturing sector in 2004, for the first time since 1996. In Argentina, FDI inflows to services reached negative values in 2002. In Mexico, FDI flows to the manufacturing sector recovered in 2004 and surpassed those in services for the first time since 2000. Conversely, in Central America and the Caribbean, the recent privatizations of public utility services in a number of countries contributed to the growing importance of services as recipients of FDI. In the Andean Community, high oil and mineral prices sustained the position of the primary sector as the main recipient of FDI inflows. Several factors are behind the declining flows of FDI into services in Argentina and Brazil:
> • the completion of most of the privatization programmes;
> • strategic changes of some parent companies facing financial difficulties; and
> • economic stagnation (1999-2003), devaluations and the rise of regulatory conflicts, which have made this sector less attractive to FDI since the early 2000s.
> These factors provoked a number of divestments by foreign companies in the services sector . . . . (2005, p.63)

Figure 3.1.7: Sectoral Distribution of FDI stock in the world, developed and developing countries and CEE, 1990, 2002



Source: UNCTAD based on annex tables A.I.18 and A.I.19. World investment report 2004 P. 30
Note: In calculating the shares of the respective sectors, amounts recorded under "Private buying and selling of property" and "unspecified" are excluded from the totals.
a Or latest year available.

3.1.7.2 The National Situation

The pattern of FDI may be different, on the one hand among different countries with varying capabilities and capacities for example, "countries with a good infrastructure bases and appropriate human skill levels, which have become increasingly important in attracting FDI projects" (World Investment Report 2005, p. 47); on the other hand, there are countries which are endowed with natural resources, for example oil producing countries. As a result, the location choices of TNCs between countries are increasingly related to advantages arising from other factors that influence the supply capacities of host countries, such as economies of scale (particularly in the manufacturing sector), as well as institutional and other economic, social and political variables, such as an appropriate level of liberalisation, for example.

> . . . in many developing countries , the growth of high-technology clusters in developed countries and the use of clustering as a tool of industrial strategy. It is therefore to be expected that the location of TNCs in home and host economies reflects agglomeration forces. . . . Clusters of competitive domestic firms tend to attract foreign firms to their proximity, enhancing geographical concentration and specialization. In Austria, a half of all foreign affiliates are located in Vienna (World Investment Report 2001. p 59).

Indeed, "TNC's are more and more attracted to clusters of knowledge, and seek to upgrade ownership advantages by tapping into location-bound sources of collective learning and innovation; incentive structures in host countries also play a role. [This is particularly important for developing economies because TNC's activities are pleasing in developing economies because they are interested in more technology-intensive activities (including innovative activities),] as evidenced by its concentration in a limited number of countries"(World Investment Report 2004, p.31). In the services sector, according to World Investment Report "the global FDI stock more than quadrupled during the period 1990-2002. As a result, there is more rapid growth in this sector than in the other sectors, services accounted for about 60% of the global stock of inward FDI in 2002, compared to less than 50%, a decade earlier" (2004, figure 1.18). In terms of inflows, "the increase in the share of services between 1989-1991 (54%), and 2001-2002 (67%) was even larger than that of the stock" (2004, figure 1.18). "[Moreover, inward] and outward FDI, both flows and stock, in services grew in most countries, as did the share of services in overall FDI flows and stock" (2004, pp. 22-23).

3.1.8 Conclusion

In the liberal view, FDI is one of the important wheels of the modern economy that expands international economic relations in an international free-market-cum-free-trade system associated to globalisation. In this view, different factors structure the foundation of this evolutionary process, such as, self-regulation of markets, individualism, marginal productivity of capital, interest and returns, and the principle of relative cost advantages, new technology, know-how and skills, which all depend on economic aims, theoretical foundations, policies and their implementation. For example, while the market-seeking policies, based on liberal free-market theory, have had a dominant role in developing economies, the resource-seeking policies also have played a great role in some developing economies. Even recently, market-seeking policies were predominantly pursued by international corporations, in both developing and developed economies. This is the case, for example, in countries with developing economies, like China, Brazil and Argentina.

However, this brings about a complex situation because of the various kinds of facilities that could be obtained from abroad, such as human skills in the form of managerial, engineering and expert groups, which include technical abilities and knowledge, soft and hard wares, new technologies as well as real and monetary forms of FDI. These foreign facilities gradually have increased and are invested in sectors with the best competitive positions and also in the sectors with the highest rate of value added in the host countries, in accordance with the aims of guest investors. But some points must be learned. First there is some doubt whether the flows of foreign investment, above all FDI, assist developing economies appropriately as is expected by dominant neoclassical theory. This important point will be taken up in chapter 4 below.

Second the short-term progress initiated by increased effective demand does, eventually, not continue creatively in the long run in the developing countries receiving FDI; in fact, these countries are limited in the process of ongoing world division of labour and world specialisation. As a result, neoclassical doctrine based upon the vision of a self-regulating economic mechanism is not able to theoretically justify the real effects of FDI, which have very different effects in the recipient and the investing countries.

This problem has been analysed through a glance at the reality and evidence of FDI, by different data, sectors, countries, regions and the world as a whole. The data show that FDI has been always been growing during the time-periods considered, except between 2001-2003

(Table 3.1, and Figure 3.1.6). However, the growth of FDI very greatly differs between regions, countries and even economic sectors within a country. This is, presumably, the main for the increasing inequality between regions, countries and industrial sectors. As World Investment Report states, "the pattern of FDI may be different among countries with similar endowments and resources. The locational choices of TNCs between countries are increasingly related to advantages arising from other factors that influence the supply capacities of host countries, such as scale economies" (2004, p. 31). This eventually should also be considered when looking at distribution of FDI in the various economic sectors. Again, according to the World Investment Report:

> The industrial pattern of FDI in manufacturing differs among different home and host countries. Developed countries' outward FDI in manufacturing shows that FDI is concentrated in technology-intensive industries, while TNCs in those countries having abundant low- cost labour, this often develops ownership advantages in more labour-intensive industries. In the case of inward FDI, its industrial distribution largely reflects, on the one hand, the size of markets (reflecting GDP and per capita GDP), and on the other hand, the structure of the comparative advantages of the countries, based on immobile location advantages. (2004, p. 31)

Efficiency-seeking strategies have also contributed to the increase of FDI in the developing economies. Nevertheless, the related experiences are not very well documented, probably due to the fact that the process started somewhat later in industrializing economies than in industrialized countries. Technological progress is viewed as an incremental and cumulative capacity-building process that occurs through sustained investment in the absorption and application of new knowledge and skills (Trevino et al.1999, p.30). In addition, the progress in telecommunications, and a superior transportation system are both related with transferring FDI capital-intensive industries. This allowed the countries to improve the level and size of their economic activities (Jomo 2002, p.125).

However, as a result, first labour has been increasingly replaced by capital and knowledge. In an unregulated trend, countries with developing economy with low-cost labour advantage are also increasingly attracting FDI through capital- and technology-intensive industries (Trevino et al. p.30). According to an ILO Report, "there are two major reasons for the declining importance of labour-intensive FDI [for example] in manufacturing: First, there has been a decline in labour-intensive manufacturing in general, and second, the share of traditional manufacturing employment has also steadily declined" (ILO Report 2001, p. 109).

In addition, technological change, including advances in telecommunications and

information-processing in the technology, has also been a key element in the decline of labour-intensive FDI in manufacturing for example. But, as far as technology transfer is concerned, the evidence shows rather weak spill over effects. In fact foreign firms do not seem to have had a significant contribution to upgrading the economic pattern of countries with a developing economy, such as a better distribution of income and a higher rate of employment. China, for example, despite sustained high growth, has faced problems of transitional unemployment that are likely to intensify with the stepping up of the reform of State-owned enterprises. Similarly, as evidenced by the Asian financial crisis, "even countries with exemplary past records of economic performance can suffer heavy social costs" (ILO 2004, p. 35).

In addition, Prasard et al stated: " in 1990 Robert Lucas pointed out that capital flows from rich to poor countries were very modest, and nowhere near the levels predicted by theory. Financial globalization has, of course, surged in the past decade and a half. What then has become of the empirical paradox that Lucas identified? .[The fact is that] capital has been flowing from poor to rich countries!" (Prasad et al. 2007, p. 16). This is a very important point indeed to be dealt with to some extent in chapter 4 below.

The paradox becomes more complex, as was historically explained at chapter 1 and 2. Moreover, an unexpected phenomenon has emerged regarding the explanation of economic phenomena by neoclassical theory on the basis of self-regulating markets, specifically demand curves for factors of production. Indeed, higher factor prices, interest rates for example, do not imply that capital is scarce, leading on to larger inflows of foreign resources, FDI for instance. This is an important implication of the capital-theoretical debate (Bortis 1997, ch. 5, pp. 281ff.). Moreover, there are increasing amounts of money fleeing from economically poor countries to rich countries.

However, on the one hand, in a neoclassical microeconomics perspective, the sum of all companies' decisions determines probably how much FDI each country receives. The portion of FDI each country receives largely varies over time, relative to countries' opportunities and risks, economic and social capabilities, infrastructures, technology and trade relevant advantages and manager's perception. This in a neoclassical microeconomics outlook is also the reason, why the opportunities and risks of FDI must be calculated (Trevino et al. 2002, p. 30).

On the other hand, simultaneously, from the macroeconomics point of view, the socio-economic effects of FDI flows – on employment and distribution, for example - differ widely among the recipient countries (Kurz and Salvadori, 1998) Nevertheless, according to Yean

(1998) all countries took it for granted that, under supposedly free market conditions, FDI effects would be positive and competed to receive more shares of the limited FDI flows (Trevino et al. 2002, p. 30). Laplane and Sarti (2001) confirm the fact "that the main determinants of FDI in Brazilian manufacturing are related to the size and the potential growth of the domestic market" (Chudnovsky 2002, p. 122) Therefore, from a practical point of view, making decisions is not on the same bases in developing and in developed economies (Damyanov, Atanas and Dragomir Lliev, 2000, pp. 407-415). For example, Porta (2001) emphasises that the domestic market has been a key determinant of FDI (Chudnovsky 2002 p.123). Moreover, to evaluate the effects of FDIs, political, social and economic factors, dependent on outside and inside elements, external and internal and endogenous and exogenous variables, have to be considered (Meier 1995, p. 228).

Given this, such complex situations will probably require a comprehensive and holistic analysis based upon political economy – a partial, purely economic analysis will not suffice. A comprehensive political economic approach has the potential to set out, probably though, the conditions under which FDI flows are appropriate for a country in a specific situation. This would imply taking advantage of all the internal and international opportunities related to a limited resource potential for a given period of time so as to achieve a maximum level of employment and a socially appropriate distribution of incomes. Hence, as in earlier chapters, effects of FDI on employment and the distribution of income as the two basic socio-economic criteria, are examined by considering empirical data at a world level. This is to consider the effects of economic policies associated with market reforms, based upon micro and macroeconomic neoclassical economic policy advice in order to attract FDI. Here, a number of closely related factors are considered to explain the effects of FDI on countries with a developing economy. This goes far beyond factors related to both distribution of income and employment, and even growth. For example, the change in trend of the distribution of FDI, economically, historically and geographically, starting from the early twentieth century until now is another dimension of the study.

The next problem emerged in a situation of high interest rates and also permanently high rates of inflation in developing economies. This led to low investment volumes, and consequently, high rates of unemployment. Given an unstable effective demand, the rates of gross fixed investment remain at low levels and this increased uncertainty and investment risk during the period. This, in turn, had negative effects on domestic and foreign investment. According to Chudnovsky, for example in Brazil, "when the context of high interest rates

appeared in the1990s (real average interest rates of approximately 20 per cent) the rate of gross fixed investment remained at low levels (around 19 per cent since 1995), with the exception of some domestic economic groups directly participating in the privatization process, the size of Brazilian private firms and groups has been generally shrinking" (Chudnovsky 2002, p.122). This implies that developing economies have been damaged by a chronic deficit in the balance of payments and by tiny shares of domestic private investment in gross fixed investment. Such a situation created the best possible opportunities for the activities of foreign investors. This showed up in the rapidly expanding activities of TNCs and in the growing number of M&As. In addition, the technological and spillover effects of FDI are additional reasons that make developing countries keen to attract FDI through TNCs and M&As actions (World Investment Report 2005, p. 99). In this regard, FDI inflows also have helped to finance the balance-of-payments deficits. Nevertheless, with respect to the increasing amount of FDI in the whole and in comparison to total transferred capital, it is significant to note that the volume of investment in the developing economies was very low even during the golden FDI period 1990s. This important fact is to be explained in the next chapter. We may already remark here that long-period effective demand governs long-term investment.

Moreover, FDI played a key role in the privatization process, for example in Argentina. According to Fernando Porta "[the] data show that privatization accounted for 40 per cent of FDI in 1990- 1998" (Chundovsky, 2002 p.124). In addition it is important to say that, compared with overall capital formation, the amount of FDI in most developing economies is insignificant on the whole, especially when one takes into account the very uneven sectoral distribution of FDI. For example FDI did not participate in R&D and innovation in countries with a developing economy, that is in high-tech products (World Investment Report 2005, p. 99). This is very important since it, probably, implies that the technological dependency of developing countries from developed countries remains. It is also clear that investment embodying advanced technology in traditional industries' sectors does not mean permanent technological progress. Indeed the domestic know-how to reproduce technologies is, as a rule, lacking in developing countries. The reason is that education is not basic in development plans. In fact this is not possible since development plans are, as a rule, of a medium term nature. Education, however, is, necessarily, of a long-term nature.

These circumstances, particularly outside dependency, have created good opportunities for foreign investors to acquire local private firms at low prices in ongoing privatization processes, and through mergers and acquisitions. However, on the one hand, liberalisation and

the privatization process have been, as a rule, unmanageable, because of internal economic problems, such as the lack of a strong production structures, in fact, of economic structures in general, the absence of human and real capital to a sufficient degree, an almost total lack of R&D activities, insufficient distribution channels, not enough private banks backing up production, inappropriate laws, the presence of social and political instability and crisis, irrelevant government bureaucracy. On the other hand there were external political and economic problems, such as the intense competition on international markets that developing countries simply could not cope with, because of the before-mentioned lack of economic and legal structures. As a rule, developing economies are terribly affected through the instability and crisis situations in international markets, for example the Asian economic crisis in 1997-1998. Hence the external vulnerability has greatly reduced the marginal efficiency of capital. Indeed, according to Transnational Corporation: "Economic, social, political and institutional problems have accumulated since 1995, resulting in an increasing risk of a serious institutional crisis, especially after the external shocks of 1997-1998" (Transnational Corporation 2002, p.124). [For example], ". . . in Latin America, the Brazilian economy has performed poorly since 1995. The average annual real GDP growth rate was 2.5 per cent in 1995-2001, i.e. an annual GDP per capita growth rate was just 0.9 per cent. . . . increasing external vulnerability was also a key feature of Argentina [economy]" (2002, p. 122). There are also important differences across industries . . . [in a comparative microeconomic view, for example], Porta also calls attention to the high social cost of the industrial restructuring process in Argentina, in which foreign firms played a major role. The destruction and disappearance of local firms has inhibited externalities. Besides, the lack of industrial and technology policies has resulted in a lower benefit/cost ratio" (2002, p. 124).

In addition, "Porta argues that, in Argentina, not only the contribution of FDI to capital accumulation, technological innovation and the upgrading of trade patterns have been rather small but also that FDI inflows have been associated with an increasing concentration and centralisation of capital in Argentina" (Transnational Corporation 2002, p. 124). This produces yet another conflict with neoclassical free market doctrine as discussed below, which focuses on decentralization and competition. Here there is a paradox where, according to Streeten, "the combination of a weak, minimalist state and well working competitive markets does not exist. State minimalism and priceism do not go together. In Sought Korea and Taiwan the Invisible Hand is guided by a strong Visible Arm" (Streeten 1995, p.235). The reason is that in a majority of countries with a developing economy, governments are the unique investor and

customer, the whole being based on fragile resources. For example: "Governments in Latin America have had a pervasive influence on their societies. Historically, they owned major firms and had significant regulatory powers. In a very real sense, the line between business and government was unclear; this created uncertainty for foreign investors in Latin America" (Travino 2002, p. 32). As a result, precise and performing government intervention was not possible in view of outside economic and political interference. For example, Iran and many third world countries, have hopelessly tried to become members of the WTO to be able to trade under fair conditions and to escape unjust trade conditions imposed on many developing countries many years ago. As a result, it is remarkable that since 1970s, FDI has become the main vehicle for the countries with a developing economy to take advantage of globalisation on the basis of development plans. This is the reason, why so many developing countries are now seeking to attract FDI, and, how much attracting FDI faces economic risks in an international political policy background is important. For example, "TNCs would logically prefer certainty, especially in their ability to move funds to meet shareholders' expectations. Capital account restrictions create high uncertainty that may exacerbate the higher risk that TNCs face simply as a result of operating in an unfamiliar setting" (Travino 2002, p. 42).

As a result, attracting FDI is rendered more difficult through attempts to minimise the degrees of the risk of implementation under extreme free market conditions and the associated institutional preconditions, in the legal sphere, for example. The purpose of the institutional preconditions is to reduce uncertainty. Both the reduction of calculable risk, due to a foreseeable struggle for market shares for instance, and of incalculable uncertainty, regarding a change in property rights for example, play a significant role in attracting FDI. Both risk and uncertainty have probably increased in many countries with a developing economy, such as Latin American countries or the former socialist countries in central and Eastern Europe, and remain very high in the Middle East. This shows up in the fact that FDI flows to the area have remained relatively small. Indeed, the volume of FDI inflows to U.S.A has increased sharply, and contrariwise, FDI inflow to developing economies has decreased dramatically over the past few years (2001-2004), especially in comparison to the FDI record flows in the "golden" 1990s. This is far away from the predictions that would follow pure neoclassical economic theory. As a result, the world economy does not show a clear trend following up September 11, 2001, given the fact that the future is a black box for the time being.

At present, the world economy is under the shadow of US economic, political and military hegemony, US having remained the unique political, military and economic

superpower and a symbol of the neoclassical liberal economic system. Given this, considering the neoclassical view as a whole, and what happened after September 11, 2001, it can be said that the market system is extremely unstable and is in line with and dependent on American supreme power; for example, after the event, developed economies' FDI outflows broke down, after having reached a peak of 1046.3 billion in 2000; subsequently FDI rose again and, finally, reached about 637.4 billion in 2004, perhaps because of American economic policies, like imposing the world economy to pay its cost, by money devaluation. It is difficult to see how the developing countries will be able to pursue their economic development plans through relying on the neoclassical external market mechanism, when, for example, they lost about 100 billions FDI resources, compared to an inflow of 240,2 billions to the developing countries in 2000 and inflows of 166.3 billions in 2004 (Table 3.1. 16).

Moreover, the increasing external liabilities of countries with developing economy have given rise to greater external vulnerability. For example, the data show a significant increase in FDI flows to Latin America since 1988, but much of the recorded flow is due to debt conversions and debt-equity swaps, and to privatisations (Transnational Corporations 2002, p. 124). In this regard, the servicing of the external debt and the stock of foreign capital has become a growing impediment to the development of a great number of developing economies, Argentina being an important case in point.

Finally, fundamentalism characterises policy attitudes towards FDI in an important way. As a rule, the dominating policies are shaped by the developed countries and imposed on the developing ones. In most cases, these policies are of a neoclassical – free market – nature, rarely the emphasis is on alternative theories. Fundamentalism brings in an element of rigidity at the expense of flexibility that would be badly required in many developing economies.

3.2 A Case Study of Iran

3.2.1 Introduction

Many economists believe in FDI as a good opportunity for developing economies but others do not think so. The purpose of this section simply is to expand this study into a case study, to make clear to some extent the effects of FDI on the economy of Iran, a country with a developing economy. The general objective of the present study is to gain greater insight into the extent of the economic effects of FDI on the Iranian economy and the probable impact of FDI on distribution and employment in the past and at present. For this purpose, various historical sketches and a set of socio-economic statistical data are put to use in order to explain the position and to examine the effects of FDI on the Iranian economy. It should be realized that this way of proceeding is far from universally agreed. It is quite rational to argue that a country should not adopt a goal as others do (Myrdal 1968, p.1869), on the contrary, those who are optimistic would argue that some values are universally valid (Meen 1988). Here both points of views are to be considered. For example, the GDP per capita, that is a universal measure, on one side, and a variety of social and economical criteria, specific to a country, on the other side. In addition, both indexes, level of employment and distribution of income are examined. The criteria used here will concentrate on the macroeconomic level, and national account items, such as the current account, foreign payments account, and ratios referring to economic criteria, for example the overall rate of growth, distribution of income and employment, GDP per head, FDI levels and annual average rates of growth in GDP per year in particular. Moreover, the distribution of investment and income per capita in different economic sectors, the rate of illiteracy and other social indices, will be compared with the ratio of population who live below the poverty line in rural and urban areas, all these data are requied to broadly examine the effects of FDI on developing economies, in this case the Iranian economy. The research will be divided into three parts.

First, we deal with Iranian economic development and the associated historical background, including the history of FDI in Iran. The principal research tools, which have been used here, are extensive and structured data. These data allow comparing the economic and social foundations of the country for several time-periods regarding macroeconomic and national accounts.

Second, the survey continues through analysing investment, employment and distribution. Moreover, the following objectives have been pursued to set forth in detail the effects of FDI on Iran's economy and social profiles based on recent data and to measure the absorption of FDI in various economic sectors and activities, including regional activities. In the third place, some tentative results and propositions regarding the impact of FDI on the Iranian economy and society are presented. This case study reflects the theories and policies that have been used to shape the Iranian economy. A particular emphasis is laid on presenting correlations or relationships regarding the probable effects of FDI on the Iranian economy, most importantly on employment and distribution. Finally, the economic effects of FDI on Iran's economy are to be reviewed.

3.2.1.1 Iranian Development at the Background of Economic History

The first serious attempts for economic development in Iran began under Chief Minster Amir Kabir's administration (Mirza Taqi Khan 1807-1852). A reform aimed at increasing the economic performance of the country was carried out during1848-1851 (Ashraf and Banuazizi 2005). It was a serious economic governmental attempt aiming at modernizing the country during the Qajar Dynasty (1794-1925). However, subsequent further actions took place only gradually. For example, the education reform of 1886 motivated the outstanding students to learn advanced sciences from abroad and transfer modern industries inside the country (1889); people were encouraged to consume domestic goods and the capitalists to establish firms in the country (Adib 2001, p. 87). However, the next steps were undertaken only after the collapse of Ghajar king in 1925. Ambitious programs were implemented in view of establishing a new economic system. A modern education system emerged alongside the new social and economic system. As a consequence, academic activities developed within modern universities, new industries were established and new social classes came into being, such as technocrats and industrial workers and finally a plan was set up to implement a state budget, to shape consumption pattern and manage resources, incomes and costs. Economic growth as captured by relevant indices was considerable at this time. For example, the amount of the budget allocated to industries in 1941-1942 was 50 times greater than in 1934-1935; at the same time the share of expenditures devoted to trade and industry in the total state budget had risen from 3.5% in 1934-1935 to 24.1% in 1941-1942. The number of industrial sectors from 22 to 295 units, including, airplane factories, manufacturing construction, textiles and so on (Hosseini, 2002, p. 74).

3.2.1.2 Foreign Investment

Iranian international exchange with the West has a long history. In fact, there were trade relations with England since the time of Elizabeth I (1558-1603). Trade relations were unequal; indeed, England "dispatched trade envoys to . . . Persia [since 1567]. Britan's massive investment in building its naval supremacy allowed it to break into new markets and often to colonise them and keep them as captive markets" (Chang 2002, p.21). Early in the 19th century the first foreign investment agreements were signed with England as the biggest economic power. This resulted in unequal treaties. According to Chang "Persia signed unequal treaties in 1836 and 1857" [this went on in the first half of the 20th century], (Chang 2002, p. 54). On the basis of these treaties, 217 economic agreements in all, England has invested directly in Iran about £ 68.9 million (Abasi 2002). Similar unequal treaties were signed with Russia, from 1862 to 1913, in fact 27 treaties led to investments amounting to 99.56 million Rubles, (Zenooz 2001, p. 55). But this investment activity was not carried on, because, on the one hand, Iran was occupied by two allied nations, England and Russia, during World War II, in spite of the fact that, it was a neutral country and, on the other hand, because of Iran's endeavours to keep the country independent and, subsequently, to nationalise the Oil industry (Hosseini, 2002, p. 75). This type of 'interference' relationship was practised by other countries after World War II, for example, the U.S. and Japan and some European countries; this was based on a foreign investment and assistance law, enacted in 1955. Foreign investment agreements were of various types. For example during 1966-1977, 28 percent of foreign investment agreements were related to technical assistance, 9.26 percent were allocated to rights of representation, 9.14 percent was invested in construction, 8.13 belonged to exclusive agents, 7.9 percent guaranteed repairing services, and 7.6 percent of investment belonged to know-how goods of the technical advisers. On the other side out of 150 treaties concluded between the years 1971-1977, 57 treaties were concentrated on electric machines and industrial tools and capital goods (Abasi, 2002). Revolution in 1979, 8 years war with Iraq, a huge immigration (about 3'000'000 persons) consisting mainly of unskilled labour, and a huge brain drain, about 1'500'000 top-educated persons, who emigrated to developed countries, and especially the US have greatly benefited from the pool of highly educated and experienced Iranian immigrants, economic sanctions and capital outflow, which was estimated about 200 to 400 billions US$, that was mostly invested in the U.S, Canada, China and some European countries (Baldwin 2002), severely damaged Iran's social and economic infrastructures and left the economy in ruin.

After the war in 1988, Iran began to rebuild her economy relying on not only domestic

capacities but also foreign capital that is borrowing from abroad, loans and foreign direct investment.

This study tries to analyze the effort made in Iran to modernize the economy and the results produced by using chronological, that is time-series, data. First, to analyze the five- year plans is the best way to study, firstly, the alteration of theories, policies and the aims pursued through organized programs and, second, to compare the data individually to examine the effects of the attracted direct foreign investments. In addition, there is a short comparison between Iran and other countries based on recent data to get a rough picture of the advantages and shortcomings of foreign direct investments on the economies considered.

3.2.2 Iranian Economic Development Plans

3.2.2.1 Iran Economic Development Plans before the Revolution

3.2.2.1.1 The First Long-term Economic Development Plan

The occupiers left Iran shortly after World War II, and the first long-term economic development plan was established in the form of a seven-year plan, 1948/1949 to 1955/1956. The development plan concentrated on economic development aiming at providing the country with modern industry. It was clearly a national-based industrialization policy similar to that pursued in Europe during the reconstruction period after World War II based on reforms involving the nationalization of key industries. During the period in question the state budget amounted 21 billion Rials, with a 3 billion Rials share going to industry and mining, 14.3% of the total budget, an amount never, even approximately, realized in the past (Hosseini 2002, p. 75). However, the plan could not be implemented completely because of obvious political foreign intervention through FDI. An evident example is the role of FDI in overthrowing the national government of Prime Minister Mossadeq that was a part of an agreement to establish the dominant socio-economic and political role of FDI in developing countries. The following quotation taken from a document by Dr. Donald N. Wilber clarifies this point:

> The policy of both the US and UK governments requires [the] replacement of Dr Mossadeq as [an] alternative to [a] certain economic collapse in Iran and the eventual [loss] of the area to the Soviet orbit. Only through a planned and controlled replacement can the integrity and [the] independence of the country be ensured. General Zahedi is the only figure in Iran currently capable of heading a new

> government who could be relied upon to repress Soviet-Communist penetration and carry out basic reforms. The plan which follows is comprised of three successive stages. The first two stages precede action of a military nature. They include the present preliminary support period and the mass propaganda campaign[paragraphs below]. These stages will be of real value to the mutual interests of US and UK even if final military action is not carried out in that they will make the position of Mossadeq increasingly vulnerable and unsteady. The total estimated expenditure required to implement this plan will be the equivalent of $285,000 of which $147,500 will be provided by the US Service and $137,500 by the UK Service.
>
> 12.2 OPERATIONAL PLAN,
>
> 12.2.1 Preliminary Support of Opposition to Mossadegh Government
>
> For a period of several months both, the US field station and the British group (the Rashidian brothers), have been in close touch with Zahedi. The British group has supplied the equivalent of $50,000 (about four to five million rials) for this support.
> During this preliminary period beginning 1 June 1953, and for an estimated two months maximum thereafter, the United States will provide $35,000 and the United Kingdom the equivalent of $25,000. Initial payments under this allocation have already been made by the US field station. British funds will continue to be paid through present channels for purposes as directed by the UK or by the US field station on UK behalf. US funds are to be distributed through direct US field station contacts for the specific purpose of extending and strengthening military and political contacts of Zahedi. Early in this period Zahedi will be made fully aware of this dual support and of the joint intention that should lead on to even more concrete support. During this period the impression will continue to be given in the circle of Zahedi's contacts that the Shah is supporting him by the provision of funds. The coordination of UK-US field station activity on the developing plan will be achieved through direct contact between US field personnel and the British group with the former acting on behalf of the United Kingdom by relaying instructions and acting as a secure communications link, to augment that already existing. Appropriate steps will be taken to ensure that overt US policy will conform as closely as possible with the purpose of this plan. (1969, p. 49)

Consequently the national plan to lay the basis for economic development remained sterile and domestic market was invaded by foreign producers and their goods under a liberal trade policy. The "coup d'état" was, in fact, a "coup de grace" to a sound development of the Iranian economy. The policy actually pursued under the Shah regime also produced a very unequal distribution of income and brought about social injustice to a high degree (Hosseini 2002, p. 75).

3.2.2.1.2 The Second Economic Development Plan

The budget of the second economic development plan, 1955/1956-1962/1963, was about 84 billion Rials. It included a 39.8% share of transportation and communications, a 31.1% agricultural share and 11.8% went to industry and mining. In this period, industrialization policy and privatization policy went together and a foreign investment law was enacted (1955/1956) simultaneously. This provided the basis for Truman's point 4 Doctrine (Harry S. Truman 1884-1972, 33rd president of the United States 1944-1952, for more information on his Doctrine see Kuttner 1991, p. 48). As a result stagnation and inflation appeared because of a huge accumulation of sterile money; in fact, in Keynes's *Treatise on Money* terms, money moved from the industrial circulation into the industrial circulation. Probably, this was mainly due to the income inequalities that developed rapidly. Simultaneously the international prices of capital goods and consumption goods (imports) went up during the plan period, resulting in worsening terms of trade. All these factors brought about the failure of the second plan in achieving its goals. Nevertheless, during the plan period the industry sector improved very fast, starting, however, from a low basis. For example, the units of industries rose from 45000 units in 1957-1958 to 70000 units in 1960-1961. At the same time, the rate of employment increased by 20 % and the oil industry was associated to the plan with US$ 219.2 million (Ostad Hossein 2002, p. 275). The average rate of per capita income during the period also rose to about 5 percent for the three last years of the plan-period. Clearly, this was related, first, in a stable ratio of total rate of investment to GDP, the average being 11.8 for the last three years, and second, was due to the world prosperity period of the 1960s. The world economy was characterized by rapidly increasing international trade and capital movements. Nevertheless, the role of foreign investment was not important in Iran. Yet, this seemingly favourable development of the Iranian economy was characterised by sharply increasing income inequalities, resulting in the increase of luxury production, not of necessities (Table 3.2.1).

Table 3.2.1: The important Criteria of the Second Development Plan 1955/1956- 1961/1962 (1334-1340) (Billion Rials)

Years	GDP 3	Percentage Change	Population (person)	Per Capita Income (Rial)	Private Investment	Government Investment	Total Investment	Private to Total Investment Ratio %	Foreign Loan	Net Foreign Investment 1000 Rrials	Total Foreign Investment to GDP %	Total Investment to GDP %
1955-56	-	-		-	-	-	-	-	-	-	-	-
1956-57	-	-	18954704	-	-	-	-	-	-	8100	-	-
1957-58	-	-	19638106	-	-	-	-	-	-	6000	-	-
1958-59	-	-	20321508	-	-	-	-	-	-	13400	-	-
1959-60	2321.6	-	21004910	110527	160.2	104.6	264.8	60.5	-	9800	0.004	11.4
1960-61	2534.8	9.2	21688312	116874	204.6	95.9	301.5	68	-	8500	0.003	11.9
1961-62	2682.5	5.8	22371714	119906	215.5	108.1	323.6	66.7	1.2	6500	0.002	12.1

Sources: Economic report, Central Bank of IRI and Iran central Statistic institution reports
1- Figures are at Constant 1982/83 Prices
2- The population quantities are estimated just the population quantity year1956/57 is census.
3- GDP at factor of production price

3.2.2.1.3 The Third Economic Development Plan

The third plan was programmed for five years 1962/1963-1967/1968. The budget credit of third plan was fixed at about 222.4 billion Rials, but only about 204.6 billion Rials were used up (92% of the enacted budget). The important industrial goals of the plan included introducing and establishing industries that promote the growth of national income, improving the import substitution industries to economize on foreign exchange by reducing the import of goods, increasing the foreign exchange earnings through promoting exports, increasing the number of factories and finally encouraging the privatization (Third development plan report, Iran, Budgeting and planning organization, 1968/1969). The import substitution policy was the strategic decision this plan was concentrating on; this also holds for the next two plans before the revolution. The government encouraged the domestic and foreign investors to invest in the consumption and industrial goods sectors, and, attempted to create particularly favourable circumstances for investing in the industrial goods sector. As a result, the average ratio of investment to GDP ratio rose to about 13 percent per year. The performance report shows that the average growth rate of industrial value added was 11.8 percent; this rate was substantially higher than the yearly average annual growth rate of gross national production (GNP) which was 9.8 % at that time. The share of industrial output in gross national production increased from 5.4 in 1962/1963 to 5.9 in 1967/1968. The amount of industrial investment reached to about 66 billion Rials and, in spite of all the emphasis that had been laid on privatization policies, the government had an important role. However, given the modernist orientation of the plan, the rural community and the small industries were entirely neglected – the dual economy and the division of society came into being (Hosseini 2002, p 80). In this time period, income rose because of an increase in the oil price that was due to the Arab - Israel war. Although the growth of small and medium-sized industries and the level of employment was negligible, the value added in the large and modern, capital-intensive industry, grew by 11.8 percent per annum in the plan period, because of an investment volume of 66 billion Rials in the modern sector. At the same time, the proportion between rural and urban population changed significantly. Out of the active population in 1956/1957, 30.6 percent of employees and workers were working in the urban area, while 69.4 were living in the rural area. This changed to 36.7 and 62.3 percent in 1966/1967. Therefore, at this stage a great emigration from rural to urban areas took place. And large differences in the distribution of income and in the level of employment between two areas began to appear. The dual economy with low incomes in the rural areas and, probably, substantial involuntary unemployment in both the rural and

urban areas began to appear.

Table 3.2.2: The important Features of the Third Development Plan 1962/1963-1967/1968 (Billion Rials)

Years	GDP at factor of Production Price	Change %	Population (persons)	Per Capita Income (Rial)	Government Investment	Private Investment	Total Investment	Private to Total investment Ratio	Investment Per capita Rials	Total Investment to GDP %	Foreign Loan
1962-63	2851.6	6.3	23055116	123686	101.1	212.1	313.2	67.7	13585	11	0.0
1963-64	3032.7	6.4	23738518	127754	134.5	215.4	349.9	61.6	14740	11.5	0.0
1964-65	3281.9	8.2	24421920	134383	132.5	260.3	392.8	66.3	16084	12	0.0
1965-66	3738.3	13.9	25105322	148905	233.8	293.9	527.7	55.7	21019	14	0.0
1966-67	4089.6	9.4	25788722	158581	218.4	309.5	527.9	58.6	20470.2	12.9	0.0
1967-68	4798.9	17.3	24747304	193916	313.7	355.7	669.4	53.1	27049.4	13.9	6.2

Sources: Economic report, Central Bank of IRI and Iran central Statistic institution reports
1- Figures are at Constant 1982/83 Prices
2- The population quantities are estimated just the population quantitative year1966/67 is census

3.2.2.1.4 The Fourth Economic Development Plan

The aims of the fourth development plan 1968/1969-1972/1973 were to accelerate economic growth and to increase the capacity of production to further develop the economy, a more equitable distribution of income and a higher level of employment. The industrialization policy, import substitution, increased diversity of exports, increased domestic production in view of reducing import dependence were the important policies that employed during the plan period. The budget credit of the plan was set at about 480 billion Rials at first - in 1968-69 – but was, simultaneously with the enlargement of the industrial sector (18.3 percent), expanded to 568 billion Rials in 1971/ 72. With 22.3 percent of the total budget, the industry and mining sectors became important parts of the economy. The primary goals of the fourth plan were the following. First, the share of industry as a proportion of GDP ought to expand from 14.1percent to 17.3 percent. Second, there was a serious attempt to diversify production to substitute for imports. Third, 400000 new work places in industry were to be created. In the fourth place, an important emphasis of the plan was to limit the import of consumption goods; however, to establish the basis for economic development, intermediate goods and capital goods were to be imported at a larger scale. The import of capital goods should lead on to increased long-term independence in the economic sphere through being able to produce capital goods domestically (Hosseini 2002, p. 82).

The role of the government with 53.7 percent of total investment in 1968/69, compared to 32.3 percent in 1962/63 with a great amount of loans, became very important. In addition, contrary to the increase in per capita income, the share of consumption in gross national production decreased during 1972-1977. This widened the gap between social classes.

Table 3.2.3: The basic Features of the Fourth Development Plan 1968/1969-1972/1973(Bilion Rials)

Years	GDP at factor of production price	Population (persons)	Per Capita Income (Rial)	Private Investment	Government investment	Total Investment	Total Investment to GDP	Investment per capita	Private to Total investment Ratio	Foreign Loan
1968-69	5104.2	25430638	200711	346.2	402.2	748.4	14.7	29429	46.3	6.6
1969-70	5747.9	26132236	219954	357.4	435.8	793.2	13.8	30353	45.1	15.0
1970-71	6333.6	26850506	235884	434.2	452.7	886.9	14.0	33031	49.1	30.3
1971-72	7327.5	27587750	265607	481.0	561.6	1042.6	14.2	37792	46.1	25.9
1972-73	8597.8	28345749	303319	639.9	616.6	1256.5	14.6	44328	50.9	9.1

Sources: Economic report, Central Bank of IRI and Iran central Statistic institution reports

1- Figures are at Constant 1982/83 Prices

2- The population quantities are estimated just the population quantity year 1971/72 is census.

The relative decrease in consumption on the one hand and high investment levels and growth rates on the other hand reflects that basic post Keynesian trade-off between growth and distribution, which is temporary only. In a way, it is inevitable that in period of high growth consumption is restrained. However, in Iran there was at the time a large fundamental or institutionalised inequality in the distribution of incomes and wealth. This implies that a large proportion of the demand for and production of consumption goods was for non-necessary consumption goods. As a consequence, one has to conclude that the living standards of large parts of the population stagnated or, probably, even declined. This is typical for a dual economy and society associated with uneven development, characteristic not only of Iran, but of a great number of developing countries.

3.2.2.1.5 The Fifth Economic Development Plan

The budget credit of the fifth economic development plan 1973/1974-1977/1978 was 1560 billion Rials. This amount was divided into three parts: 7.7 percent for public consumption, 30.1 percent for social purposes and 62 percent were directed to the economic sphere. The latter amount increased during the Oil crisis in 1973/1974, specifically regarding the economic domain in general, communication, industries and oil production.

The annual – target - rate of growth of industrial output was set at 17 percent and value added had a 20 percent annual growth rate. It also concentrated on setting up new industries and developing existing industries that were efficient and self-sufficient enough to take advantage of comparative advantages to export. The proportion of employees who worked in urban areas was 46.7 percent to the 53.3 percent working in rural areas in 1976/77. This shows how the industrialization policy affected society. The average private investment share was 45.6 percent of total investment (table 3.2.4), while, the average ratio of total investment to GDP was 20.4 percent. This ratio has been increasing continuously, in fact, from 14.6 percent in 1974 to 25.3 percent in 1976/77. Foreign investment did not have an important role for the Iranian economy in this planning period, when oil revenues increased very sharply. The annual per capita income at this period increased by 6.6 percent on average. However, in 1977/78, the year of revolution, there was a sharp decline.

Table 3.2.4: The salient Facts of the Fifth Development Plan 1973/1974-1977/1978 (Billion Rials)

Years	GDP at factor of production price Billion Rials	Population (person)	Per Capita Income (Rial)	Percent of change	Private Investment Billion Rials	Government Investment Billion Rials	Total Investment Billion Rials	Private investment share in Total	Investment per capita Rial	Foreign loan Billion Rials	Net Foreign Investment 1000 Rials	Total Foreign Investment Share in Total Investment %	Total Investment to GDP Percentage
1973-74	9666.5	31089000	310930	2.5	681.2	734.1	1415.3	48.1	44360	2.6	4044	0.0003	14.6
1974-75	10746.3	31951000	336337	8.2	695.5	938.3	1633.8	42.5	51135	3.4	4500	0.0003	15.2
1975-76	11252.8	32818000	342885	1.9	1203.9	1249.1	2453.0	49.7	74745	2.7	2976	0.0012	21.8
1976-77	13131.4	33708744	389555	13.6	1424.8	1904.0	3328.8	42.8	98751	3.1	6537	0.002	25.4
1977-78	12851.3	35025000	366918	-5.8	1450.1	1780.9	3231.0	44.8	92248	1.8	6348	0.002	25.1
μ								45.6					20.4
S								3.2					5.2
rxy = -0.03													

Sources: Economic report, Central Bank of IRI and Iran central Statistic institution reports

1- Figures are at Constant 1982/83 Prices

2- The size of the population is estimated on the basis of the 1976/77 census.

3.2.2.2. Iranian Economic Development after the Revolution

The revolution in 1978 changed the relevant approaches and economic theories, the policy aims and, consequently, the policies pursued, and, unfortunately, stopped the economic planning process for more than 10 years. “The government's economic intervention on activities was increased contrary to the principle law, plan number 44 of revolution that was enacted after revolution in 1978” (Grami and Khodamoradi 2003, p. 11). Hence the revolution changed the underlying philosophy and the conceptual foundations of economic activities. Later, the War with Iraq, political and economic sanctions, and unforeseeable events such as the huge number of immigrants, (3 million from Iraq and Afghanstan) and political problems dramatically increased the economic problems. Moreover, the development plans have been suspended after the revolution from 1978/1979 until 1989/1990. The economic aims of the revolutionary government were based on vague ideological views that were shaped by endogenous factors such as the excited atmosphere of the revolution and a lack of realism, and some exogenous factors like economic sanctions and boycott, and the War with Iraq for eight years. Most importantly, economic policy was never based upon an explicit theoretical foundation, but was shaped by feeling and hope. The interventionist economic policy led to closing the economy accompanied by an informal planning and programming of the economic system. During the War, this policy worked well. It enabled the government to solve the basic economic and social problems, and to provide the essential War needs. After the War, economic activity entirely focussed on reconstruction. Given the absence of a strong economic structure such as, a well-balanced production system, and lack of a suitable fiscal and monetary policy, including liquidity control; moreover, there was no formal stock exchange facilitating investment; finally, insufficient action was taken to satisfy to very large demand for consumer goods that developed after the War. As a consequence, a huge amount of unemployment came into being accompanied by high rates of inflation. On the other side, exogenous factors, lower oil prices during the War, the U.S economic sanctions, absence of foreign direct investments and the mutual fund companies' portfolio investments, and insignificant multinational corporations and a severe drought had put more pressure on the economic decisions (Baldwin, 2002). This destroyed the foreign trade structure of the revolution economy. All these forced the new authority to experiment with different types of economic theories and the related policies. Thus, from programming-cum-planning and the closing of the Iranian economy so as to achieve a quasi-autarky the government suddenly switched to a liberal free market policy in 1989 and this still continues by now. Consequently, open and free market system policies have been

implemented successively. It began with trade policy, followed by industrialization policy and subsequently privatization; then, barriers to imports were reduced as were government interventions. All these liberalisation measures were implemented during the the first and second five year plans. The new economic structure has taken shape but slowly and exceptions exist, an example being the stock market, which in 2006, still suffered from the political events – the revolution - and even from War devastation. In any case, the basic weaknesses of the Iranian economy have remained until now. As a result, the market reform, institutional in general, made up of a capital and labour market reform in particular, was started at the beginning of the reform period and is to continue even in new political conditions, with the conservative party returning to power through the government of Mr. §Ahmadi Nejad in July 2005. The Fourth Five Year Plan (2005–2009) which is, significantly, subtitled "A Knowledge-based Economy in Interaction with the World Economy" will also be supported by the Conservative government and Parliament (Salehi-Isfahani, 2005, p118).

3.2.2.2.1 The Iran War Economy

After revolution, Iran economy faced some very serious economic problems because of the War period 1979/1980-1987/1988. This period was characterized by very high levels of unemployment and great rates of poverty, high rates of inflation, decreasing export earnings and a reduced demand for imports. At the same time both, the traditional economic sectors such as carpet making, handcrafts, fishing and agriculture, and the modern economic sectors such as Oil extracting, automobile production, houses equipment industries producing equipment for houses and apartments, mining and construction have contracted to the self- sufficiency level related to a closed economic system. Compared to the past, productivity had substantially declined. In addition, the Iranian economy that came into being during the War could not be compared with 'standard' developing economies. Involuntary unemployment was high in all urban and rural areas and in all sectors, especially in industry. The inequalities in the distribution of income had remained and probably increased. There was a very heavy dependence on the oil revenues and, as a result, an extremely high degree of risk and uncertainty all over the economy: could necessaries required in production and consumption be imported in sufficient quantities or not? What happened to investment is typical for the state of the Iranian War economy. In fact, the gross investment rate was around 22.9 per cent of GDP in 1978. This ratio decreased to 11 per cent of GDP in 1988, whereby the different levels of the value of the Rial during this period also should be considered together with differing evolutions

of inflation in the investment and in the consumption goods sectors. The decline of the investment-output ratio is, in a way, significant for the worsening state of the Iranian War economy. Several factors account for this deterioration.

First, the Iranian War economy depended very strongly on Oil revenues. In fact, there was some dependence on Oil revenues also before the revolution and the war; however, in 1978, the country had still a fully open market system and Oil could be exported at high prices. However, after the revolution, and especially during the war, the economic system changed into a closed system, and, very importantly, there were restrictions on oil exports imposed by the Western countries.

Consequently, the amount of oil revenues and other export earnings decreased sharply. For example the oil revenues during the last four years of the war (1986-1989) were equal to the oil revenues of the year just before Revolution in 1977/78 was 20713.5 Million U.S $, while the population had greatly increased in the time-period in question (1977/78-1987/88, table 3.2.5), in fact from 36332000 to 50650000 persons, (IRI Central Bank report 1998). When oil exports in value terms had decreased by 75 percent. Moreover, the nature of foreign trade changed. For example, before revolution most of the products were exported to the USA and to European countries; hence there was the possibility to import high technology products instead. However, after the revolution and during the war many of the products were exported to countries with developing economies, and this discouraged attempts to develop high technology products which could eventually be exported.

Second, employment changed in structure and level. The official employment rate was 85.8 percent of the total working population, with unemployment amounting to 14.2 percent in 1986. Urban unemployment was estimated at 54.1 percent of total unemployment and rural unemployment at 45.9 percent. While in 1956/57 the unemployment rate was 2.6 percent of the total working population, with urban unemployment at 4.5 percent and with the rate of rural unemployment being 1.7 percent, it grew to 11.2 percent of the active population in 1976/77, with urban and rural unemployment being at 2.27 and 7.9 percent respectively. These figures suggest that inequality and unemployment were growing in both rural and urban areas. This confirms the basic Keynesian idea that unemployment is the ultimate cause of involuntary unemployment, a proposition that will be theoretically substantiated in the next chapter.

Third, as a result of the inequality in income distribution, rural incomes were much lower than urban revenues, immigration from rural to urban areas continued. In relation to subject of this study, the Pearson product moment correlation coefficient between share of private

investment in total investment ratio to total investment to GDP ratio during the period was -0.026, that means there is a weak and negative correlation between share of private investment to total investment ratio and investment to GDP ratio. This confirm that government investment, considered as the main sources of investment, and the rate of private investment was low because of the risky and critical situation in investment and production; a positive growth rate of population also played a important role as a social criterion. As a result, variables such as per capita income and per capita investment strongly decreased and following that, the share of government investment to total investment ratio fell to the lowest rate in the last thirty years. Moreover, foreign investment did not play any role in this period when the oil revenue was at the lowest level, too. The average yearly per capita income in this period decreased by 5% per year (table 3.2.5). The annual investment volume also decreased by 2.65 percent in the period in question. The ratio of private investment to total investment also frequently changed, with fluctuations occurring from 33 percent to about 60 percent. This took place, first, because of the war problem and, second, because of fluctuating oil revenues. These are some of the crucial facts set forth in table (3.2.5).

Table 3.2.5: Salient Features of the years after Revolution 1978/1979-1988/1989 (Billion Rials)

Years	GDP at factor of production price	Population (persons)	Per Capita Income (Rials)	Change %	Private Investment	Government investment	Total Investment	Private Investment to Total Investment Ratio	Investment per capita Rials	Foreign Loan	Total Investment To GDP Percentage
1978-79	11440.9	36332000	314899	-14.2	873.1	1749.9	2623.0	33.3	72273	1.7	22.9
1979-80	10841.3	37730000	287339	- 8.2	898.7	917.1	1815.8	49.5	48018	1.7	16.7
1980-81	9228.4	39192000	235466	-18.1	987.1	861.3	1848.4	53.4	47044	4.2	20
1981-82	9031.7	40718000	221811	-5.8	851.2	873.0	1724.2	49.4	42233	3.6	19.1
1982-83	10335.4	42313000	244261	10.1	784.3	1057.2	1841.5	42.5	43411	5.6	17.8
1983-84	11517.6	43979000	261889	7.2	1406.8	1144.3	2551.1	55.1	57878	9.1	22.1
1984-85	11522.1	45721000	252009	-3.8	1484.4	1077.8	2562.2	57.9	55946	15.9	22.2
1985-86	11723.6	47541000	246600	-2.2	1262.6	890.7	2153.3	58.6	45250	13.9	18.4
1986-87	10692.5	49445010	216250	-12.4	885.2	760.7	1645.9	53.7	33287	11.4	15.4
1987-88	10736.2	50650000	211968	-2	790.9	569.7	1360.6	58.1	26856	6.8	12.7
1988-89	10360.6	51890000	199665	-5.8	679.3	464.3	1143.6	59.4	22031	29.5	11
μ				-5				51.9			18
S				8.5				7.9			3.9
rxy = -0.026											

Sources: Economic report, Central Bank of IRI and Iran central Statistic institution reports

1- Figures are at Constant 1982/83 Prices

2- The population quantities are estimated just the population quantities years 1981/82 and 1986/87 are census

3.2.2.2.2 The First Development Plan

The First Five-Year Development Plan (FYDP, 1989/1990-1993/1994) after the revolution and after the war began on March 21, 1989. The new economic development plan was aimed at opening the economic system. In fact, the entire economic system, and, specifically, trade policies, import and export policies and monetary and fiscal policies suffered from a long lasting ambiguity through the lack of a clearly formulated policy system – there was in fact a mix-up of selected fragments of socialism and liberalism – and, linked to this, the absence of clearly specified economic policies. The situation was aggravated through huge amounts of capital flight, special requirements for the war reduced private consumption and state expenditures for civilian requirements, and the economic sanctions of the US and its allies against Iran for the last 27 years, that is from 1978, the year of revolution, until now. Very high fertility and birth rates, and a huge immigrant population from Afghanistan and Iraq were other reasons for the serious economic situation. This ambiguous economic circumstance came to an end by the first five-year development plan 1989-1994. The new economic activities and policies were clearly based on the liberal economic doctrine, and this even continued through the second five-year development plan period. This evidently changed the economic condition in every respect. However, this temporary economic expansion was finally stalled by a severe financial crisis due to the accumulation of some 30 billion dollar short-term debt in 1993. The main goals of the plan were the following.

- Set up economic structures with all necessary components to change the economic situation according to the liberal reconstruction program set up after the War.
- Develop the economy through liberalization and privatization policies.
- Make a systematic performance instead of instable performances and lack of coordination.
- Change the disadvantages of international economic activities in international markets to advantages, for example, through attempting to export industrial goods, to developing countries at least; moreover, a better allocation of resources inside the economy was aimed at.

There was, however, a deep cleavage between theory and practice. For example, while liberalization was the central policy, the regulation of international trade was based on protectionist policies. On the whole, this plan was, in the main, aiming at reconstructing the country after the war (Hosseini 2002).

Table 3.2.6: The salient Features of the First Development Plan 1989/1990-1993/1994(Billion Rials)

Years	GDP at Factor of production price	Population (person)	Per Capita Income Rial	Private Investment	Government Investment	Total Investment	Private to Total investment Ratio	Investment per capita Rial	Foreign borrowing
1989-90	10799.9	53167000	2031.32	748.0	468.8	1246.8	60.1	22878	24.6
1990-91	12045.2	54483000	2210.82	765.8	613.0	1378.8	55.5	25301	58.1
1991-92	13264.1	55837163	2375.50	1136.3	806.6	1942.9	58.5	34796	178.4
1992-93	14049.5	56656000	2479.79	1143.0	934.3	2077.3	55.0	36665	127.0
1993-94	14742.2	57488000	2564.40	1243.7	889.7	2133.4	58.3	37110	2959.2
μ	12980.18		2332.36	1007.4	3712.4	1755.84	57.48	31350	3347.3

Sources: Economic report, Central Bank of IRI and Iran central Statistic institution reports
1- Figures are at Constant 1982/83 Prices
2- The population quantities are estimated

3.2.2.2.3 The Second Economic Development Plan

This plan is of considerable interest for two reasons. First, it did not focus on a particular sphere; in fact, it was based on a balanced growth approach, while the first plan had emphasised on reconstruction based on industrial development policy. For example, the participation papers aimed at motivating investment in all economic sectors during the period of the second five year plan 1994/1995-1999/2000; conceptually the plan was based upon ordinary on free market theory. For example, it was aimed at developing the construction sector through participation papers. As a second difference, the government aimed at employing all potentials, domestic and foreign resources, to increase production and the level of the investment-output ratio, in order to respond to the huge demand, which had been accumulated during the war years. This led the government to recreate the Tehran stock market, which should help the capital market to find new resources.

Table 3.2.7: The salient Features of the Second Development Plan, Years 1994/1995- 1998/1999, Billion Rials

Years	GDP at factor of production price	Population Person	Per capita Income Rial	CChange %	Private Investment	Government Investment	Total Investment	Private to Total investment Ratio	Investment per capita	Foreign Borrowing	Investment to GDP Ratio
1994-95	14984.6	58278000	257123	0.3	1278.4	927.9	2206.3	57.9	37824	2264.2	14.7
1995-96	15458.4	59151000	261338	1.6	1310.4	966.8	2277.2	57.4	38669	1994.0	14.7
1996-97	16192.3	60055488	269622	3.2	1394.6	1072.4	2467.0	56.5	41079	2953.8	15.2
1997-98	16698.2	60937000	274024	1.6	1406.0	1055.6	2461.6	57.1	40384	4686.2	14.7
1998-99	17046.8	61831000	275700	0.6	1403.7	902.9	2306.6	60.9	37281	5292.1	13.5
μ				1.5				57.96			14.6
S				1.13				1.7			0.62

Sources: Economic report, Central Bank of IRI and Iran central Statistic institution reports
1- Figures are at Constant 182/83 Prices
2- The population quantities are estimated

3.2.2.2.4 The Third Five Years Development Plan

The second plan was clearly focussing on policies aiming at liberalising markets through reducing controls and interventions by the government in the functioning of markets. Moreover, the ratio of investment to GDP was to be stabilised. Subsequently, the third five year development plan (3rd FYDP Law 2000/01-2004/05) focused on privatization. On this basis, output and investment grew. Consequently, the provision of liquidity and of financial resources as were required by all economic sectors and the reduction in unemployment and inflation rates were among the major priorities of this plan. With the ongoing revision of the plan, the growth of output, investment and employment turned out to be higher than the plan projections. Structural reform appeared to be the main driving force behind the growth. These reforms required large amounts of investments. And it is very likely that the income effect produced by these investments brought about the growth of output and employment. In post-Keynesian terms there was presumably an interaction between profits and investment which acted as an engine of growth.

This plan covered a great variety of spheres: first, government budget and finance, second, investment, production and consumption, third, Oil and oil products, fourth, foreign trade and rate of the exchange, fifth, money and inflation, sixth, distribution of income, seventh, employment and unemployment. The government budget for 3rd FYDP Law was formulated in line with the targets such as focusing on employment, restraining the growth of current expenditures, completing semi-finished development projects and initiating the start of new projects, enhancing the contribution of the private sector, improving the efficiency of government through reducing and rationalising the government sector, reforming the budget structure, enhancing budget transparency, utilization of participation papers to finance government projects in a non-inflationary way and unification of all taxes and fees in a single sales tax under the Tax Consolidation Law for consolidating tax collection from importers and producers (the tax reform started in 2003/04).

The privatisation policy aimed to utilise the best fortunes to balance the foreign payments. However, unfortunately, the increasing size of government economic activities that were centralized was not even able to utilise the regular resources. Unexpected economic and political conditions and uncertainties on international markets do not enable investors make long time decision. As the studies show the privatisation policy did not contribute to achieve the five-year plan goals (Grami and Khodamoradi, 2003 -1381 p. 20). Consequently, in addition to market-oriented liberalization policies, some alternative and opposite policies were

pursued during the plan as well, for example protectionist policies to realise a surplus on current account (Third plan law 2001-02, attachments number 1 & 2, pp. 23, 22).

In 3rd FYDP investment, production and consumption got a new impetus. There was a heavy reliance on internal and external resources to support production and consumption, even through subsidies, and this was at a time when the main policy emphasis was on liberalization of markets. On the one hand, new internal fiscal and monetary instruments were used. For example, allocation of administered funds, provision of banking facilities for job creation and participation papers that were issued to finance development projects to be continued. These included projects in the water, electricity, road and transportation and petrochemical sectors. For example, at 2003-04, the total participation papers issued by the government and public corporations (including budgetary and off budgetary) grew by 38.6 percent compared to the previous year (Annual Review, 2003-04, p 8). Government's support policies like guaranteeing the purchase of agricultural crops and supply of agricultural inputs (fertilizer, pesticide and seed) at support prices continued, for example in 2003-04.

On the other hand, foreign exchanges were extended, also in the financial sphere. For example, facilities from the OSF, and utilisation of foreing finance; a foreign investment law to attract FDI was approved in 2004-2005. This was seen as the best possibility to balance foreign payments, and to balance supply and demand on the capital market. However, the ongoing economic activities were, unfortunately, no even able to utilise the amount received from the privatisation policies (Table 3.2.9).

Table 3.2.8: The salient Features of the Third Development Plan 1999/00-2003/04 (Billion Rials)

Years	GDP Billion Rial	Population Person	Per Capita Income Rial	Private Investment	Government Investment	Total Investment	Private to Total investment Ratio	Foreign Borrowing
1999-00	17455.1	62738000	278222	1495.4	999.5	2494.9	59.9	154.0
2000-01	18490.7	63658000	290469	1651.4	1056.0	2707.4	60.9	175.0
2001-02	330565	64592000	5117739	-	-	-	-	228.9
2002-03	355554	65540000	5424992	-	-	-	-	284.1
2003-04	379838	66991573	5669937	-	-	-	-	73.3
μ	220380.6	64703914.6	3411916.2	1573.4	1027.8	2601.2	60.4	4568.7

Sources: Economic report, Central Bank of IRI and Iran central Statistic institution reports

1- Figures for years before 2001-02 are at constant 1982/83 Prices and others are at constant 1997-98 prices
2- The size of the population is estimated

Table 3.2.9: Privatisation Proceeds (Billion Rials)

Years	Approved	Performance	Realization Percent	Government Revenues budget share (percent) Approved	Government Revenues budget share (percent) Realization
1998-99	0	0	0	0	0.0
1999-00	-	4.2	-	-	0.0045
2000-01	500	0.2	0.0004	0.47	0.0002
2001-02	1200	93.6	7.8	0.89	0.075
2002-03	15000	8364.0	55.8	18.1	13.5
2003-04	18000	2531.2	14.1	17.9	3.2

Source: Social Security Organization report and Economic report and balance sheet 2002/03, 2003/04 Central Bank of the Islamic republic of Iran, table, 51

Among the driving forces behind the boom in manufacturing and mining activities are the continued support of private sector as a strategy set out in the 3rd Plan and government's attempts in this regard during the 3rd Plan period. To reduce unemployment as the major challenge of the Iranian economy, certain measures were reviewed in the plan under review. In this regard, facilities were extended by banks for economic sectors to be used both in required working capital of manufacturing units and in implementing job creation projects and projects for the expansion of productive units. The mechanism of Article 56 of the third Plan Law was among the policies adopted by the government in the area of employment creation. In the course of 2000- 2002, facilities were extended to the unemployed as self- employed loans, while, since 2002/03 only entrepreneurs who hired the unemployed were authorized to receive the facilities. The sum total of the facilities, at the end of 2003/04 amounted to Rial. 11,469.8 billion (Rial. 2,630.4 billion facilities of the old plan and Rial. 8,839.4 billion facilities of the new plan). Out of these facilities, 558 thousand new jobs were expected to be created during the first four years of the plan. It is to be noted that the sources allocated within the framework of Article 56 of the 3rd Plan Law for 2003/04 was Rial 3 trillion, which was projected to create 100 thousand jobs. However, the use of these resources was somehow obstructed in 2003/04. Direct credit was another mechanism to create new job opportunities. On this basis, out of a Rial. 3,600 billion increase in the outstanding of banks' credits, Rial. 1,755 billion were allocated to employment facilities. In addition, some social indicators suggest how inequality in income distribution and involuntary unemployment cause the migration of parts of the rural population to urban areas. In fact, there was a 0.6 percent reduction in the population of rural areas as compared to the previous year (2002/2003), which indicates the continuing migration from rural to urban areas. Against this background, active population had a remarkable 2.9 percent growth compared to the previous year (2002/2003), and reached to 21 million, which

was due to the baby boom during the 1976/77-1986/87 period. The people moving from rural to urban areas were in their great majority very young. Indeed, the less than 20 years old made up 43.4 percent of the total urban population, those of less than 25 years of age 55.1 percent of the total population. In this context, the third Plan policies concerning employment became a major element in the credit policies of the government in the next plan. Credit facilities were extended by the banking system to various economic sectors, public and non-public, had direct and indirect effects on employment. These facilities were used for providing working capital to manufacturing units, implementing new development projects, maintaining current levels of employment and creating new jobs. To reduce unemployment, the government and the banking system were required to implement policies aiming at employment creation in the framework of the 3rd Plan Law and of annual budget laws 2003/04. The significance of the employment issue and its ensuing effects on society as well as economy of the country made the employment related policies and combating the unemployment crisis an economic challenge (Annual Review, IRI Central Bank reports and balance sheets years 2000-01,2001-02, 2002-03, 2003-04).

Table 3.2.10: Quantitative Targets and Performance in 3rd FYDP (2000/01- 2004/05) Percentage change

Elements /Years, Targets	2000/01	2001/02	2002/03	2003/04	2004/05	Annual Average
GDP	4.5	5.5	6.5	6.7	6.8	6.0
Gross fixed capital formation						
Liquidity	20.8	18.0	15.7	14.2	13.1	16.4
Inflation	19.9	17.4	15.3	14.0	13.0	15.9
Unemployment rate: Maximum scenario Minimum scenario	 16.0 15.3	 -	 -	 -	 12.6 10.7	 -
Non-oil/gas GDP	5.9	7.0	7.2	6.8	7.1	6.8
Total investment	6.0	6.9	7.3	7.8	7.9	7.1
Private	6.1	9.5	9.7	9.6	7.6	8.5
Public	5.6	2.8	3.3	4.7	8.4	5.0
Private consumption Expenditures	3.3	3.4	3.5	3.6	3.7	3.5
Public consumption Expenditures	6.1	0.3	1.5	3.5	1.9	2.5
Performance						
GDP	5.0	3.3	7.5	6.7	4.8	5.5
Non –oil GDP	4.5	5.5	8.0	5.9	5.1	5.8
Gross fixed capital formation	4.1	14.2	11.8	10.1	6.4	9.3
Liquidity	29.3	28.8	30.1	26.1	30.2	28.9
Inflation	12.6	11.4	15.8	15.6	15.2	14.1
Unemployment rate	14.3	14.7	12.2	11.3	10.3	12.6

Source: The Central Bank of I.R.I. Annual report 2004/2005, p26.

The unemployment rate is projected to decline from 16.0 percent in 19999/00 to 12.6 percent in the last year of the 3rd FYDP, based on the maximum scenario, and from 15.3 percent to 10.7 percent based on the minimum scenario. As mentioned before based on the results of second chapter, in spite of liberal market policies during the plans, some alternative and contrary policies were utilised as well. Such as, applying direct and indirect measures for some economic sectors, for example a lower rate of profit, banking facilities, and import tariff and export subsides for some sectors. There were even measures to reduce the amplitude of the frequently occuring economic cycles. Moreover, as the studies show, the privatisation policy did not succeed in realising the five-year plan goals to direct sterile money into an economically productive function. Some general reasons account for reaching only imperfectly the aims of the plan were mentioned:

"- A weak governmental infrastructure,

- A high level of bureaucracy

- A group of struggle on commercial law, rule and regulation of government

- Insufficient governmental fiscally and monetary courage

- Influences of unexpected elements on economic decisions" (Grami and Khodamoradi, 2003, pp. 46- 49).

Table 3.2.11: Quantitative Targets in the (4th FYDP) 2005/06- 2009/10 Percentage change

Elements /Years	2005/06	2006/07	2007/08	2008/09	2009/2010	Period Average
GDP	7.1	7.4	7.8	8.4	9.3	8.0
Gross fixed capital formation	11.3	11.0	11.7	12.9	14.1	12.2
Aggregate consumption expenditure	4.8	5.5	5.9	6.4	7.4	6.0
Inflation	14.6	11.5	9.1	7.9	6.8	9.9
Liquidity (M2)	24.0	22.0	20.0	18.0	16.2	20.0
Non-oil/Gas exports	10.7	10.7	10.7	10.7	10.7	10.7
Unemployment rate (percent)	11.9	-	-	-	8.4	-

Source: The Central Bank of I.R.I. Annual report 2004/2005, p26.

3.2.3 Finance Market Structure

As a rule, weak finance market structure is related to bad performances in the real sector as well. Policies of growth, employment and distribution will inevitably only be successful to a limited extent. Indeed, all countries, specifically if developing, need comprehensive production and market systems as the foundation of fiscal and monetary policies to bring about an optimum allocation of resources and a general rise in labour productivity. An important

example of imperfection of the Iranian capital market is the participation paper. Indeed, in the Iranian economy the participation paper does not have important share in financing capital accumulation. For example, the share of the participation paper in the overall financing of capital accumulation was just 5% in 1995 while at the same time; this ratio was nearly 50% percent in industrial countries (Rafiei Kavnani 2003, Table, 7 p. 42). This led to weak investment performances. For example, during 1997-2002, only 465 billion Rials were invested in construction (Iran Central Bank Reports 2004, table 20).

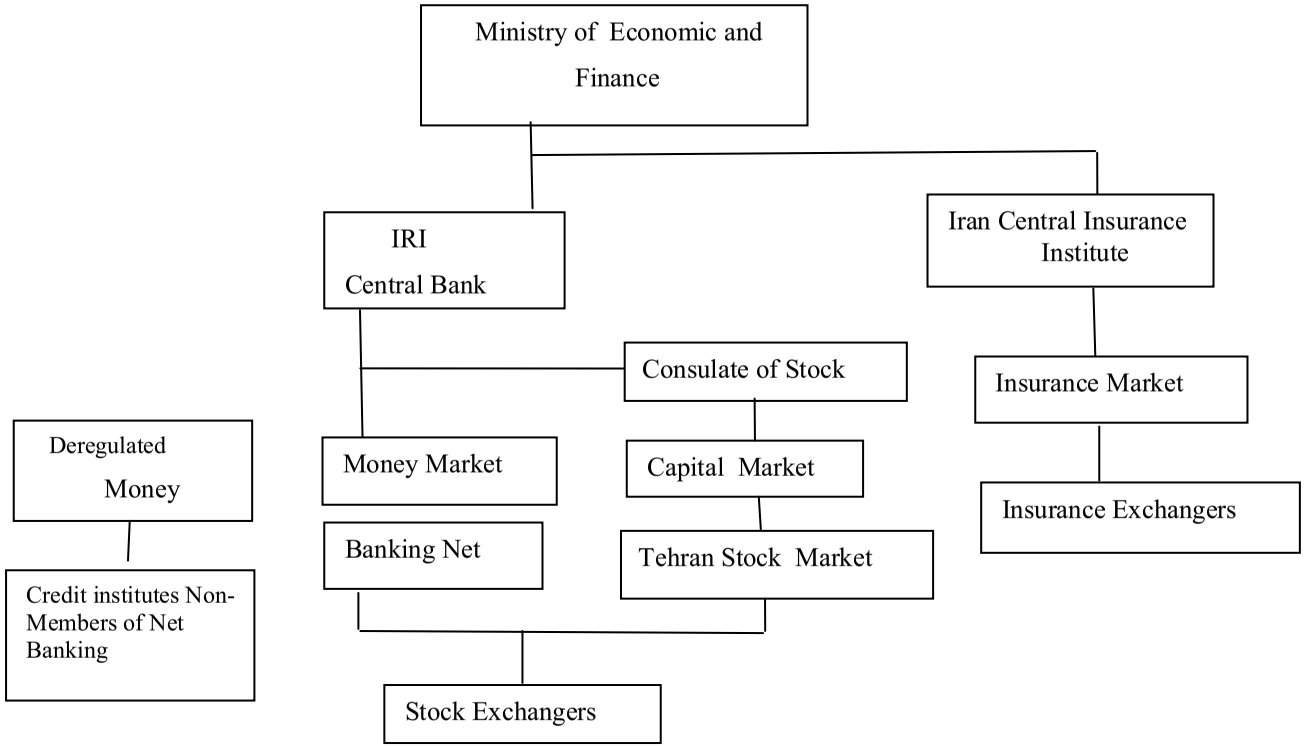
In table 3.2.1 we present a brief review on the various components of fiscal and monetary institutions in order to be able to examine the relationship between the government decisions and their implementation in practice.

Table 3.2.12: Salient Facts of the (4th FYDP) 2005/06-2009/10 at constant 2002/3 prices, (Billion Rials)

Years	GDP	Population (person)	Per Capita Income Rial	Private Investment	Government Investment	Total Investment	Foreign borrowing
2004/05	404334	67477500	5992131	-	-	-	283.5
2005-06 [3]	399345	68467413	5832629	-	-	-	3126.7

Sources: Economic report, Central Bank of IRI and Iran central Statistic institution reports
1- Figures are at Constant 1982/83 Prices
2-The quantities Population are prediction
3-approved budget

Figure 3.2.1: The current Macro Structure of Iran Finance Markets



Source: Azizy, Firozeh. 2004, pp.147, 151, 203

3.2.3.1 Government Intervention

The aims of government intervention become somewhat clearer when protection plans such as subsidies to different economic sectors are considered. These could indeed be interpreted as a policy to reduce the distribution gap, which is particularly large in many developing countries. There is some evidence for using subsidies in ancient Iran (Persia). More recently, subsidies were used to relieve distress as occurred through natural events such as drought, or through Wars. In modern times, the first protection plan was started in 1970s (from 1973 onwards) when an increase in oil revenues faced oil producing countries with a huge rates of inflation- In this situation, government intervention became vital and necessary and protection seemed essential. After the revolution the protection policies were pursued on the basis of idealistic ideology and on humanistic values, such as justice and equality, protecting the domestic economy and the poor classes of society. Consequently the government intervention became the main policy feature, especially when the government had to deal with the effects of sanctions by the U.S.A and her allies, and the free-world trade partners; the 8 years war (1980-1988) and a high rate of population growth – more than 3% for several years - also required special intervention.

However, after the war (1988) government moved in new directions and followed new policies, such as adjustment policy, liberalization, and privatization. But these changes occurred in an ambiguous situation, with protection prevailing, revolutionary ideals being pursued, huge debts having been accumulated; moreover, there were very high inflation rates, for example 35 and 49 percent at the 1994-1995 and 1995-1996. All these factors greatly hampered the liberalisation measures implementend by the government.

3.2.3.2 The Economic Structure of Iran, Control and Regulation of the Capital Market and of the Trade System

Before the revolution, Iran's net finance Market was supported by various fiscal and monetary components, reflecting the outcomes of an open market. However, after revolution, because of the new economic philosophy introduced by the religious revolution, the relations between finance markets components were damaged. The gap between the religious ideals, and socio-economic realities changed everything. For example, the concept of interest and money was changed. Consequently, the economic decisions, in the absence of a robust economic theory, became ambiguous and uncertain. Policy makers and managers decided to run plans frequently

based on extreme and even opposed policy lines. For example, action was, in some instances, based on central planning principles, and, in other instances, on hard-line liberal principles. This confusion grew on account of unforeseeable events, such as the war with Iraq, the economic sanctions through the U.S.A and her allies, and a huge immigration of unemployed people, in fact around 3,000,000 persons from Afghanistan and Iraq. After the war, the control and regulation of the structure of the Iranian capital market were changed considerably, in fact to bring it into lines with liberal principles. The changes have appeared everywhere, especially in trade policy regulations and "foreign exchange" management (Forex).

First, the banking system manages the vital part of the Monetary and Credit Policies in the economy of Iran, especially in the commercial sector. Each year after the approval of the government's annual budget by the Islamic Consultative Assembly, the Central Bank presents a detailed monetary and credit policy to the Money and Credit Council for approval. Thereafter, certain core elements of monetary and credit policy need to be approved by the Cabinet. This procedure is followed in accordance with Article 19 of usury-Free Banking Act of 1983 which stipulates that short-term credit policies need to be approved by government and long-term credit policies have to be incorporated within the Five Year Development Plan documents and approved by the Parliament. The Money and Credit Council (MCC) approved the following decisions to be implemented at each year of plan. Banks are required to allocate credits as approved by the government until the completion of a project. According to the budget law, an increase in the ceiling of the outstanding banking facilities is to be approved by the MCC. Here according to the Central Bank report (2005/6) the major changes in foreign exchange monagemant is exhibited table no 3.2.2 (of I.R.I. Annual Report 2004/2005, p.26).

Table 3.2.13: Trade Policies, Regulations (Revised) and Major Changes in Foreign Exchange (Forex) after unification as of 2002/3

	Pre-unification	Post-unification as of 2002/3
A.Forex regulations		
1.Prepayment on LCs for imports	Minimum 10% for private sector	At banks discretion for private sector
2.Import of goods using forex with external origin	Financed through forex with external origin and 100% prepayment on LC	Regardless of the origin of forex, LC prepayment subject to banks discretion
3.Import of goods from FTZs	Banks(domestic network) were authorized to open LC	Banks in the mainland
4.Transportation	Opening Petty cash LC for freight up to	Without any limitation or ceiling
5.Insurance cost for import of goods	Purchase of foreign exchange paid on insurance costs for import of goods through:forex quotas of organizations, purchase from TSE, Non-oil export proceeds, or forex accounts with external origin	Through banking system
6. Inspection	Submission of inspection certificate was mandatory for forex quotas	Submission of inspection certificate Subject to owner of goods`discretion
7.Purchasing of forex	At negotiated rate	At bank`s market rate
8.Selling forex to passengers	Maximum $2,000 per passport and $ 1,000 for four persons (accompanied) sold three times a year at negotiated rate	Through banking system
9.Selling forex for medical treatment	Receipt of promissory note as collateral a Rials. 2,500 perU.S. dollar up to certain ceilings as determined by High Council of Health	At banks` market rate against creditable documents, up to $30,000, And through confirmation of High Concil of Health for amounts in excess of $ 30,000.
10. Selling forex for missions abroad	On the basis of rates stipulated in forex quotas of organizations	At banks` market rate
11. Sabbatical leave	Up to maximum ceiling of forex quota of organizations	No ceiling, as allocated by the respective organizations
12.Repatriation of salary of foreign workers	In public sector, up to $ 500 at CD rate	At banks` market rate for both public And private sectors
13.Financing marketing expenses, lawyer`s fee, principal and return of foreign investments, revenues of Embassies` consulate section ,bank comission fees, settlement of forex commitments of exporters and importers	At preferential rate for executive bodies having forex quota (budget), CD rate for TSE transactions, negotiated rate for other purposes.	At banks` market rate and confirmation of competent bodies in certain cases

14. Opening forex accounts	Distinction between forex with internal and external origins, minimum amounts for opening an account , saving account :$ 100, current account :$10,000, term-investment account :$1,000.	Elimination of the condition for origin of the forex, the minimum amounts and interest rate will be determined by banks
B. Trade policies		
15. Import of goods		Changing non-tariff barriers to tariff ones, through increasing customs tariff base, reducing centers issuing import licenses to one ministry (Ministry of Commerce), changing the base rate for conversion of dollar value of imports for collection of customs duties and commercial benfits from Rials. 1,750/US dollar To Rials.8,000(approximately), increasing the list of permitted imports
16.Export of goods		Elimination of surrender requirements

Source: The Central Bank of I.R.I., Annual report 2004/2005, p. 26.

In order to regulate foreign exchange commitments and to maintain BOP equilibrium, the Central Bank is, according to the budget law, obliged to observe the conditions mentioned in this Note in the framework of Money and Banking Law and monetary and foreign exchange policies in creating new foreign exchange obligations and fulfilling previous obligations. As is mentioned in the law, the Central Bank is responsible for regulating and creating equilibrium in foreign exchange market and management of BOP with the supervision of the committee named in Article 86 of the 3rd FYDP Law. For example, to speed up the implementation and completion of projects scheduled for 2003/04 and 2004/05, the Cabinet is given the authority to finance credit and guarantee repayment of Rials. 18,285 billion through the OSF account or through selling participation papers, with the priority given to agriculture, water resources, manufacturing and mining, environment, transportation, electricity, urban development and natural resources which were stipulated in the appendix I and II of this Law. Moreover, any expenses from this source out of the content of this paragraph is totally forbidden. For example, The government is authorized to issue up to Rials. 5,400 billion participation papers to accelerate the implementation of acquisition of non-financial assets and deposit the revenues received as is determined in the third part of the 1382 Budget Law appendix. Moreover, the Ministry of Energy and its affiliated organizations are authorized to utilize up to Rials 1,600 billion, through issuing participation papers for completing the executive operations of acquisition of non- financial assets of the electricity sector.

Second, the Foreign Exchange System and the Trade Policies, prior to March 21, 2002, included two official exchange rates. First was the "oil-notional rate" which was applied for government budget purposes and for some external transactions in relation with “priority sectors”. The second rate called "non-oil export" or "certificate of deposit" rate, was effectively equivalent to market exchange rate, the so called, Tehran Stock Exchange (TSE) rate and was applied to non-oil export receipts and non-priority import transactions. But from March 21, 2002 onwards, active preparations were made to unify the exchange rates (the beginning of 2002/03 Iranian fiscal year), leading to a unified managed floating system. The unification of exchange rates was launched alongside with the elimination of all exchange restrictions on current account transactions which existed prior to March 2002. Therefore all foreign exchange transactions that formerly took place in TSE market were shifted to a newly established interbank market. The basic official rate (oil-notional) was eliminated, and the exchange rate was unified at the rate prevailing at TSE market before the unification. On this basis, the

Central Bank (CB) introduced the managed floating regime. As a result the country's foreign exchange system has gone through notable changes as the unified rate of exchange was applied since the beginning of March 21, 2002.

Third, the management of foreign exchange is by regulations proposed by the Ministry of Commerce and approved by the Cabinet. According to these regulations, import goods are divided into "authorized", "conditional" and "prohibited" goods. "Authorized" goods require no special license or permits for importation, while importation of "conditional" goods requires license by respective authorities. "Prohibited" goods are those, which are forbidden by Islamic Sharia, or respective laws. However, it should be noted that during the elimination of certification procedures for almost all import items, the number of goods under conditional categories was reduced to a minimum (Economic Research& Policy Department, Economic trends, No, 33, 2003/2004, Second Quarter, 2003, p. 25). Therefore, all the changes in Foreign Exchange regulations and Trade Policies, import and export policies, since the beginning of March 21, 2002, in the areas of transactions of goods, services, and banking operations were revised during the time in the areas of transactions of goods, services, and banking operations to comply to the new economic regime. Other policy and regulation developments in this area could been summarised according to report of the Research Office of Ministry of Economic and Finance (see appendix to this chapter).

3.2.3.3 Iran Economic Models and Investment Equations

There have been many attempts to model Iran's structure of economic activities on the basis of different theoretical approaches. In most of these models the equations of investment have been based on flexible accelerator models, but only the equation of investment for the service section had acceptable results. For example, the results show that return on investment in the service section is higher than the return on investment in other sectors. Probably, in unstable economies the share of the service sector will increase even if other sectors stagnate since it plays the role of ‘an employer of the last resort’ (Gerami and Khodamoradi 2003, p.52). On the other side, mining and industry compared to other sections have the largest fluctuations in the level of investment. These sections, in fact, heavily depend on Oil revenues. This shows that the structures of these industries are dependent on the outside world and are not substantially influenced by import restriction policies (Ministry of Economic and Finance 2003, p. 53). The elasticity of short-term investment in the mining and industry sectors is 28 percent while it is 55 percent at long term. This difference suggests that, due to unforeseeable factors, unused

capacities were large in the short term compared to the long run. Hence it is likely that the capital/labour ratio will increase in the long-term.

Although the revolution had some effects on the mining and industry sectors, and it did not have any effects on the agricultural sector; it had, in fact, a negative effect on the service sector. Meanwhile the oil price crisis had great negative and positive effects on agriculture, industry and mining, but no effects on services (Gerami and Khodamoradi 2003, p. 55). The production function of agriculture, mining, industry and services include labour, financial capital and medium import goods, in broadly equal proportions. However, the share of medium import goods in agricultural inputs, is 6 percent in the short term and 13 percent in the long term, while share of labour is more than 90 percent. This shows that in the agricultural sector traditional production methods still dominate. The industrial sector has the highest dependence on import goods, but the elasticity of production in the industrial section is smaller than in the service sector (Gerami and Khodamoradi 2003, p. 54).

In addition, the capacity to pay direct taxes is different in the various regions, states and provinces; this reflects large welfare differences between regions and social groups and can accelerate the socio-economic inequality and development cleavages between the areas. This affects per capita income and it is a reason for migration of people to large cities (Mehregan 2004, p. 96).

3.2.3.4 Central Bank and Government

The relation between the Central Bank and the Government to create the optimal conditions to manage the economy is delicate and risky. On the one hand, the independence of the Central Bank to finance various economic activities, most importantly investment, is very important, and on the other hand, the Central Bank has had a corporative relation with the Government to achieve goals that are vital for the macroeconomic management aimed at preserving the great equilibria, between the quantitiy of money and nominal income, government expenditures and tax receipts, to give examples (Wray 1998 and Ha –Joon Chang 2002, p.94 and Chang and Grabel 2004, pp. 187-193). There are also doubts about the concept of interest on deposits in the Iranian economy. This shows how much the domestic potential of finacial instruments is still largely unused and points to the potential of Iran to reach a high degree of self-dependency through the domestic economy that is by internal means. On the other side, this illustrates how a lack of a complete financial system in developing countries, specifically in Iran essentially shapes the allocation of resources. This has emerged more clearly recently through the growth

of certain financial instruments, for example, the ratio of stock exchanged to the amount of liquidity in Iran financial markets was 0.06% in 1989/1990; this ratio rose up to 3.68% in 2000-2001. Consequently, it seems likely that the scarcity of financial capital has affected the investors especially in countries with a developing economy. Furthermore, another point is related to the extent that policies are in accordance with implementations, for example the interest rate of deposits (Table 3.2.14) compared with the rate of profits on loans (Table 3.2.15) during 1990-2001, has not changed in spite of the different policies having persued over time. This seems to reflect some rigidity in adapting the facts to the needs. For example, there is a lack of a sufficiently efficient law to attract the sterile money during time-periods when the different policies have been pursued. As already suggested, these policies have indeed touched extremes, in fact, the extreme policy in line with a closed economic system, which suddenly shifted to the other extreme of an open market system. Badly developed financial markets confront investors in developing countries with high degrees of risk for finance and investment, to which uncertainty adds to a high degree; this is mainly because of internal and external political development, which cannot be foreseen. Finally, as has been already alluded to, there is no satisfactorily functioning finance system in many developing countries. In these countries access to finance is, in most instances, extremely difficult; this delays the accumulation of capital and simultaneously renders very imperfect the allocation of resources. In this situation, there is a tendency to save capital through the real assets such as land, gold and other permanent precious goods. As a result, there is a bad relation between the financial structure in developing countries on the one hand, and a gap between the government decisions and the required structure of decisions for the economy as a whole (Economic development policy, p. 28).

Table 3.2.14: The interest rate of deposits 1990-2001 (percentage)

Years	Deposited For five years	Deposited For three Years	Deposited For two Years	Deposited For one Year	Special Short time Deposited	short time Deposited
1990-91	13	11	10,	8.75, 9	-	6.25 , 6.5
1991-92	13, (14)	11, 11.5	10, 10.5	8.75, 9	-	6.25 , 6.5
1992-93	14.5 (15)	12.25, 13	11, 11.5	9.5, 10	-	7, 7.5
1993-94	15.5 (16)	14, 14.5	13, 13.5	11, 11.5	-	8
1994-95	15.5	16	13	11	-	8
1995-96	18.5	16	15	14	-	8
1996-97	18.5	16	15	14	-	8
1997-98	18.5	16	15	14	-	8
1998-99	18.5	16	15	14	10	8
1999-00	18.5	16	15	14	10	8
2000-01	18.5	16	15	14	10	8
2001-02	17	13-17	13-17	13	9	7
2002-03	17	13-17	13-17	13	9	7
2003-04	17	13-17	13-17	13	9	7
2004-05	17	13-17	13-17	13	9	7
2005-06	17	13-17	13-17	13	9	7

Source: Khdijeh Rafiei Kavnani, study the ways to prepare and to provide long – time Finance resource at structural sector, Ministry of Economic and Finance 2003 (1381) Table 9, p. 46

*The amount in the parantisis is the permanent accounts and the other is short- term lived accounts.

Table 3.2.15: Approved facilitates interest rate for different sectors 1990 - 2003 (Percentage)

Year	Agriculture	Manufacture and mining	Commercial And service	Construction and Domicile
1990-91	6-9	11-13	17-19	12-14
1991-92	6-9	11-13	17-18	12-16
1992-93	9	13	18-19	12-16
1993-94	12-16	16-18	18-24	12-16
1994-95	12-16	16-18	18-24	15
1995-96	13-16	17-19	22-25	15-16
1996-97	13-16	17-19	22-25	15-16
1997-98	13-16	17-19	22-25	15-16
1998-99	13-16	17-19	22-25	15-16
1999-00	13-16	17-19	22-25	15-16
2000-01	13-16	17-19	22-25	15-16
2001-02	14-15	16-18	23(min)	15-16
2002-03	13-14	15-18	22(min)	14-15
2003-04	13.5	16	21(min)	15
2004-05	13.5	15	21(min)	15
2005-06	16	16	16(min)	15

Source: Central Bank yearly reports, and Ḱhdijeh Rafiei Kavnani, 2003,Table 8, p. 46

1.This rate may change for some classes of society

Meanwhile the rate of interest on various financial loans, and facilities to investors (table 3.2.15) for different economic sectors are so divergent, that this induces economic decision makers to pursue policies which are contrary to those implemented during the time period 1990-2000. Moreover, the large difference between rate of interest of various financial loans and rate of interest of deposits is very important to explain the contradictory decisions of savers and investors (Tables 3.2.14, 15&16). The private banks and credit companies realise entirely different benefit rates, which differs completely from free market condition. The table 3.2.16 shows different benefit rate of the private banks and credit companies 1990-2000.

Table 3.2.16: Differences in benefit rate of the private banks and credit companies (1990-2000, Percent)

Type of deposit	Benefit rate
Short long investments	1
Special Short long investments	12
Investment	16
Two years investment	17
Three years investment	18
Four years investment	19
Five years investment	20.5

Source: Khdijeh Rafiei Kavnani, 2003, Table 11, p. 50

The ratio of exchanged stock amount to gross national production is another indicator. In principle, this financial potential could be used to fill the gap between the investment supply and demand through a domestic resource policy. For example, the ratio was 0.04% in 1989-1990, and stood at 1.62 % in 2000-2001. However, political reasons, not free market preferences affect this ratio decisively. On the other side, the sectoral allocation of banking facilities is another instrument to have an improved allocation of resources. For example, there is the allocation of direct banking facilities to the public sector or to the non-public sector: banks were authorized to extend the non-public sector facilities up to 25 percent in 2001-02 and up to 35 percent in 2002-03, and up to 45 percent in 2003-04; these facilities were not tied to specific sector allocations. The share of the various sectors in these facilities of the non-public sector, after deduction of freely usable amounts, legal obligations and facilities from Gharz –al-hasaneh deposits to meet urgent needs and for employment and commercial banks are as follows:

Table 3.2.17: Sectoral allocation of banking facilities extended to non-public sector:

Sectors	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	Rate of return on banking facilities	
Agriculture and water	26.0	23.2	20.2	25	21.8	25.0%	25.0%	Agriculture	13.5
Manufacturing and Mining	19.4	22.0	26.2	33.5	38.0	33.0%	32%	Manufacturing and mining	16
Housing and Construction	34.0	29.0	29.6	20	29.2	28.5%	28%	Housing (housing saving fund)	15
Exports	2.4	13.3	9.5	8	-3.7	9.5%	11%	Housing (without depositing)	18
Domestic trade, Services and Miscellaneous	18.2	12.0	14.5	4.5	14.7	4.5%	4%	Exports	16
Total	100%	100%	100%	100%	100%	100.%	100%	Commerce, services, Construction and miscellaneous	21

Source: Central Bank of the Islamic Republic of Iran, Yearly Reports 1998-99 to 2004-05
1. Private Banks and non-bank credit institutions are not subject to sectoral allocation.

The ratio of direct taxing capacity to the amount of taxes that was effectively collected is another criterion that provides important hints at the high degree of inequality of income distribution. This ratio widely differs between the various regions, states and provinces of Iran; this may cause great economic gaps and accelerate inequality and the economic differences between the areas. On the other hand, the gap between the real tax capacity and the amount of tax that was received probably widens the inequality between the regions. This also affected the per capita income and the distribution of income, and, finally, the level employment (Mehregan 2004, p. 96). In chapter 4 we shall get more specific on the relationship between employment and distribution on a theoretical level.

On the other side, the participation of stock to the GDP ratio has a great role in development plans and growth. The percentage rate of the current value of stock to GDP in 2000 was 7.2 percent. This was the highest value of this rate after the revolution; meanwhile this ratio for Finland, Switzerland and Singapore, was 288.7, 267.5 and 233.2 percent respectively in the same year. Given this, FDI was probably the best solution that was offered by international institutions. But there are some problems here. First, FDI will affect the distribution of income. Second FDI will induce an increase in the rate of saving on the one side, although, on the other side the rate of consumption does not rise at the same level. This induces a decrease in gross domestic production and, as a consequence, in employment. In spite of these contradictory view, there is a tendency to accept FDI unconditionally in developing countries. As an instance, during the second Iranian development plan after the revolution, foreign resources were put to use as a complementary instrument to overcome the domestic disequilibrium in the capital market. An example is Iran's stock market and the percentage of FDI participation in the Tehran Stock Market (Table 3.2.18).

Table 3.2.18: Percentage of participation FDI at Tehran Stock Market in 2002-03

Company	Stock Holders	Percentage of participation
Iran Transfow	Simens	4.89
Charkhshgar	Z-F Fridrish Haghen	16.67
Shirin Darow	Lico Goomez world wide	35.0
Pars Oil	International in land water ways	6.25
	Shell awrise holding Limited	6.25
	Shell finance limited	6.23
	Mexicain Ekle O, Bill	6.25
Hnkel Pakvash	Hankel K.G.I	60.0
Glucose N	C.P.C	2.1
Navard aluminum	Palmin Kamrs A.K	49.0
Shisheh Ghazvin	Nipon Glass	5.78
Vars Iran	A.S. Phonix	10.0
Iran communication long distance industrial	N.A.C	10.0
Pars Carpet	Al gamanieh	51.34
Ardl industrial	Jastion Gas	4.74

Source: Firozeh Azizy, 2004 (1383) P, 147

3.2.3.5 Foreign Direct Investments

After revolution, because of political and economic problems and also of inappropriate policies, Iran did not succeed to attract FDI in the way others did. As time went by, it seemed to have progressed somewhat, followed by setbacks. For Example in 2002 Iran stood at the 88th rank out of 196 countries, having attracted 276 million US $ FDI; however, in 2003, Iran lost ground, attracting 120 million US$ to occupy the 124th, again out of 196 countries. Regarding the average amount of FDI attracted between 2001 and 2003 Iran only obtained the 136th rank out of 140 countries, just before Kuwait, Saudi Arabia, Indonesia and Surinam. Among the oil exporting countries, Iran obtained just 1% of FDI out of a total of 10 billion US$. In 2004, FDI amounted to 559$ billion worldwide; 336 billion went to developing countries, 87 billion to Luxembourg, which occupied the first place, 53 billion to China and 47 billion to France, occupying the next places (UNCTAD - Report 2004).

Table 3.2.19: FDI Inflow after revolution Million US $

Year	FDI Inflow Million US $	Foreign Investment Million US $	Foreign financing Billion Rials	Percentage change	FDI Share into the government revenue budget Percent
1992-93	-	-	-	-	-
1993-94	2	-	-	-	-
1994-95	17	0.3	-	-	-
1995-96	26	2.6	-	-	-
1996-97	53	45.8	153.7	-	0.3
1997-98	24	62.1	191.0	24.3	0.3
1998-99	35		135.7	-28.4	0.3
1999-00	39	1047.1	154.0	12.5	0.2
2000-01		491.1	175.7	2.3	0.4
2001-02	67.991	620.9	229.6	30.7	6.8
2002-03	591.262	52.1	287.4	25.2	0.6
2003-04	120	1500.	73.3	-74.5	0.09
Total: 1993-03		3,606,			

Source: Firozeh Azizy, 2004, pp.147, 151, 203 and UNCTAD report 2004) and Parisa Manafneghad, 2005, pp. 17-25 and Iran economics, second year, Number 11, 1999, p. 38 columns 1 and 2. Central Bank of the Islamic Republic of Iran, Yearly Reports 1998-99 to 2004-05 columns 3, 4 and 5. Iran obligated picture

Table 3.2.20: Total exchange obligations (million US. $ Dollar) /00-2001/02

Years	1999-00	2000-01	2001-02 *
Total obligations**	21900	21242	20757
Potential obligation	11453	13284	14760
Total debts	10257	7953	5993
Short and Long time	6739	4275	3478
Finance	2989	2585	2668
World Bank	775	785	741
Credit trans actions	1349	387	61
Oil forward sale	1726	518	8
Short time	3618	3678	2515
Delayed			
Instruments Credit	3618	3678	3618

Source: IRI, Central Bank, obligations bureau, p 18

* February

** Obligations are included the main, interest of potential and practical obligations, the small industries and mining have a great potential to be successful. And the Oil sector has a great need to get FDI.

3.2.4 The Stony Road of Iran's Economy and Changes in the FDI Inflows

At the beginning of the last century, Iran had a self-sufficient agricultural economy. The attractive Oil and other raw material resources and also its strategic geographic position that connects the West to the East were important reasons why powerful countries and their companies were induced to invest in Iran. On the other side, Iranian governments had to

prepare the ground for a transition of the county into the modern competitive world. In this process, Iran had to rely exclusively upon foreign investment, given the absence of a banking and financial system of her own. Given this, powerful foreign countries were given control of the Oil resources for more than 50 years; these countries also entirely dominated the banking and finance sectors; moreover, these countries and their companies obtained exemptions from import tariff law. The great majority of these privileges were obtained by the British and by the Russian Empire. Given this situation, one crisis emerged after the other, rendering Iran's economic development path very stony indeed. For example, a big conflict happened about Oil when the Iranian government under Prime Minister Mossadeq tried to nationalise Oil resources, which were under the control of the British Petroleum Company. Moreover, the new needs of society required rapid change. For example, the need to achieve as much welfare as possible, that is, on the one hand, improved health, better education, a high level of employment and a fair distribution of incomes, and, on the other hand, the new government that emerged from the constitutional revolution of 1906 against the Qajar dynasty was, in fact, a reaction to modernisation. Thus, contradictions made the Iranian way of economc development particularly stony.

In the following, some economic indexes are exhibited to present some important features of the Iranian economy. We divided the data chronologically according to three separate periods. First, the period before the Islamic revolution, from 1959-60 until 1978-79, which, in turn, can be divided into two sub periods, that is the years before the Oil price increase 1972-73 and after that until 1978-79. The first subperiod still reflect the results of the Oil nationalization attempt in the 1950s. In the years after the Oil nationalization, data could be easily obtained. This period is characterised by liberal economic policies such as industrialization and free trade, that was accelerated through huge Oil revenues. Second, there is the revolution and war period, 1978/79- 1988/89. In this period, economic activities were mainly affected by endogenous and non-economic factors such as War, national and international political intervention, sanction and a huge internal migration and large immigration, capital flights abroad, brain drain and a very high internal rate of population growth. Hence policies were essentially aiming at establishing a closed and protected economy. Self-reliance, trade control, tough customs laws, high import tariffs and various measures to protect domestic production, and export facilities.

Finally, there is a third period that is from 1989/90 to 2004/05. It is the reconstruction period after the war. This shaped the ensuing plans. There was a return to liberalisation, to open

and free market theory, modified by the old and new policies based on an Islamic tradition. For example, free trade, privatisation and a set of compatible fiscal and monetary policies have been combined with the Islamic tradition to set up an appropriate economic system. In the following we review these periods by comparing the respective data.

3.2.4.1 The First Period – 1959/60 – 1977/78

Industrialization policy based on open and competitive markets and associated to free trade policies was the main characteristic of this period, 1959/60 to1977/78, which was, in fact, shaped by foreign intervention, outside pressures, and war (1945-1990). Considering the role of the oil sector, this period can be divided in to two parts, first, the Oil sector contribution to GDP before the Oil crisis 1972/73 and, second, after the Oil crisis. An obvious change in the share of various sectors in GDP can be regarded as a basic characteristic of this time period. For example, the share of the agricultural sector in GDP decreased from 33.5 percent in year 1959/60 to 14.4 percent in 1972/73, and at the same time, growth in industry accelerated; indeed, the share of the industrial sector in GDP rose from 8.8 percent in 1959/60 to 11.5 percent in year 1972/73. But the share of service decreased from 30.2 percent in the year 1959/60 to 27.9 percent in 1972/73. At the same time, the share of Oil sector in GDP ratio increased from 27.5 percent at 1959/60, to 46.1 percent in year 1972/73. The level of the Oil price per barrel actually declined which implies that quantities increased sharply to bring about the increase in the share of Oil sector in GDP ratio during the first period (Table 3.2.21 and Table 3.2.22). In the whole, the non-Oil sector share in GDP ratio in 1959/60 fell from 72.5 percent to 53.9 percent in 1972/73.

The second part of modern Iranian economic history 1959/60 to 1977/78, has been shaped by a great dependence on oil sector revenues, specifically from 1972/73 to 1977/78. In some of those years, the economy depended on Oil sector revenues for more than 48 percent (table 3.2.19). The share of agriculture in GDP dropped to a minimum size of 12.4 percent in the last year of this period 1977/78. This ratio for industry, service and Oil was 17.6, 36.5 and 33.4 percents at the beginning of the period. However, the average share of the non-Oil sectors in GDP at the end of period grows to 66.6 percent from 1972/73 to 1977/78 (table 3.2.22). Average yearly GDP growth was 9.7 percent for the years 1959/60 to 1977/78. The GDP growth rate for the year's 1964/65 and after the approval of FDI law was 11.4 percent. The growth rate of GDP since first year 1959/60 to 1972/73 and to the last, year of period 1977/78 increased by 3.7 and 5.7 percent. In other words it was the beginning of the era of Oil

dependency. The events following up the Oil crisis during 1972-1978 (table 3.2.21), are illustrated through the radical changes brought about by the rising oil price per barrel.

Table 3.2.21: The Oil price index per barrel shows the extent of the radical changes

Years	Price Per Barrel US$	Percentage Changes %
1961-62	2.2	
1970-71	1.25(Feb.1971)	- 76.0
1971-72	1.31(July.1971) 1.42(Jan.1972)	4.6 8.3
1972-73	1.42	0.0
1973-74	3.08 (Oct.1973) 9.32 (Jan.1974)	117.0 202.6
1974-75	9.57 (Jun.1974) 10.22 (Nov.1974)	2.7 6.8
1975-76	11.12 (Sep.1975)	8.8
1976-77	12.49 (Jan.1977)	12.3
1977-78	12.49	0

Source IRI Central Bank Reports

In the first part of this period the Oil price was actually quite stable and did not rise substantially. But in the second part, the Oil price rose by 202 percent compared to 1970/71. In the first year of the crisis the oil price was seven times higher than the oil price in 1970/1971.

Table 3.2.22: (continue 1) Gross Domestic Product and income, various economic sectors at constant price 1982/83 (Billions Rials)

Years	Agriculture	Total ratio %	Industry & Mining	Total ratio %	Service	Total ratio %	Non Oil GDP	Total ratio %	Oil	Total ratio %	GDP Change %
1959-60	783.8	33.5	205.2	8.8	705.3	30.2	1694.3	72.5	641.4	27.5	2335.7
1960-61	805.8 (2.8)	31.6	233.0(13.5)	9.1	788.7(11.8)	30.9	1827.5 (7.9)	71.7	720.5(12.3)	28.3	2548.0(9.1)
1961-62	821.4 (1.9)	30.5	264.6(13.6)	9.8	805.2(21.0)	29.8	1891.2(3.5)	70.1	806.1(1.9)	29.9	2697.3(5.9)
1962-63	825.7 (0.5)	28.8	287.8(8.8)	10.0	828.6(2.9)	28.9	1942.1(2.7)	67.7	926.4(5.0)	32.3	2868.5(6.3)
1963-64	836.7 (1.3)	27.4	317.4(10.3)	10.4	863.4(1.2)	28.3	2017.5(3.9)	66.3	1036.7(1.9)	33.9	3054.2 (6.5)
1964-65	825.4 (1.4)	25	340.4(7.2)	10.3	947.9(9.8)	28.7	2113.7(4.8)	63.9	1191.7(5.0)	36.1	3305.4 (8.2)
1965-66	877.1 (6.3)	23.3	403.5(18.5)	10.7	1103.0(10.4)	29.3	2383.6(12.8)	63.3	1383.1(6.0)	36.7	3766.7 (14)
1966-67	905.3 (3.2)	21.9	433.3 (7.4)	10.5	1195.3(8.4)	29.0	2533.9(6.3)	61.4	1589.7(4.9)	38.5	4123.6(9.5)
1967-68	970.0 (7.1)	20.1	504.9(16.5)	10.4	1317.0(10.2)	27.2	2791.9(10.2)	57.7	2047.0(8.7)	42.3	4838.9(17.3)
1968-69	1053.2 (8.6)	20.4	570.9(13.1)	11.1	1406.8(6.8)	27.3	3030.9(6.6)	58.8	2125.4(3.8)	41.2	5156.3(6.6)
1969-70	1072.4 (1.8)	18.4	636.8(11.5)	10.9	1534.8(9.1)	26.4	3244.0(7.0)	55.8	2569.9(0.9)	44.2	5813.9 (2.7)
1970-71	1105.3 (3.1)	17.2	726.0(14)	11.3	1686.3(9.9)	26.3	3517.6(8.4)	54.8	2897.9(2.8)	45.2	6415.5(10.3)
1971-72	1115.1 (0.9)	15.0	841.7(15.9)	11.3	1943.7(15.3)	26.2	3900.5(10.9)	52.5	3520.6(1.5)	47.4	7421.1(15.7)
∑Xi	38.9	313.1	150.3	134.6	116.8	368.5	85	761.7	54.7	483.5	112
μ	3.2	24.1	12.5	10.4	9.7	28.3	7.1	58.6	4.6	37.2	9.3
S^2	7.0	34.8	12.9	0.6	26.7	2.4	9.8	264.4	10.9	43.6	19.1
S	2.6	5.9	3.6	0.8	5.2	1.6	3.1	16.26	3.3	6.6	4.4
1972-73	1262.1(13.2)	14.4	1002.7(19.1)	11.5	2436.9(25.4)	27.9	4701.7(20.8)	53.9	4027.2(4.4)	46.1	8728.9(17.6)
1973-74	1343.7 (6.5)	13.7	1229.0(22.6)	12.5	2533.5(4.0)	25.8	5106.2 (8.6)	51.9	4722.7(7.3)	48.1	9828.9(12.6)
1974-75	1393.5 (3.7)	12.6	1430.7(16.4)	13.0	3370.5(3.0)	30.6	6194.7(21.3)	56.2	4826.0(2.2)	43.8	11020.7(12.1)
1975-76	1529.9 (9.8)	13.2	1703.1(19.1)	14.7	4102.0(21.7)	35.4	7335.0(18.4)	63.3	4249.8(8.6)	36.7	11584.8 (5.1)
1976-77	1706.2(11.5)	12.7	2347.3(37.8)	17.4	4640.7(13.1)	34.4	8694.2(18.5)	64.5	4781.1(2.5)	35.5	13475.3(16.3)
1977-78	1640.4 (6.1)	12.4	2330.0(-0.8)	17.6	4817.3(3.8)	36.5	8787.7(1.1)	66.6	4408.3(8.8)	33.4	13196.0(-2.1)
∑Xi	50.8	79	114.2	86.7	71.0	190.6	88.7	356.39	33.79	243.6	61.6
μ	8.5	13.2	19.0	14.5	11.8	31.8	14.8	59.4	5.6	40.6	10.3
S	3.6	0.8	12.4	2.6	9.9	1.3	8.1	6.2	3.1	6.2	7.5
∑Xi	89.7	392.1	264.5	221.3	187.8	559.1	173.7	1118.09	88.5	727.1	173.6
μ	5.0	20.6	14.2	11.6	10.4	29.4	9.7	58.8	4.9	38.3	9.6
S	3.9	7.1	37.1	2.5	6.9	3.1	6.3	13.7	3.15	6.5	5.4

Source: Central Bank of Islamic Republic of Iran Reports from Different Years

3.2.4.2 Second period

The second period 1978/79 to 1988/89 was a transition period shaped by crises and profound changes. This period starts with the revolution in 1978/79. This simultaneity influenced both the world economy and the national economy, through driving up the OIL price on the world market and through profound changes in the domestic economic system. In this period, international factors such as sanctions and War, and the internal tendency to rely on the domestic economy, caused the share of agriculture in GDP to rise from 14.8 percent in 1978/79 to 25.4 in 1988/89. Contrariwise, the Oil share in GDP ratio was reduced from 26.6 percent in 1978/79 to 16.8 in 1988/89, after having reached its lowest rate, that is 9.2 percent, in 1980/81. Consequently, the GDP volume fell from 13475.3 billion Rials in 1976/77 to 11836.6 billion Rials in 1978/79. Moreover there was a 22.2 percent reduction in the level of GDP. In fact, the GDP decreased on average by - 1.2 percent annually from 1978/79 to 1988/89. One may conclude that unforeseeable events like the war brought about the decline in GNP. Morevover, no FDI took place in this period.

3.2.4.3 The Third Period

The third period began with end of the War and the beginning of the reconstruction plan in 1988/89. An increasing tendency to liberal free market policies appeared in the Iranian economy together with the fundamental changes that were taking place in the world, that is the breakdown of Socialism. In this period the share of Agriculture sector in GDP decreased from 25.3 percent to 13.7 percent. The shares of the Industry & Mining sector and of the Oil sector in GDP were frequently unstable. Moreover, the share of the Service sector rose considerably from 37.8 percent to 51.4 percent of GDP in 2001-2 (Table 3.2.22., continuation, 2)

Table 3.2.22: (continue 2) Gross Domestic Product and income By Economic Sectors at constant price 1982-83 (Billions Rials)

Second period 1978-79 to 1988-89 the passage period based on crises and changing events

Years	Agriculture	percent to Total	Industry & Mining	Percent to Total	Service	Percent to Total	Non Oil GDP	Percent To Total	Oil &Gas	Percent to Total	GDP
1978-79	1747.2 (6.5)	14.8	2104.3(-9.7)	17.8	4841.1 (0.5)	40.9	8692.6(-1.1)	73.4	3144.0 (-28.7)	26.6	11836.6(-7.6)
1979-80	1851.2 (6.0)	16.6	1773.7(-9.7)	15.9	4964.4 (2.5)	44.6	8589.3(-1.2)	77.2	2535.2 (-14.0)	22.8	11124.5(-6.1)
1980-81	1914.9 (3.4)	20.1	1874.4(5.7)	19.7	4855.0 (-2.2)	51.0	8644.3(0.6)	90.8	866.1 (-65.9)	9.2	9510.4 (-11.4)
1981-82	1952.7 (2.0)	21.2	1875.1(0.04)	20.3	4507.2 (7.2)	48.9	8334.8(-3.6)	90.4	882.6 (1.9)	9.6	9217.4(-3.1)
1982-83	2091.4 (7.1)	20.0	1884.0(0.5)	18.0	4543.4 (0.8)	43.4	8518.8(2.2)	81.4	1947.7 (120.0)	18.6	10466.5(13.6)
1983-84	2193.0 (4.9)	18.9	2254.6(19.7)	19.4	5135.6 (13.0)	44.3	9583.2(12.5)	82.7	2006.3 (3.0)	17.3	11589.5(10.7)
1984-85	2353.7 (7.3)	20.3	2364.3(4.9)	20.4	5260.5 (2.4)	45.3	9978.5(4.1)	86.0	1625.6 (-0.19)	14.0	11604.1 (0.1)
1985-86	2537.6 (7.8)	21.5	2232.2(-5.6)	18.9	5373.2 (2.1)	45.6	10143.0(1.6)	86.0	1644.4 (1.2)	14.0	11787.4 (1.6)
1986-87	2650.5 (4.4)	24.7	2032.7(-0.9)	18.9	4654.7 (-13.7)	43.3	9337.9(-7.9)	87.0	1403 (-0.12)	13.0	10740.9 (-8.2)
1987-88	2715.8 (2.5)	25.3	2084.1(2.5)	19.4	4340.5 (-6.7)	40.4	9140.4(2.1)	85.1	1598.7 (13.9)	14.9	10739.1 (-0.2)
1988-89	2648.0(2.5)	25.4	1978.1(-5.1)	19.0	4030.2 (-0.2)	38.7	8656.3(5.3)	83.2	1754 (9.7)	16.8	10410.3(-3.1)
μ	(4.9)	20.8	(0.2)	18.9	(0.5)	44.2	(1.3)	83.9	(3.7)	16.1	(- 1.2)
S	(2.6)	3.2	(8.0)	1.2	(6.5)	3.4	(5.1)	5.0	(43.6)	6.3	(7.8)

Source: Central Bank of Islamic Republic of Iran 2005

Table 3.2.22: (continue 3) Gross Domestic Product and income by economic sectors at constant price 1982-83 (Billions Rials)

Third period; 1989-90 to 2004-05, Reconstructing and return to open market trade through realising revolution obligations

Years	Agriculture	Percent to Total	Industry & Mining	Total %	Service	percent to Total	Non Oil GDP	Percent to Total	Oil & Gas	Percent to Total	GDP
1989-90	2746.0 (3.7)	25.3	2109.1 (6.6)	19.4	4100.9(1.7)	37.8	8956.0 (3.5)	82.6	1889.5(7.7)	17.4	10845.5 (4.2)
1990-91	2967.5 (8.1)	24.5	2391.8 (13.4)	19.7	4499.6(9.7)	37.1	9858.9 (10.1)	81.3	2264.7(19.9)	18.7	12123.6(11.8)
1991-92	3120.2 (5.1)	23.3	2802.0 (17.2)	20.9	4945.9(9.9)	37.0	10868.1(10.2)	81.2	2516.7(11.1)	18.8	13384.8(10.4)
1992-93	3351.6 (7.4)	23.6	2932.2 (4.6)	20.7	5343.5(8.0)	37.7	11627.3 (7)	82.0	2553.5(1.5)	18.0	14180.8 (5.9)
1993-94	3535.7 (5.5)	23.7	2970.0 (1.3)	20.0	5743.7(7.5)	38.6	12249.4 (5.4)	82.2	2645.3(3.6)	17.8	14894.7 (5.0)
1994-95	3605.5 (1.9)	23.9	3114.9 (4.9)	20.6	5885.2(2.5)	39.0	12605.6 (2.9)	83.5	2496.1(-0.3)	16.5	15101.7 (1.4)
1995-96	3688.4 (2.2)	23.8	3285.9 (5.5)	21.2	6024.6(2.4)	38.8	12998.9 (31)	83.8	2517.8(-0.87)	16.2	15516.7 (2.7)
1996-97	3822.9 (3.6)	23.5	3541.0 (7.8)	21.8	6339.1(5.2)	39.0	13703. (89.5)	84.2	2566(1.9)	15.8	16269.0 (4.8)
1997-98	3957.6 (3.5)	23.7	3731.2 (5.4)	22.3	6608.9(4.3)	39.5	14297.7 (4.3)	85.5	2430(-5.4)	14.5	16727.7 (2.8)
1998-99	4333.6 (9.5)	25.4	3735.3 (.01)	21.9	6599.6 (-.2)	38.6	14668.5 (2.6)	86.0	2410.4(-0.8)	14.0	17078.9 (2.1)
1999-00	4320.6(-.3)	24.7	3900.0 (4.4)	22.3	6881.0(4.3)	39.3	15101.6 (3)	86.4	2386.3(-1)	13.6	17487.9 (2.4)
2000-01	4483.1(3.8)	24.2	4240.2 (8.7)	22.9	7187.4(4.5)	38.8	15910.7 (5.4)	85.9	2617.7(9.7)	14.1	18528.4 (5.9)
2001-2 (1)	44738(-2.3)	13.5	74079 (10.2)	22.4	177267(5.7)	53.6	292512 (5.5)	88.5	38053(-11.1)	11.5	330565 (3.3)
2002-03	49825(11.4)	14	83430 (12.6)	23.5	186828(5.4)	52.6	316149 (8.1)	89.0	39405 (3.6)	11.0	355554 (7.6)
2003- 4 (2)	53345 (7.1)	14	89910 (7.8)	23.7	195614(4.7)	51.7	335144 (6.0)	88.2	44694 (13.4)	11.8	379838 (6.8)
2004-05	54521 (2.2)	13.7	97490 (8.4)	24.5	204603(4.6)	51.4	352363 (5.1)	88.5	45871(2.6)	11.5	398234 (4.8)
μ	(4.5)	21.6	(7.4)	21.7	(5.0)	41.9	(5.5)	84.9	(3.5)	15.1	(5.1)
S	(2.8)	4.7	(4.4)	1.5	(2.8)	6.3	(2.4)	2.7	(7.5)	1.3	(2.9)

Source: Central Bank of Islamic Republic of Iran 2005

1- Figures after 2001/02 are at constant 1376 Prices

2- Figures 2003/04 & 2004/05 are provisional

3.2.4.4 The Current Situation

Iran has the biggest resources of Gas in the world, after Russia. It also has 10 percent of the world Oil resources. The highest level of Iranian Oil production is six million barrel per day, realised during the 1970 decade. But after the revolution, production decreased to even less than an average of 1’500’000 Barrel per day in 1981-82, because of two main reasons. First, after the revolution there was a tendency to switch to an economy not dependent at all on Oil revenues. The aim was to set up a self-reliant and self-sufficient economy, relying on its domestic production potential. Second, unprecedented economic and political problems accelerated this tendency; indeed, War and sanctions heavily damaged the industrial foundations of the country and, as a consequene, a strong reaction ensued. For example, the Oil industry lost nearly an amount of 250’000 barrel per day (Yaqhoti, 2005). To bring about an economy without Oil (the central economic policy tenet of Dr. M. Mossadeq's government) became the fundamental task of the revolution. But this aim was never realised, even not approximately, mainly because of exogenous problems.

Here, in order to give a picture of this issue, we have a look at the Iranian resources for a complementary study through dividing the economy into two separate sections: Iran’s economy without Oil and the Iranian economy with Oil. First, we have a look at Iran’s economic main data indexes to analyse the changes and the results obtained.

Table 3.2.23: Iran Foreign trade without the Oil revenues (million US$)

	Non–Oil exports (1)			Imports (CIF) (2)			Ratio Export Average Value to Imports Average value percent
Year	Weight (thousand tons)	Value Million US$ (percent change)	Average value (US$ per tons)	Weight (thousand tons)	Value Million US$ (percent change)	Average value (US $ per tons)	
1996-97	7041(21.5)	3106 (11.6)	441	21009	15117 (-11.5)	719	20.5
1997-98	8690(23.4)	2876(11.9)	330 (-25.2)	21845 (4.0)	14196 (13.1)	650(-9.6)	20.3
1998-99	14460 (66.4)	3013(4.8)	208 (-37.2)	16297 (-25.4)	14323 (0.9)	879(35.2)	21.0
1999-00	17567 (21.5)	3362(11.6)	191 (-8.2)	21543 (32.2)	12685 (-11.5)	589(-33.0)	26.5
2000-01	14281(-18.7)	3763(11.9)	263 (37.7)	25981 (20.6)	14347 (13.1)	552 (-6.3)	26.2
2001-02	16214(13.5)	4224(12.3)	261 (-1.0)	27464 (5.7)	17627 (22.9)	642 (16.3)	24.1
2002-03	13362(-17.6)	4608 (9.1)	345 (32,4)	26927 (-2.0)	22275 (26.4)	827 (28.9)	20.7
2003-04	14223 (8.6)	5592(26.5)	393 (16.5)	29114 (20.9)	26158 (23.5)	898 (2.1)	21.4
2004-05 3	15802(11.1)	6384(14.2)	404 (2.8)	31331 (7.6)	34105 (30.4)	1809(2.1)	18.7
μ	(14.4)	4103.1 (12.7)	2.2	(8)	18981.4 (11.9)	4.5	22.2
Б =		1226.9			7190.1		
rxy = 0. 96							

Source: Table 12 Central Bank of Islamic of Iran economic trends

*Figures in parentheses indicate percentage change over respective period of the previous year crude

(1) Excludes export of electricity, export of goods through cross border markets and shuttle trade.

(2) Imports and exports monthly data in 2003/2004 have been changed based on customs revision.

(3)Figures are provisional

3.2.5 The Oil Independent Economy

According to the data released by "Iran formal census reports 1996/97" and "Economic Research and policy department reports, 2004/05 and 2006/2007", weights (except some years) and values of Non–Oil exports increased during the period, while there were frequent changes in the average yearly values in US$ per ton. While imports weights and values steadily rose, especially after 1999/2000, the average yearly values of exports in US$ per ton, was very irregular, different and risky. The average yearly value per ton of the terms of trade also underwent great changes.

For example, the ratio of the average yearly value of Import US$ per ton to the average yearly value of export US$ per tons was 273.4% for the period in question. This clearly indicates that the terms of trade persistently moved in favour of the developed countries; given this, there is unequal trade: labour is, in a way, undervalued in the developing countries, and these countries export goods containing a given quantity of labour, exchanging these against quantities of import goods containing much less labour. Unequal exchange is, probably, widespread in the trade relations between developed and underdeveloped countries.

However, the phenomenon of unequal exchange does not clearly emerge in the case of Iran, since Iran has extensive trade relations with other underdeveloped countries as far as non-Oil products are concerned. For example, 17.6 million tons of non-oil goods were exported in 1999-2000, valued at U.S $ 3,362 million (US $ 191 per ton; this money value had *declined* by 8.2 percent with respect to the previous year), these exports showed a 21.5 and 11.6 percent increase in weight and value as compared to the previous year, i.e. 1998-99. At the same time average yearly value per ton of non-oil imports goods amounted to 589 US$, declining thus by -33.0 percent with respect to the previous year. Import quantities reached 21'543 million tons, growing thus by 32.2 percent growth; imports in value terms reached 12685 Millions US$, declining thus by -11.5 percent growth. The increase in the value of non-oil good exported was mainly due to the rise in the export of agricultural and traditional goods, especially carpets with 21.2 percent. During this year, about 21,549 thousand tons of goods valued at US$ 12,683 million, were imported, which despite 32.2 percent increase in weight faced an 11.5 percent decline in the value. The value of imports of raw materials and of intermediate goods, with 1.3 percent reduction compared to the previous year, reached $ 6.2 billion (Table 3.2.24). Import of capital and consumer goods, in this year, fell by 24.9 percent and 3.1 percent, respectively. Thus, the composition of import changed towards raw materials and intermediate goods.

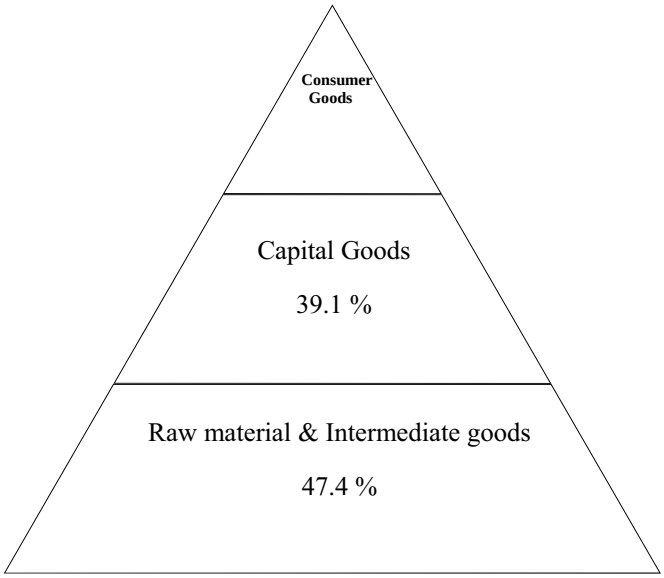
The data exhibited in the trade tables and just alluded to, point to the irregular and erratic character of Iranian trade relations. This holds, above all, for Iran's trade relations with other developing countries. As to her trade with developed countries, the terms of trade presumably worsened as far as non-Oil products are concerned.

Table 3.2.24: Composition of imports by uses (Million dollars US $)

Year	Raw material & Intermediate goods	Share (Change %)	Capital goods	Share (Change %)	Consumer Goods	Share (Change %)	Total Million US $	Total Change %
1999-00	6225	49.1 (-1.3)	4510	35.6 (-24.9)	1948	15.3 (-3.1)	12683	-10
2000-01	7401	51.6 (18.9)	4834	33.7 (7.2)	2112	14.7 (8.4)	14347	13.4
2001-02	8228	46.7 (11.2)	7127	40.4 (47.4)	2270	12.9 (7.5)	17626	25.3
2002-03	9766	43.8 (18.7)	9668	43.4 (35.6)	2842	12.8 (25.2)	21761	26.9
2003-04	12187	45.8 (24.8)	11226	42.2 (16.1)	3185	12.0 (12.1)	26598	19.6
μ	8761.4	47.4 (14.5)	7473	39.1 (16.3)	2471.4	13.5 (10.0)	18603	15.0

Source: Economic Report and Balance Sheets, 2001-2002, 2002-2003, 2003-2004,
Central Bank of The Islamic Republic of Iran (IRI),

Figure 3.2.2: Hierarchy of Imports years 1999/00 – 2003/04



Hierarchy of Imports years 1999/00 – 2003/04
Consumer Goods 13.5 %
Capital Goods 39.1%
Raw material & Intermediate goods 47.4 %
Total 100.0 %

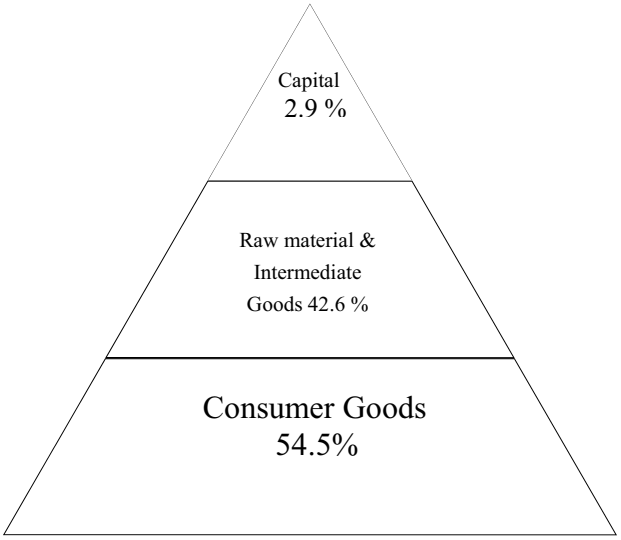
On the other hand, the composition of exports and imports did not change so unexpectedly, even under effect of the new plan of 2003/04 to facilitate attracting FDI. Except the year 1999/00, imports have risen at an average yearly rate of 21.3 percent during the years 2000/01 to 2003/04, but the average 15 percent import decline in 1999/00 should also be considered, as well as the average yearly changes in the import percentages in the raw material & intermediate goods, capital goods and consumer goods sectors, which were 14.4, 16.2 and 10.02 percent respectively. However, the important point is the great percentage share of the Raw material & Intermediate goods in total imports with 47.4 % for a country with a developing economy. The main part is related to the amount of Gas, that the government has to import each year. In addition, the highest growth percentage is related to the years in which attracting foreign investment had reached the highest rate, with the sectors coefficients remaining unchanged. Average percentages were 26.5 in 2002/03, 22.03 in 2001/02 and 17.6 percent in 2003/04. Moreover, the highest overall percentage of change occurred in 2001/02, that is 47.4 percent in the capital goods sector which had a share of 40.4% in total imports.

Table 3.2.25: Composition of exports according to uses Excluding Oil Gas and Electricity (Million dollars US $)

Year	Raw material & Intermediate goods	Share (Change %)	Capital goods	Share (Change %)	Consumer Goods	Share (Change %)	Total Million US $	Total (change) %
1999-00	1478.0	44.0 (4.7)	36.3	1.0(183.6)	1847.7	55 (16.3)	3362	(11.6)
2000-01	1465.8	39.0 (-0.8)	37.7	1.0(3.9)	2259.2	60 (22.3)	3762.7	(11.9)
2001-02	1794.0	42.5(10.5)	155	3.7(11.2)	2275	53.8 (13.7)	4224	(12.3)
2002-03	2059.0	44.7(14.8)	178	3.9 (15.3)	2371	51.4 (4.2)	4608	(9.1)
2003-04	2563.0	42.9(24.5)	298	5.0 (67.1)	3111	52.1 (31.2)	5972	(29.6)
μ	1872	42.6(10.7)	141	2.9(56.2)	2372.8	54.5 (17.5)	4385.7	(14.9)
б	-	2.2	-	1.8	-	3.4	-	8.3

Source: Economic Report and Balance Sheets, Central Bank of the Islamic Republic of Iran (IRI) 2000-01, 2002-03 and 2003-2004

Figure 3.2.3: Hierarchy of Exports in the years 1999/00 – 2003/04



Consumer Goods 54.5 %
Raw material & Intermediate Goods 42.6 %
Capital Goods 2.9 %
Total 100 %

The composition of imports and exports is extraordinary. Indeed, the biggest share in imports is taken by Raw material & Intermediate Goods with 47.4 % . These goods also have a high share in exports, that is 42.6 %, and consumer Goods have highest share in exports with an average of 54.5% over five years. Clearly, this is heritage of the ambiguity of globalisation. Moreover, the average yearly change percentage change for exports during 1999/00 to 2003/04 was 15 percent; for Raw material & Intermediate goods, Capital goods and Consumer goods the average yearly change amounted to 10.7, 56.2 and 17.5 percent.

From comparing years and sectors it emerges that the highest percentage of change for imports has occurred in 2003/04, that is 24.5 percent for Raw material & Intermediate goods, 67.1 for Capital goods and 31.2 for Consumer goods; the capital goods import share was just 5% percent of total exports in 2003/04. In addition, total value of non-Oil exports was only 22.5 percent of the corresponding imports in year 2003/04.

Obviously, this gap between the non-Oil exports and imports has to be filled just with the revenue of Oil exports. In addition, economists extensively discussed the positive correlation between non Oil imports and Oil exports. This relationship occurred because of a high dependence on foreign industrial products. This points to another way to be independent from Oil revenues. Indeed Oil export revenues lead on to importing capital and intermediate goods to keep running domestic industries, above all if they do not work well. Given this, production and, eventually, the export of non-Oil goods could not continue, if Oil exports face a problem. Therefore, the amount of non-oil export depends on the size of Oil revenues. However, it also depends on other variables. For example, changes in the price and in the quantity of Oil exported depend on the evolution of demand in the international crude oil market; the economic and political crisis in Iran was of course an important element, too. These are the factors that also affect non oil sectors of the Iranian economy in the period 1999/00-2004/2005 (See table no 3.2.226 and following).

An increase in the oil export brought about a positive trade balance on the one hand, and a reduction of external obligations, on the other hand. It also allows the government to create an Oil stabilisation fund (OSF) to administrate unexpected events. For example, a noticeable rise of 78 percent in the price of crude oil per barrel raised the export revenues in 1999/00, so that the oil export revenues, with 63.8 percent growth, increased from $ 9.9 billion in 1998/99 to $ 16.3 billion in 1999/00. Similarly, the non-oil export increased in this year by 11.6 percent compared to the previous year, and reached about $ 3.4 billion. In the same period, imports decreased by 5.4 percent and reached $ 13.5 billion from $ 14.3 billion in 1998/99. In association with the significant rise of exports the trade balance resulted in a surplus of $ 6.2 billion in 1999/00. The trade balance continued to develop favourably in the next five years, first because of the change in both the quantity and the price of oil and, second, productivity and efficiency in the non Oil sectors increased and this was, in turn, brought about by the favourable development of the Oil revenue. Indeed, the current account balance faced a $ 4.7 billion surplus in 1999/00, which paved the way for the repayment of external obligations and an increase in foreign exchange reserves. In this period, $ 633 million foreign capital was

absorbed within the framework of buyback agreements and $ 677 million and $ 2,397 million were respectively allocated to the repayment of external debt and to purchasing foreign assets in the form of short- and long-term capital. Nevertheless, US $1,845 million could be added to the country's foreign reserves in the same period. Moreover, special facilities have been granted to the non-oil exporters to settle their requirements, especially reducing the base rate for evaluating the requirement for many exports and to be able to import at favourable conditions. In addition, "Economic Revitalisation Plan" has been extended recently to the foreign exchange market in order to create stability in this market, to promote the non-oil exports, and to prevent the weakening of the competitiveness in international markets. The major part of reform policies proposed to improve the foreign exchange structure was based on the policy guideline, which was implemented in 2003/2004. Although it is, perhaps, too soon to judge, it is clear that the main objective of of these policy measures has not been realised. The foreign exchange did not become more flexible, the very large fluctuations in the exchange rate could not be reduced; as a consequence, it has not been possible to implement more reliable long-term policies to attract foreign investment or even to rely more on domestic non Oil potentials (Economic Report and Balance Sheets, Central Bank of the Islamic Republic of Iran (IRI) 2003/2004).

Nevertheless, the Iranian long-term growth plan (20- Year plan) looks very ambitious as the various targets show:

Growth of gross national product: 8.6% per year,

Annual growth of per capita income: 7.2 %,

Growth of labour productivity: 4.4% per year,

Rate of unemployment at the end of program: 7%,

Investment growth p.a. 10.9%

Non-oil goods export at end of program: 23645million US $,

Growth of liquidity, 16%

Rate of inflation at end of program, 5%,

Ratio of average income of the poorest ten percent to the average income of the richest ten percent: 14%.

Table 3.2.26: (continue 1), Total Imports and Exports at Constant 1082/3 Prices Years 1959-60 to1971-72 (Billion Rials)

Years	Total Service Import	Share in Total (% change)	Total Goods Import	Share in total%	Total Import Goods & Service	Goods & Service Export	Oil & Gas Export	Share in total %	Total Export Goods & Service	Ratio Import to export %
1959-60	13.8	7.0	182.6	93.0	196.4	85.8	786.0	90.2	871.8	22.5
1960-61	12.1	6.0 (-12.3)	188.3	94.0	200.4	78.1	884.6	91.9	962.7	20.8
1961-62	10.5	5.5 (13.3)	180.4	94.5	190.9	84.0	995.4	92.2	1079.4	17.7
1962-63	12.1	6.9 (15.2)	164.2	93.1	176.3	78.4	1143.3	93.6	1221.7	14.4
1963-64	14.2	8.5 (17.4)	152.6	91.5	166.8	82.0	1263.6	93.9	1345.6	12.4
1964-65	18.0	7.7 (27)	216.0	92.3	234.0	87.4	1425.2	94.2	1512.6	15.5
1965-66	18.6	6.9 (3.3)	250.8	93.1	269.4	106.0	1654.4	94.1	1760.4	15.3
1966-67	19.2	6.3 (3.2)	287.2	93.7	306.3	95.3	1884.9	95.2	1980.2	15.5
1967-68	19.6	5.1 (2.1)	361.1	94.9	380.6	107.3	2194.0	95.3	2301.3	16.5
1968-69	25.3	5.5 (29.1)	432.2	94.5	457.5	127.9	2501.0	95.1	2628.9	17.4
1969-70	29.6	5.8 (17.9)	481.2	94.2	510.9	133.2	2977.2	95.7	3110.4	16.4
1970-71	41.1	7.5 (39.5)	509.1	92.5	550.2	150.8	3354.5	95.7	3505.3	15.7
1971-72	33.0	5.0 (-19.7)	624.5	95.0	657.5	201.4	3907.6	95.1	4109.0	16.0
μ		6.4 (10.5)		93.6				94.0		16.6
б		1.1		1.05				1.7		2.6

Source: Economic Report and Balance Sheets, Central Bank of the Islamic Republic of Iran (IRI)

Table 3.2.26: (continue 2), Total Imports and Exports at Constant 1982/3 Prices Years -73 to1977-78 (Billion Rials)

Years	Total Service Import	Share in Total %	Total Goods Import	Share in total %	Total Import Goods & Service	Goods & Service Export	Oil & Gas Export	Share in total %	Total Export Goods & Service	Ratio Import to export %
1972-73	31.0	4.1	733.6	95.9	764.6	196.8	4502.7	95.8	4699.5	16.3
1973-74	59.3	6.1	911.7	93.9	971.0	215.3	5023.4	95.9	5238.7	18.5
1974-75	92.3	6.9	1242.9	93.1	1335.2	220.6	4938.4	95.7	5159.0	25.9
1975-76	144.5	7.3	1846.8	92.7	1991.3	242.1	4607.8	95.0	4849.9	41.1
1976-77	214.3	10.1	1936.9	89.9	2151.2	231.1	5172.9	95.7	5404.0	39.8
1977-78	295.2	11.9	2189.1	88.1	2484.3	228.7	4477.8	95.1	4706.5	52.7
μ		7.7		92.3				95.5		32.4
б		2.8		2.8				0.38		9.3

Source: Economic Report and Balance Sheets, Central Bank of the Islamic Republic of Iran (IRI

Table 3.2.26: (continue 3), Total Imports and Exports at Constant 1982/83 Prices Years 1978/79 to 1988/89 (Billion Rials)

Years	Total Service Import	Share in total %	Total Goods Import	Share in total %	Total Import	Goods & Service Export	Share in total %	Oil &Gas Export	Share in total %	Total Export	Ratio Import To export %
1978-79	188.0	11.2	1490.7	88.8	1678.7	182.1	5.3	3275.0	94.7	3457.1	48.6
1979-80	279.5	23.2	924.7	76.8	1204.2	111.4	4.2	2547.8	95.8	2659.2	45.3
1980-81	136.0	11.6	1038.7	88.4	1174.7	70.1	8.0	798.5	92	868.6	135.2
1981-82	59.4	4.6	1230.4	95.4	1289.8	35.8	4.0	806.7	96	842.5	153.1
1982-83	37.1	3.0	1213.8	97.0	1250.9	28.9	1.7	1697.4	98.3	1726.3	72.5
1983-84	50.2	2.7	1832.4	97.3	1882.6	35.1	1.8	1863.7	98.2	1898.8	99.1
1984-85	58.9	3.6	1579.0	96.4	1637.9	32.1	2.0	1513.6	98.0	1545.7	106.1
1985-86	56.7	4.3	1248.7	95.7	1305.4	36.2	2.6	1363.6	97.4	1399.8	93.3
1986-87	24.2	2.6	922.2	97.4	946.4	46.3	3.8	1174.3	96.2	1220.6	77.5
1987-88	20.6	2.0	985.0	98.0	1005.6	26.5	1.7	1530.6	98.3	1557.1	64.6
1988-89	11.7	1.0	779.7	99.0	791.4	68.5	4.0	1661.0	96	1729.5	45.8
μ		6.3		93.7			3.7		96.4		85.6
б		6.6		6.6			1.9		9.2		39.9

Source: Economic Report and Balance Sheets, Central Bank of the Islamic Republic of Iran (IRI)

Table 3.2.26: (continue 4a), Total Imports and Exports at Constant 1982/3 Prices Years from 1989/90 to2004/05 (Billion Rials)

Years	Total Service Import	Share in Total %	Total Goods Import	Share in Total %	Total Import Goods & Service	Goods & Service Export	Oil & Gas Export	Share in total %	Total Export Goods & Service	Ratio Import to export % Y	GDP at constant price 1997-98
1989-90	11.0	1.16	934.7	98.8	945.7	121.3	1744.5	93.4	1865.8	50.7	10799.9
1990-91	24.6	1.93	1249.5	98.7	1274.1	154.3	2098.2	93.1	2252.5	56.6	12045.2
1991-92	51.9	3.14	1599.2	96.9	1651.1	208.9	2319.9	91.7	2528.8	62.3	13264.1
1992-93	69.8	4.28	1557.4	95.7	1627.2	239.3	2478.6	91.1	2717.9	59.9	14049.5
1993-94	31.2	2.29	1330.9	97.1	1362.1	326.4	2828.5	89.6	3154.9	43.2	14742.2
1994-95	9.4	1.14	812.4	98.9	821.8	314.3	2881.9	90.1	3196.2	25.7	14984.6
1995-96	n.a	n.a	n.a	n.a	662.4	n.a	n.a	n.a	2930.6	22.6	15458.4
1996-97	n.a	n.a	n.a	n.a	716.5	n.a	n.a	n.a	2875.9	24.9	16192.3
1997-98	n.a	n.a	n.a	n.a	627.7	n.a	n.a	n.a	2502.7	25.1	16698.2
1998-99	n.a	n.a	n.a	n.a	591.6	n.a	n.a	n.a	2221.4	26.6	17046.8
1999-00	n.a	n.a	n.a	n.a	549.6	n.a	n.a	n.a	2344.9	23.4	17455.1
2000-01	n.a	n.a	n.a	n.a	558.3	n.a	n.a	n.a	2772.0	20.1	18490.7
μ					1803792.3				161163.29	170.124	31512345
б					1343.05				401.45	13.4	5613.58

Source: Economic Report and Balance Sheets 2001-2002, 2002-2003, 2003-2004, Central Bank of the Islamic Republic of Iran (IRI)

Table 3.2.26: (continue 4b) Total Import and Export at Constant 1982/3 Prices Years from 1989/90 to2004/05 (Billion Rials)

Years	Total Service Import	Share in Total %	Total Goods Import	Share in Total %	Total Import Goods & Service	Goods & Service Export	Oil & Gas Export	Share in total %	Total Export Goods & Service	Ratio Import to export %	GDP at Constance price 1997-98
2001-02	-495	-2.73	18624	102.73	18129	4565	19339	80.9	23904	75.8	330565
2002-03	-3503	-15.89	25539	115.89	22036	5271	22966	81.3	28237	78	355554
2003-04	-4160	-14.44	32955	114.44	28795	6636	27355	80.5	33991	84.7	379838
2004-05	-5011	-13	41650	113	36639	7576	36827	82.9	44403	82.5	398234
μ					66009027.5				13565868		865334038
S					8124.5				3683.1		29416.5

Source: IRI Centrall Bank Reports

Table 3.2.27: National account at constant 1982/3 prices (1) from 1959-60 to 2004-05 Billion Rials

Years	Agriculture	Change %	Industries & mining 2	Change %	Services	Change %	Non Oil Sectors Share in GDP	Charege %	Share In GDP %	Change %	Oil Share in GDP	Change %	Oil Share in GDP %	Change %	DP at factor cost	GDP Change %
1959-60	783.8	-	205.2	-	705.3	-	1694.3	-	72.9	-	641. 4	-	27.1	-	2335.7	-
1960-61	805.8	2.8	233	3.5	788.7	11.8	1827.5	7.9	72.1	1.4	720.5	12.3	27.9	3	2534.8	9.1
1961-62	821.4	1.9	264.6	13.6	805.2	2.0	1891.2	3.5	70.5	-2.2	806.1	11.9	29.5	5.7	2682.5	5.9
1962-63	825.7	0.5	287.8	8.8	828.6	2.9	1942.1	2.7	68.1	-3.4	926.4	14.9	31.9	8.1	2851.6	6.3
1963-64	836.7	1.3	317.4	10.3	863.4	4.1	2017.5	3.9	66.5	-2.3	1036.7	11.9	33.5	5.0	3032.7	6.5
1964-65	825.4	-1.4	340.4	7.2	947.9	9.8	2113.7	4.8	64.4	-3.1	1191.7	14.9	35.6	6.3	3281.9	8.2
1965-66	877.1	6.3	403.5	8.5	1103	16.4	2383.6	12.8	63.8	-0.9	1383.1	16.0	36.2	1.7	3738.3	13.9
1966-67	905.3	3.2	433.3	7.4	1195.3	8.4	2533.9	6.3	62.1	-2.6	1589.7	14.9	37.9	4.7	4089.6	9.5
1967-68	970	7.1	504.9	16.5	1317	10.2	2791.9	10.1	58.2	-6.3	2047	28.8	41.8	10.3	4798.9	17.3
1968-69	1053.2	8.6	570.9	13.0	1406.8	6.8	3030.9	8.6	59.4	2.0	2125.4	3.8	40.6	-2.9	5104.2	6.6
1969-70	1072.4	1.8	636.8	11.5	1534.8	9.0	3324	9.7	57.8	-2.7	2569.9	20.9	42.2	3.9	5747.9	12.8
1970-71	1105.3	3.0	726	14.0	686.3	9.9	3517.6	5.8	55.5	-3.9	2897.9	12.8	44.5	5.5	6333.6	10.3
1971-72	1115.1	0.9	841.7	15.9	1943.7	15.3	3900.5	10.9	53.2	-4.1	3520.6	21.5	46.8	5.2	7327.5	15.7
1972-73	1262.1	13.2	1002.7	19.1	2436.9	25.4	4701.7	20.5	54.7	2.8	4027.2	14.4	45.3	-3.2	8597.8	17.6
1973-74	1343.7	6.5	1229	22.6	2533.5	4.0	5106.2	8.6	52.8	-3.5	4722.7	17.3	47.2	4.2	9666.5	12.6
1974-75	1393.5	3.7	1430.7	16.4	3370.5	33.0	6194.7	21.3	57.6	9.0	4826.0	2.2	42.4	-10.2	10746.3	12.1
1975-76	1529.9	9.8	1703.1	19.0	4102	21.7	7335	18.4	65.2	13.2	4249.8	-11.9	34.8	-17.9	11252.8	5.1
1976-77	1706.2	11.5	2347.3	37.8	4640.7	13.1	8694.2	18.5	66.2	1.5	4781.1	12.5	33.8	- 2.9	13131.4	16.3
1977-78	1640.4	3.9	2330	-0.7	4817.3	3.8	8787.7	1.0	68.4	3.3	4408.3	-7.8	31.6	-6.5	12851.3	- 2.1
1978-79	1747.2	6.5	2104.3	-9.7	4841.1	0.5	8692.6	-1.1	76.1	11.3	3144.0	-28.7	23.9	-24.4	11440.9	-7.6
1979-80	1851.2	5.9	1773.7	-15.7	4964.4	2.5	8589.3	-1.2	79.2	4.0	2535.2	-19.4	20.8	-13	10841.3	- 6.1
1980-81	1914.9	3.4	1874.4	5.7	4855	-2.2	8644.3	0.6	93.7	18.3	866.1	-65.8	6.3	-69.7	9228.4	-11.4
1981-82	1952.7	2.0	1875.1	-0.3	4507.2	-7.2	8335	-3.6	92.3	-1.5	882.6	-1.9	7.7	22.2	9031.7	-3.1
1982-83	2091.4	7.1	1884	0.5	4543.4	0.8	8518.8	2.2	82.4	-10.7	1947.7	120.7	17.6	128.6	10335.4	13.6
1983-84	2193	5.0	2254.6	19.7	5135.6	13.0	9583.2	0.7	83.2	1.0	2006.3	3.0	16.8	118.2	11517.6	10.7
1984-85	2353.7	7.3	2364.3	4.9	5260.5	2.4	9978.5	4.1	86.6	4.0	1625.6	-19.0	13.4	-20.2	11522.1	0.1
1985-86	2537.6	7.8	2232.2	-5.6	5373.2	2.1	10143	1.6	86.5	-0.1	1644.4	1.2	13.5	0.7	11723.6	1.6
1986-87	2650.5	4.4	2032.7	-8.9	4654.7	-13.4	9337.9	-7.9	87.3	0.9	1403	-14.7	12.7	-5.9	10692.5	-8.2
1987-88	2715.8	2.5	2084.1	2.5	4340.5	-6.8	9140.4	-2.1	85.1	-2.5	1598.7	9.7	14.9	17.3	10736.2	-.2
1988-89	2648	-2.5	1978.1	-5.1	4030.2	-7.1	8656.3	-5.3	83.6	-1.8	1754	9.7	16.4	10.0	10360.6	-3.1
1989-00	2746	3.7	2109.1	6.6	4100.9	1.8	8956	3.5	82.9	-0.8	1889.5	7.7	17.1	4.3	10799.9	4.2
1990-91	2967.5	8.1	2391.8	13.4	4499.6	9.7	9858.9	10.0	81.8	-1.3	2264.7	19.9	18.2	6.4	12045.2	11.8
1991-92	3120.2	5.1	2802	17.2	4945.9	9.9	10868.1	10.2	81.9	0.1	2516.7	11.1	18.1	-0.5	13264.1	10.4
1992-93	3351.6	7.4	2932.2	4.6	5343.5	8.0	11627.3	7.0	82.8	1.0	2553.5	1.5	17.2	-5.0	14049.5	5.9
1993-94	3535.7	5.5	2970	1.3	5743.7	7.5	12249.4	5.4	83.1	0.4	2645.3	3.6	16.9	-1.7	14742.2	5.0
1994-95	3605.5	2.0	3114.9	4.9	5885.2	2.5	12605.6	2.9	84.1	1.2	2496.1	-5.6	15.9	-5.9	14984.6	1.4
1995-96	3688.4	2.3	3285.9	5.5	6024.6	2.4	12998.9	3.1	84.1	0.0	2517.8	0.9	15.9	0.0	15458.4	2.7
1996-97	3822.9	3.6	3541	7.8	6339.1	5.2	13703	5.4	84.6	0.6	2566	1.9	15.4	-3.1	16192.3	4.8
1997-98	3957.6	3.5	3731.2	5.4	6608.9	4.3	14297.7	4.3	85.6	1.2	2430	-5.3	14.4	-6.5	16698.2	5.8
1998-99	4333.6	9.5	3735.3	0.1	6599.6	-0.1	14668.5	2.6	86.0	0.5	2410.4	-0.8	14.0	-2.8	17046.8	2.1

1999-00	4320.6	-0.3	3900	4.4	6881.0	4.3	15101.6	3.0	86.5	0.6	2386.3	-1.0	13.5	-3.6	17455.1	2.4
2000-01	4483.1	3.8	4240.2	8.7	7187.4	4.4	15910.7	5.6	86.0	-0.6	2617.7	9.7	14.0	3.7	18490.7	5.9
2001-02	44738	-2.3	74079	10.2	177267	5.7	292512	4.2	88.5	2.9	38053	-11	11.5	-17.9	330565	3.3
2002-03	49818	11.4	83430	12.6	186828	5.4	316149	8.0	88.9	0.5	39405	3.6	11.1	-3.5	355554	7.6
2003-04	53362	7.1	89910	7.8	195614	4.7	335144	6.0	88.2	-0.8	44694	13.4	11.8	6.3	379838	6.8
2004-05	54521	2.2	97490	8.4	204603	4.6	352363	5.1	88.5	0.3	45871	2.6	11.5	-2.5	398234	4.8
μ	-	4.6	-	7.8	-	6.6	-	5.5	-	0.6	-	5.7	-	3.4	-	

Source: Economic trends, different years report (National accounts)
1- Years Data included in 2001-02 to 2004-05 are at constant 1376 prices
2- Discrepancy in figures is due to imputed bank service charges and due to value added in sub sectors
3- Figures in parentheses indicate percentage change over the previous period

Table 3.2.28: Major Changes in Control and regulation; the Trade policies, regulations and Iran capital Market structure

Years	1999/ 2000	2000/ 2001	2001/ 2002	2002/ 2003	2003/ 2004(2)	2003/ 2004	2004/ 2005(3)
Current account balance	6,589	12,500	5,985	3,585	2,059	816	3,989
Trade balance	7,597	13,375	5,775	6,201	4,993	4,430	7,764
Exports	21,030	28,461	23,904	28,237	33,788	33,991	44,403
Oil and gas and oil products	17,089	24,280	19,339	22,966	27,033	27,355	36,827
Others	3,941	4,181	4,565	5,271	6,755	6,636	7,576
Imports	13,433	15,086	18,129	22,036	28,795	29,561	36,639
Services	-1,533	-1,485	-,495	-3,503	-4,160	-4,535	- 4,812
Receipts	1,396	2,012	3,488	5,025	6,415	6,249	6,991
Freight and insurance	310	450	731	1,316	1,869	1,704	1,897
Passenger services	183	210	231	250	244	233	250
Travel	403	467	891	1,357	1,777	1,033	1,074
Investment income	181	215	655	653	633	781	808
Other public services	239	368	576	632	820	1,099	1,297
Other private services	80	302	404	817	1,072	1,399	1,665
Payments	2,929	3,497	3,983	8,528	10,575	10,784	11,803
Freight and insurance	1,240	1,347	1,539	434	824	756	820
Passenger services	8	3	6	240	299	278	300
Travel	631	668	708	3,750	4,190	3,842	4,053
Investment income	473	370	397	1,082	640	1,046	1,166
Other public services	552	966	1,135	2,065	3,484	3,306	3,703
Other private services	25	143	198	957	1,174	1,556	1,761
Transfers(net)	525	610	705	887	1,226	921	1,037
Public	17	74	23	36	48	4	6
Private	508	536	682	851	1,178	917	1,032
Net capital account	-5,894	-4,573	1,150	2,534	4,015	4,476	5,575
Long-term	-3,342	-3,218	2,361	3,329	1,350	2,045	1,164
Public	-3,371	-3,299	2,455	3,079	707	1,545	664
Liabilities	-3,365	-3,297	2,456	3,081	708	1,548	666
Assets	-6	-2	-1	-2	-1	- 2	- 2
Others	29	81	-94	250	643	500	500
Short-term	-2,552	-1,355	-1,211	-796	2,665	2,431	4,410
Public	-130	260	94	-64	-16	- 2	104
Banks and others	-2,422	-1,615	-1,305	-732	2,681	2,433	4,306
Changes in exchange rate	-157	211	-156	-210	-350	-506	-168
Errors and omissions	1,307	-1,609	-2,219	-1,242	-2,203	-1,114	- 1,742
Overall balance (changing in Foreign exchange reserves)	1,845	6,529	4,760	4,667	3,521	8,282	1,461

Source: Final report of study the various implemental instruments to develop capacity of Iran capital market, Ministry of Economic and Finance 2004 Table 52,

1- Increase in services receipts and payments during 2001-2003 are due to extension of statistical bases coverage.

2- Previous figures now revised

3- Figures are provisional

3.2.6 Investment

The eight-year war with Iraq severely damaged Iran's social and economical infrastructures and left the economy in ruin. In addition, a severe control of foreign exchange made the economy incompatible with the requirements of free capital mobility in the global economy. At the end of the war in 1988, the Islamic Republic began to rebuild the economy. Five-Years Development Plans were launched to manage the reconstruction based on a free market environment. In spite of a fact that investment activities in Iran are benefiting from various advantages: fiscal advantages, cheap domestic raw materials resources, and monetary advantages, such as Stock Exchange participation papers, tax and privatisation income and above all mostly fixed revenue by Oil, which gives the government a great potential to guide the economic activities, there are also weak, fragile and risky aspects in the economic sphere. For example, capital shortage have hampered the privatization of the government enterprises and reduced the availability of liquid means at the stock exchange. In addition, extravagant development plans also made of Iran a highly illiquid economy thirsty and eager for foreign investors. This capital shortage was financed mostly by borrowing from abroad; this was contrary to past practice, which relied on domestic resources. Consequently, the development plans were finally stalled by a severe financial crisis due to accumulation of some 30 billion dollar long and short-term debt in 1993. Consequently, the problems and huge debt forced Iran to attract foreign investments by offering some of the oil fields to international oil companies in the form of oil buyback contracts (Table 3.2.20). This was the only solution; otherwise the legislative of the revolutionary council would not have legally permitted this way of proceding. In addition, exogenous factors, such as the economic crises, the downfall of oil prices in 1998 and early 1999, the US economic sanctions, and a severe drought put more pressure on the Iranian economy. For example in 1995, the comprehensive US economic sanctions subsequent to the past made the situation even more difficult by cutting off the flow of American funds and of her allies to Iran. This included US multinational corporations' direct investments and the mutual fund companies' portfolio investments. In the absence of the mutual fund of American companies and those of her allies, other countries' portfolio investment in Iran was not considerable. On the other hand, Iran did not succeed to attract foreign investment even through rich Iranian expatriates abroad. After the revolution, wealthy Iranians, who had good relations to the former regime and who refrained from investing in Iran because of the political instability of the Middle East region and, above all, in Iran, left the country. The Iranian

expatriates have invested about $ 200 to 400 billion in the U.S, Europe, and China, but almost nothing of the principal returned to Iran (George B. Baldwin, 2002). But the hope to attract capital from Iranian expatriates remains.

In a macroeconomic view, Iran needs very robust economic theories, based on a solid social philosophical foundation, in order to be able to derive appropriate socio-economic policies and the best possible development plans to achieve the optimum results. Many different studies have measured diverse correlation coefficients between FDI and social and economic variables such as, the role of Governance infrastructure (Globerman and Shapiro, 2002), distribution of income (Aitken, Harrison and Lipsey 1996), welfare and poverty line (Pack and Saggi 2001), education (Egger et al.2005), technology (Dunning and Rugman, 1985, Liu 2002 and Lithuania, Javorcik 2004), domestic firms (Holger, and Greenaway 2004), regional inequality (Baily and Driffield 2002) growth and development (Moran et al. 2005 and Li and Liu 2005). However, there are many doubts about the usefulness of FDI; the doubtful results may also be due to the fact that different types of FDI have differing effects. The various authors mentioned here have tried to find correlations between two specific variables between which one might expect a positive relationship. Moreover, foreign investment was supposed to enhance the domestic abilities to act, and to solve all the important problems for developing economies to progress, making thus everything easy for development. Specifically, foreign direct investment is supposed to bring modern technology and advanced knowledge to countries with a developing economy. As a consequence, the improvement of all the production elements will enhance labour productivity, making thus the economy more efficient.

On the other hand, there is the idea that inappropriate FDI increases the cleavages between the various sectors of the economy, particularly between the traditional and the modern sector; the duality of the economy gets more pronounced. Given this, FDI may isolate domestic abilities and capacities, and capital developments. Most importantly, foreing direct investment is likely to bring about a more unequal distribution of incomes, also between the traditional and the modern sector. As a consequence, many developing countries attempt to regulate the distribution of incomes and to pursue some kind of incomes policy. The rate of inflation might also increase, making the distribution of income more unequal, contrary to the distributional effects of socially appropriate FDI which broadly insert into the socio-economic environment of developing economies. Socially inappropriate FDI which reinforce the dual character of developing economies will also accelerate migration from rural to urban areas and this will wipe out domestic capital and industries (table 3.2.35). This also probably changes the

consumption pattern such as to increase import dependence.

In the following the Iranian FDI experience is briefly reviewed, although FDI was not important quantitatively if compared with the size of Iran's economy, especially after the revolution, when FDI amounted overall to about 3 billion US$ (Table 3.2.29).

Table 3.2.29: The Foreign finance (Loan and investment) to GDP Ratio (Billion Rials)

Years	Foreign Loan	GDP	The ratio %
1959-60	n.a	2321.6	0
1960-61	n.a	2534.8	0
1961-62	1.2	2682.5	0.04
1962-63	0	2851.6	0
1963-64	0	3032.7	0
1964-65	0	3281.9	0
1965-66	0	3738.3	0
1966-67	0	4089.6	0
1967-68	6.2	4798.9	0.13
1968-69	6.6	5104.2	0.12
1969-70	15.0	5747.9	0.26
1970-71	30.3	6333.6	0.47
1971-72	25.9	7327.5	0.35
1972-73	9.1	8597.8	0.10
1973-74	2.6	9666.5	0.02
1974-75	3.4	10746.3	0.03
1975-76	2.7	11252.8	0.02
1976-77	3.1	13131.4	0.02
1977-78	1.8	12851.3	0.01
1978-79	1.7	11440.9	0.01
1979-80	1.7	10841.3	0.01
1980-81	4.2	9228.4	0.04
1981-82	3.6	9031.7	0.03
1982-83	5.6	10335.4	0.05
1983-84	9.1	11517.6	0.07
1984-85	15.9	11522.1	0.13
1985-86	13.9	11723.6	0.11
1986-87	11.4	10692.5	0.10
1987-88	6.8	10736.2	0.06
1988-89	29.5	10360.6	0.28
1989-90	24.6	10799.9	0.22
1990-91	58.1	12045.2	0.48
1991-92	178.4	13264.1	1.3
1992-93	127.0	14049.5	0.9
1993-94	2959.2	14742.2	20.07
1994-95	2264.2	14984.6	15.11
1995-96	1994.0	15458.4	12.89
1996-97	2953.8	16192.3	18.2
1997-98	4686.2	16698.2	28.6
1998-99	5292.1	17046.8	31.04
1999-00	7177.6	17455.1	41.1
2000-01	15079.8	18490.7	81.5
2001-02	19286.2	330565	5.8
2002-03	90692.2	355554	25.5
2003-04	92780.0	379838	24.4
2004-05	-	398234	-

Source: IRI Central Bank Reports different years

Table 3.2.30: (continue1), Investment in different sectors, Billion Rials (at Constant 1982/83 Prices)

Years	Agriculture	Industry and Mine	Oil and Gas	Service	Total Investment
1959-60	n.a	n.a	n.a	n.a	264.8
1960-61	n.a	n.a	n.a	n.a	300.5
1961-62	n.a	n.a	n.a	n.a	323.6
1962-63	n.a	n.a	n.a	n.a	313.2
1963-64	n.a	n.a	n.a	n.a	349.9
1964-65	n.a	n.a	n.a	n.a	392.8
1965-66	39.0	89.9	71.7	327.1	527.7
1966-67	34.4	99.9	55.8	337.8	527.9
1967-68	54.8	113.6	80.7	420.3	669.4
1968-69	59.5	128.9	96.0	464.0	748.4
1969-70	63.0	140.4	88.7	501.1	793.2
1970-71	71.5	175.0	66.2	574.2	886.9
1971-72	97.4	180.6	95.9	668.7	1042.6
1972-73	127.6	201.4	145.0	782.6	1256.5
1973-74	132.6	228.0	140.7	914.6	1415.3
1974-75	174.5	281.9	148.2	1029.2	1633.8
1975-76	201.6	557.3	201.6	1492.5	2453.0
1976-77	187.8	681.8	620.1	1839.1	3328.8
1977-78	164.7	782.4	402.4	1881.5	3231.0

Source: IRI Central Bank Reports different years

Table 3.2.30: (continue 2), Investment in the Government, private, service, Construction, other services, Industry and Mining sectors, Agriculture, Communication, Billion Rials (at constant 1982/83 Prices)

Years	Agriculture	Industry & Mine	Oil and Gas	Service	Total Investment
1978-79	119.3	537.9	294.8	1671.0	2623.0
1979-80	114.0	254.1	139.4	1308.3	1815.8
1980-81	120.9	246.3	95.9	1385.3	1848.4
1981-82	128.4	238.2	115.0	1242.6	1724.2
1982-83	108.9	298.5	167.9	1266.2	1841.5
1983-84	150.5	356.0	188.5	1856.1	2551.1
1984-85	106.6	424.3	139.6	1891.7	2562.2
1985-86	110.7	296.9	98.8	1646.9	2153.3
1986-87	94.0	233.4	89.6	1228.9	1645.9
1987-88	86.9	195.6	45.6	1032.5	1360.6
1988-89	83.4	169.0	47.2	844.0	1143.6
1989-90	78.4	195.0	57.5	885.9	1216.8
1990-91	108.9	254.5	48.0	967.4	1378.8
1991-92	124.0	471.4	110.5	1237.0	1942.9
1992-93	108.5	507.2	73.2	1388.4	2077.3
1993-94	119.8	650.6	66.6	1296.4	2133.4
1994-95	95.1	622.2	100.1	1388.9	2206.3
1995-96	118.8	593.8	116.0	1448.6	2277.2
1996-97	150.8	586.7	140.3	1589.2	2467.0
1997-98	158.4	504.0	171.3	1627.8	2461.6
1998-99	138.6	429.2	101.8	1637.0	2306.6
1999-00	149.9	464.2	110.1	1770.6	2494.9
2000-01	-	n.a	-	n.a	2707.5

Source: IRI Central Bank Reports different years

Table 3.2.31: Total Investment, at constant prices of 1982-3 Price,(Billion Rial)

Years	Private	Government	Total Investment	GDP	Total Investment to GDP ratio	Private Investment to GDP ratio
1959-60	160.2	104.6	246.8	2321.6	10.63	6.9
1960-61	204.6	95.9	300.5	2534.8	11.85	8.07
1961-62	215.5	108.1	323.6	2682.5	12.06	8.03
1962-63	212.1	101.1	313.5	2851.6	10.99	7.43
1963-64	215.4	134.5	349.9	3032.7	11.53	7.1
1964-65	260.3	132.5	392.8	3281.9	11.96	7.93
1965-66	293.9	233.8	527.7	3738.3	14.11	7.86
1966-67	309.5	218.4	527.9	4089.6	12.90	7.56
1967-68	355.7	313.7	669.4	4798.9	13.94	7.41
1968-69	346.2	402.2	748.4	5104.2	14.66	6.78
1969-70	357.4	435.8	793.2	5747.9	13.79	6.21
1970-71	434.2	452.7	886.9	6333.6	14.00	6.85
1971-72	481.0	561.6	1042.6	7327.5	14.22	6.56
1972-73	639.9	616.6	1256.5	8597.8	14.61	7.44
1973-74	681.2	734.1	1415.3	9666.5	14.64	7.04
1974-75	695.5	938.3	1633.8	10746.3	15.20	6.47
1975-76	1203.9	1249.1	2453.0	11252.8	21.79	10.69
1976-77	1424.8	1904.0	3328.8	13131.4	25.53	10.85
1977-78	1450.1	1780.9	3231.0	12851.3	25.14	11.28
1978-79	873.1	1749.9	2623.0	11440.9	22.92	7.63
1979-80	898.7	917.1	1815.8	10841.3	16.74	8.28
1980-81	987.1	861.3	1848.4	9228.4	20.02	10.69
1981-82	851.2	873.0	1724.2	9031.7	19.09	9.42
1982-83	784.3	1057.2	1841.5	10335.4	17.81	7.58
1983-84	1406.8	1144.3	2551.1	11517.6	22.14	12.21
1984-85	1484.4	1077.8	2562.2	11522.1	22.17	12.88
1985-86	1262.6	890.7	2153.3	11723.6	18.36	10.76
1986-87	885.2	760.7	1645.9	10692.5	15.39	8.27
1987-88	790.9	569.7	1360.6	10736.2	12.67	7.35
1988-89	679.3	464.3	1143.6	10360.6	11.03	6.55
1989-90	748.0	468.8	1216.8	10799.9	11.26	6.92
1990-91	765.8	613.0	1378.8	12045.2	11.44	6.35
1991-92	1136.3	806.6	1942.9	13264.1	14.64	8.56
1992-93	1143.0	934.3	2077.3	14049.5	14.78	8.13
1993-94	1243.7	889.7	2133.4	14742.2	14.47	8.43
1994-95	1278.4	927.9	2206.3	14984.6	14.72	8.53
1995-96	1310.4	966.8	2277.2	15458.4	14.73	8.47
1996-97	1394.6	1072.4	2467.0	16192.3	15.23	8.61
1997-98	1406.0	1055.6	2461.6	16698.2	14.74	8.42
1998-99	1403.7	902.9	2306.6	17046.8	13.53	8.23
1999-00	1495.4	999.5	2494.9	17455.1	14.29	8.56
2000-01	1651.4	1056.0	2707.5	18490.7	14.64	8.23
2001-02	-	-	-	330565	-	-
2002-03	-	-	-	355554	-	-
2003-04	-	-	-	379838	-	-
2004-05	-	-	-	398234	-	-

Source: Central Bank of IRI, annual Review different years

3.2.7 Employment

Iran's labour markets are not able to induce investment in productive human capital sectors, because they are burdened with the task of providing social insurance and security to those employed. In this way, the labour costs became almost unbearable for employers.

Under these circumstances, the usual task of the labour market, allocation of workers, which ensures economic productivity and efficiency, became ambiguous. The gap between the average yearly gross income in nominal terms versus real income in urban and rural areas could result from the large differences between capital allocation in urban and rural areas, reinforeced by FDI and the modern technology associated with it. The inequality created by the unfair distribution of capital, including FDI, between rural and urban areas can be explained by two primary factors: high inflation, and inequality in the terms of trade betweem rural and urban areas; this diminished the competitive position of the rural areas in production and trade. The increasingly unfair terms of trade also encouraged migration from rural to urban areas. This process has been going on between the developed and the developing economies as well. Moreover, these problems are, as a rule, much more acute in large cities, as opposed to the small cities. Consequently, migrants from rural areas prefer to remain in small cities where inflation is lower, but, simultaneously, the chance of finding work in small cities is less than large cities investment is centralised in the latter. Hence there is nevertheless migration from small to large cities as well.

Table 3.2.32: Employment and Unemployment people at urban and rural area, population 10 Years old and over (Percent)

Regions	Rural area		Urban area		Active Population		Total population	
Years	Employment	Unemployment	Employment	Unemployment	Employment	Unemployment	Active	Inactive
1956/57	98/3	1/7	95/5	4/5	97/4	2/6	47/5	52/5
1966/67	88/8	11/2	94/3	5/7	90/7	9/3	46/1	53/9
1976/77	85/8	14/2	94/9	5/1	89/8	11/2	42/6	57/4
1986/87	87/1	12/9	84/7	15/3	85/8	14/2	39/1	60/9
1991/92	87/9	12/1	89/6	10/4	88/9	11/1	38/1	61/9
1996/97	90/6	9/4	91/1	8/9	88/9	11/1	35/3	64/7
1999/00	87/0	13/0	86/0	14/0	86/5	13/5	-	-
2000/01	86/6	13/4	85/1	14/9	85/7	14/3	37/2	62/8
2001/02 1	86/5	13/5	85/2	14/8	85/8	14/2	37/2	62/8
2002/03 1	89/1	10/9	85/7	14/3	87/2	12/8	37/2	62/8
2003/04 2	90/1	9/9	87/9	12/1	88/2	11/8	38/1	61/9
2004/05	-	-	-	-	89/6	10/4	38/6	61/4

Source: concerted from difference Iran Central Statistic Institute tables

1. The Items are related to November

2. The Items are related to February

3.2.8 Distribution of Income

In this section, we first have a look at some income distribution data referring to rural and urban areas. The ratio of average yearly income of households to average yearly costs of living of households in urban and rural area shows differences. For example, this ratio shows the existence of *permanent absolute poverty;* the degree of absolute poverty has, however decreased somewhat over the years (Table 3.2.34).

Table 3.2.33: Average yearly gross income and cost of living in Iranian area, 1991/92 – 2003/04 Rial

Income Years	Average yearly total Gross Monetary and Non-monetary income	Average yearly Gross Cost Total	The ratio
1991-92	3263658	4141558	78.8
1992-93	4112924	5214226	78.9
1993-94	5375311	6376620	84.3
1994-95	6504449	8138244	79.9
1995-96	8323276	10905688	78.3
1996-97	11079933	13612602	81.3
1997-98	14535846	17167187	84.7
1998-99	17705404	20630996	85.8
1999-00	21538568	25271337	85.2
2000-01	25925997	30253120	85.7
2001-02	31674194	35037726	90.4
2002-03	40253287	43875805	91.7
2003-04	46130551	49515102	93.2
			84.5

Source: Results study reports of Household budget
1991/92, 1996/7, 2000/01 and 2003/04 pp. 67-79, tables 41-47

This state of affairs of generalised poverty is due to different reasons. Poverty forces people to migrate from rural to urban areas. This population movement is a direct result of a very unequal – regional – distribution of income and inappropriate investment policies, centralising investment in the large cities. Probably, the increasing rate of unemployment has also contributed to the growing inequality of income distribution.

There is, in fact, a big gap between the average yearly cost of living, in fact the average socially necessary income, to the average yearly income of households. Many factors are part of the problem. There is the increasing percentage rate of rural population that has emigrated to urban centres, and, as a consequence, the decreasing population of the rural areas; in the rural areas it would, in fact, be possible to create new jobs quite naturally, based upon traditional technologies; this would allow to manage hidden unemployment and would lay the basis for gradual modernisation. In the urban areas it is, however, very difficult to find work, even

simple and of low quality. Moreover, it is, by definition, not possible to hide unemployment, through working in agriculture, for example. The high birth rates and the great number of young people seeking a job in rural and in urban areas further aggravate the inequality problem (Tables 3.2.34 & 3.2.35). In the next chapter it will be argued that, in fact, distribution and employment interact.

The permanent ratios of inequality are expressed here through the average yearly total gross monetary and non-monetary income in relation to the average yearly total gross costs of living, in fact the socially necessary income. Obviously, there is poverty as this percentage ratio falls below 100%, with poverty increasing as the ratio gets smaller, and vice versa. This percentage ratio was obtainable from the mid-seventies. The ratio stood at 72.6% percent in 1975-76, 79.4% percent in 1976/77, 80.2% percent in 1977-78, 73.9% percent in 1979-80, 77.5% percent in 1982-83, 78.2% percent in1984-85, 85.8% percent for 1988-89. Poverty increased again after war. The ratio was at 80.9% percent for 1991/92, 83.9 % percent for 1996/97, 86.7 percent for 1998-99, 84.7 percent for 1999/00 and 83.2% percent for 2000/01. The ratio in question shows a more favourable picture for the urban areas. Indeed the urban ratios for the same time-period are 96.2%, for the year 1975/76, 100.2% for 1977/78 and 97.3% for 1979/80, 80.3 for 1982/1983, 83.3% for 1984/85 and 74.4% for 1988/89, 92.8% percent for 1991/92, 89.3% percent for 1996/97, 90.8% percent for 1998-99, 89.6 percent for 1999-00 and 92.6% percent for 2000-01. The average ratio of the yearly income of households to the average yearly costs of living of households was 80.41 % for the rural areas, while, for the urban areas, this ratio stood 88.28%, if all accessible data are taken account of.

For the rural areas, the average of the ratio in question for all years was 78.5% before the revolution and 80.8% after the revolution; and in urban areas, this ratio was 92.8% before revolution and 87.6% after revolution. The average deviation for rural areas is 4.16 and for urban areas this statistic is 9.04.

The table 3.2.34 shows that throughout the period, in which data were gathered, the average yearly total gross cost of living has remained consistently higher than the average yearly total gross monetary and non-monetary income. This proposition is also valid for the urban areas, to a lower degree though. Lower differences between the average yearly gross income and gross cost of living in large cities reveal that there is an inequality between income earned and household expenditure between the regions. Clearly, the problems of affording life in a large city affect migrant workers just as acutely as Iranian workers. It is reasonable to assume that many workers would be reluctant to move into the cities when there standard of

living would be severely impinged upon. For example, the ratio of income to cost of living in the city of Kerman is 99.9 percent, in Khorasan it is 77.1, in Qazvin it is 78.7 percent, in Sistan and Baluchistan 77.8 percent, Isfahan 83.3 percent, Qom 84.4 percent and Tehran 89.3 percent. This shows that in relation to the annual average income of an urban household the deciles of living costs highlight the inequality in the distribution of income and the large gap between income earned and the cost of maintaining a household. This ratio is often quite different from year to year. The ratios in Tehran are acutely different from the ratios in other large cities, particularly for those, with the lowest incomes decile (decile 1). The ratio is not nearly as acute for those in the lower deciles living in large cities other than Tehran. In contrast the ratio is much smaller for those in the highest decile (decile 10) in both Tehran and other large cities.

Table 3.2.34: Average Yearly Gross Income and Living Cost in large cities (Rial) 2000-01

Income	Cities	Tehran	Isfahan	Sistan & Baluchistan	Khorasan*	Kerman	Qazvin	Qom
Total Gross Living Cost		38317813	29482588	25347055	28510682	25395824	38941629	26616295
Total Gross Monetary and Nonmonetary Income		34249590	24571698	19960567	22003436	25390002	30650354	21673736

Results: Study of Household budgets, 2000/01, Tables, 46, 47, and 48 pp.72-78
*Khorasan is divided to three separate areas in 2003/04

Income is distributed differently according to the social class a worker belongs to. The shares in total income and the Gini Coefficient (%) are shown in the table 3.2.35 below. This table shows, that for the last 30 years the average income for those in lower classes, who make up 40 percent of the population, is just 14.13 percent of the total income earned by the population, while 20 percent of the population, who belong to the highest classes of society, earned more than 49.1 percent of the total income. In other words, 80 percent of the population earn just half of the total income. In addition there are other problems related to the role of capital, such as, inefficiency of production in urban and rural areas; there are also really unproductive sectors producing luxuries, which do not contribute at all to reducing the proverty situation sketched in this section on income distribution.

Table 3.2.35: Distribution of income, Lowest 40%, Middle 40% and Highest 20% Share of income & Gini Coefficient (%)

Years	40% Lowest Amount %	40% Middle	20% Highest	(%)Gini Coefficient
1969-70	13.87	35.85	50.28	43.68
1970-71	13.84	35.03	51.13	44.29
1971-72	12.53	34.69	52.78	46.79
1972-73	12.74	34.76	52.5	46.06
1973-74	12.09	33.7	54.21	47.75
1974-75	11.12	32.79	56.09	49.92
1975-76	11.10	32.48	56.42	50.20
1976-77	11.56	34.68	53.76	48.05
1977-78	12.19	35.5	52.31	45.84
1978-79	13.33	36.29	50.48	43.60
1979-80	12.71	35.83	51.46	46.18
1980-81	15.17	39.88	44.95	39.84
1981-82	14.50	38.7	46.80	42.00
1982-83	13.92	37.35	48.73	44.10
1983-84	13.17	36.9	49.93	45.40
1984-85	15.33	38.04	46.63	40.43
1985-86	15.96	38.44	45.60	39.10
1986-87	15.89	38.07	46.04	39.44
1987-88	15.08	38.22	46.70	40.38
1988-89	15.43	38.1	46.47	40.43
1989-90	14.80	38.13	47.07	40.92
1990-91	15.56	38.23	46.21	39.69
1991-92	15.58	37.83	46.59	39.96
1992-93	16.06	38.68	45.26	38.70
1993-94	15.71	37.55	46.74	39.76
1994-95	15.87	37.09	47.04	39.93
1995-96	15.35	37.11	47.54	40.74
1997-98	16.24	37.6	46.17	39.10
1998-99	-	-	-	-
1999-00	-	-	-	-
2000-01	-	-	-	-
2000-01	13.17	36.9	49.93	45.4

Source: Iran Central Bank reports, different years 1974/75-2000/01

3.2.9 Conclusion

As a creature from the outer space, economic growth and economic development was effected during the last century by the process of expansion of free market system on a world level. This socio-economic was extended by political powers such as U.S.A and supranational organisations, notably the International Monetary Fund (IMF), the World Bank and the World Trade Organisation (WTO). They have encouraged the countries with a developing economy to reduce the government intervention through liberating and emancipating the governmental economic activities and by establishing a free market system based on competititon; privatisation and providing the bases for FDI moved to the fore.

However, there is growing awareness that the presently developing countries cannot take the same way to grow and develop which had been taken by the presently rich and developed countries; moreover, it turns out that FDI has not been the miracle means developing countries have been waiting for in order to grow and to develop (FDI Report 2005).

The 8 year war with Iraq, 26 years of sanction, the problems of imigration of some 3 million Afghani and Iraqi refugees into the country, who were mostly unskilled labours that worsened the rate of unemployment in the past few years, a dramatic brain drain (1’500’000 people), and capital flights amounting to $200 to $400 billion (George B. Baldwin, 2002), a permanently high rate of unemployment and an unstable administration due to inappropriate management recommendations leading on to equally inappropriate decisions, all these factors are creatures from the inner space, so to speak, that have been severely affecting Iran's economic infrastructures and left her economy in ruin. Therefore, there are many extraordinary problems in this country.

At the end of the war in 1988, the country had to rebuild its economy. The free market system was at the core of the reform debates, which started after the war on the basis of the economic development plans. The reform period, appears to have converted public opinion from a vision of state control of the economy toward a free market vision of the economy; in this time-period, confidence in the public sector had greatly diminished, more than in any other time-period of recent history, and therefore the public and policy-makers were most willing to support privatization, foreign investment, and more competition in the markets for capital and labour. Therefore, after the revolution, the first development Plan was launched, and contrary to the past, development projects were financed mostly by borrowed funds from abroad. However, the government had, nevertheless, to intervene in economic activities such as the

control of foreign exchange. This made the economy incompatible with the requirements of free capital mobility in the global economy. The temporary economic expansion was stalled by a severe financial crisis due to accumulation of some $30 billion dollar short-term debt in 1993. The Tehran Stock Exchange was also highly illiquid and was thirsty for foreign investors. The capital shortage greatly slowed down the privatization process of the government enterprises and the illiquidity of the stock exchange (Salehi-Isfahani, 2005, p. 56) increased the needs for capital in a very exaggerated way. In addition, the huge debt forced Iran to attract foreign investments by offering some of its oil fields to international oil companies in the form of oil buyback contracts; other arrangements were not permitted legally by revolutionary legislative council until the recent foreign investment law was approved in 2004/2005 (Table 3.2.10). In microeconomic debates, according to Salehi-Isfahani (2005), the difficulty for economic growth appears to lie in translating rising FDI into rising productivity and efficiency. Doing so is not just a matter of restoring growth, though that is an essential task, but to alleviate acute social pressures arising from youth unemployment fuelled by rapid population growth. Above all, in a macroeconomic view, Iran needs to strengthen the theoretical basis of the socio-economic policies to be pursued in view of implementing the best possible plan to achieve improved results in the fields of distribution and employment in the main.

To conclude, the very important role of education and of promoting human capital must be emphasised. Indeed, countries with developing economy, because of, frequently, low standards of education and R&D suffer of a lack of highly qualitified experts. And even if there is a pool of experts at home, these are frequently unemployed; moreover, large parts of and their educated elites are self-exiled and live abroad. Both resources, education and R&D, must increasingly become accessible for developing countries. In a way, the accumulation of human capital will move to the centre of the growth process. For the Islamic Republic a basic policy aim will be to hire high-level scientists in order to promote research in advanced technology. For example, some highly trained Iranian scientists and engineers are working abroad in prestigious scientific research centres and some top university research centres. Many of them are capable of leading advanced research in various scientific and engineering fields. For example, in 1993, it was reported that 2,600 Iranian experts returned home when the government's policy of attracting Iranian experts working abroad was initiated (Baldwin, 2002).

Appendix: Report of the Research Office of the Ministry of Economics and Finance

1. In order to facilitate and regulate foreign exchange transactions, transactions of foreign exchange CDs on the TSE were eliminated as of mid of 2002 (beginning of 1381) and currencies are transacted at the reference rate in the interbank market. In this market, in addition to the CB, other banks can buy and sell foreign currencies. Thus, exporters are availed with full options in managing their foreign exchange resources.
2. To further liberalize the non-oil export process, and on the basis of the approval of the High Council of Export Promotion, export of all goods and services was exempted from surrender requirement as of mid of 2002.
3. To maintain coordination between foreign exchange and trade policies, the Ministry of Commerce revised the regulations pertaining to duties and tariffs, based on the Cabinet approval. In this regard, downward adjustments were put into effect by a ratio of 5/22 as of beginning of 2001/2002.
4. To compensate losses incurred by the exporters owing to exchange rate fluctuations, likely drastic fall of world prices of exported goods and finance of export rewards, the Cabinet envisaged certain measures in this context. It was also stipulated that the mentioned incentives be financed through Export Guarantee Fund.
5. To promote private sector activities and accelerate non-oil exports, the by-law for the establishment of private Export Promotion Funds was approved by the Cabinet.
6. New conditions were set for using short-term credit lines (refinance) for importers. On the basis of the CB circular, import of spare parts and manufacturing machinery by the private sector was authorized through these facilities.
7. The new Law for Attraction and Protection of Foreign Investment was approved on Khordad 4, 1381.1n this Law, the maximum share of foreign investment in each economic sector is set at 25 percent and in each activity at 35 percent. The oil sector is exempted from mentioned ceilings. Furthermore, the executive by-law for the said law was approved by the Cabinet.
8. Central Bank amounted the guidelines for the issuance of establishment permits of exchange bureaus (a similar guideline for free trade zones was also issued).
The main foreign exchange and trade policies (before and after the implementation of exchange rate unification) are presented in the following table:
9. In order to ease the foreign trade procedures, the Cabinet eliminated surrender requirement in exports and authorized exporters in using their export proceeds in the following ways:
a. Export proceeds are convertible to Rial in inter bank market and banks are required to purchase exporters' foreign exchange resources.
b. Export proceeds can be deposited with the domestic banks and remunerated at international market level.
c. Export proceeds can be used for import and order registration.
10. To ease trade restrictions and combat with smuggling of goods, Ministry of Commerce announced the list of those intermediate and capital goods which are importable without foreign exchange transfer. Import of these goods is permitted after order registration and payment of commercial profit.
11. In order to promote non-oil export by the private sector, Ministry of Commerce announced the by-law for the payment of export rewards for 2001/2002 (1381). According to this by-law, goods with 10 to 100 percent of their value-added from domestic origin, receive a reward of 1 to 3 percent of their export values. In addition,

equal to 1 to 3 percent of the value of export shall be rewarded for marketing and export of new commodities.
12. since December 2002, subsidiary foreign exchange inter bank market has been allowed in Kish Free Trade Zone.
13. For the import of goods all import duties, taxes, and charges (except commercial profit tax) were unified since the beginning of March 21, 2003 and a 4 percent duty rate is levied as the base customs duty. (Ministry of Economic and Finance, Research Office Report. 2003, p. 52)

Chapter 4 :
The Classical-Keynesian Synthesis

Somewhere, in between the failed utopias of pure Socialism and pure Laissez-faire, a practical middle ground exists where economics can operate dynamically and civil society can flourish.

It was the challenge of the generation of the 1940s to rebuild liberal society and keep totalitarianism at bay. It is our challenge, half a century later to renew the promise of a mixed economy and a social conception of citizenship. In the coming decades, we will live in a post-cold war world, which no great power will dominate. It is likely to be a post-laissez-faire world as well. (Kuttner 1991, p. 24)

4.1 Introduction

A country's growth and development plans are established in view of evaluating and of eventually realising, step by step, the potentials of its economy. Consequently, appropriate theories and policies have to be applied to realise the development potential of an economy. Historically speaking exceptional results have been achieved through pursuing policies based upon appropriate conceptual foundations. Britain's ascent to world dominance in the 19th century, and the irresistible rise of Germany and the United States are telling instances. Considering the body of economic theories, different approaches to the development problem may be broadly distinguished. Most important is, at present, the economic theory of liberalism that is neoclassical theory. This theory is recommended by the majority of economists and the international institutions that have played and still play an important role in shaping the development plans of most developing countries. As a rule, these recommendations go along predetermined and standard lines. On the policy level, the Washington Consensus figures prominently: Fiscal discipline, trade liberalisation and liberalisation of foreign direct investment are prominent elements of this consensus. On the theoretical level, "the unfettered operation of the market price system leads to an optimal allocation of resources at full employment, with production matching demand implying an equilibrium on all markets"(Papanek 1968, p.7). Consequently, in principle and in the long run, competitive markets bring about the most productive and efficient allocation of resources; moreover, the self-regulating market is supposed to bring about a just functional distribution, implying that employment is put to its most productive and efficient use in the long run. Nevertheless, there are also provocative critiques of the neoclassical approach. There are indeed economists emphasising protectionism which, as a rule, goes along with some economic planning. The protectionist-cum-planning approach, protectionist for short, represents, in fact, a vaguely socialist alternative to the liberal neoclassical approach. In many instances, protectionism represents a serious challenge to the neoclassical approach. Indeed, protectionism simply becomes a necessity when, for example, imported goods threaten entire sectors of the domestic economy.

The cleavage between liberal doctrine and – capitalist - economic reality may lead on to social and economic policies containing simultaneously neoclassical and protectionist elements, according to whether liberal recommendations are followed or the requirements of economic

reality have to be taken into account. This contradictions show up, for instance, in the coexistence of free trade policies in some spheres with tariffs and protection in other spheres. Contradictory positions have also been taken, regarding foreign investment. What, for example, is the impact of foreign investment on distribution and employment? The liberals would point to the overwhelmingly positive effects of FDI on both and for a developing economy in general. Critics would argue that, based upon the Kaldor and Myrdal law of cumulative causation, foreign direct investment may enhance already existing disequilibria with mutually reinforce each other. Income distribution becomes more unequal which, in turn, negatively influences employment on account of reduced purchasing power. More unemployment almost inevitably leads to a pressure on wages and thus to income distribution becoming more unequal. Cumulative causation thus leads to a vicious circle associated with more severe disequilibria. Moreover, as has been suggested in chapter 3, the role of Foreign Direct Investment has changed in an important way in the course of the last century; most important, perhaps, is the increasing importance of financial capital at the expense of real capital.

Given this ambiguous, even contradictory theoretical situation, many theoreticians and policy makers were and increasingly are looking for an intermediate way between neoclassical economics and protectionism-cum-planning, that is, in a wider view, between liberalism and socialism. Maynard Keynes's General Theory of Employment, Interest and Money may really be considered the starting point for such an undertaking. In this work Keynes has indeed laid the foundation for a monetary theory of theory of production, represented by the famous Marxian sequence:

$$M – C \ldots P \ldots C' – M'$$

It is true that Keynes focussed on the scale aspect contained in this sequence, that is on C' - M', that is on the determination of the level of employment. However, classical, that is Ricardian, theory, which deals with proportions, relative prices and quantities and distributional shares, is implied Keynes analysis. This is evident, for example, from his choice of units:

> In dealing with the theory of employment I propose […] to make use of only two fundamental units of quantity, namely, quantities of money-value and quantities of employment. […] We shall call the unit in which the quantity of employment is measured the labour-unit; and the money-wage of a labour-unit we shall call the wage-unit. Thus, if E is the wages (and salaries) bill, W the wage-unit, and N the quantity of employment, E = N W. (1936, p. 41)

It is, therefore, appropriate to associate Keynes with classical (Ricardian) theory as has indeed been undertaken through the attempts of many post Keynesian and classical-Keynesian

political economists. This chapter presents the Classical-Keynesian synthesis which is a suitable framework to come to grips with our complex subject that is foreign investment, in a wider historical and political context of economic development. However, before setting forth the classical-Keynesian framework, some preliminary remarks are required. In the first place, it is necessary to distinguish between the theoretical foundations, that is the approach taken, and the result produced by policies based on a specific approach. For example, there is conflict between theoretical circumstances and realised results especially in international development economic experiences. For example, many institutions, like, "[multinational enterprise] the MNE, has became the object of criticism, with pessimistic warning about future detriment to the developing countries if the MNE is not sufficiently regulated" (Meier 1995, p.256); this statement is in striking contrast to the neoclassical support of globalisation and of MNEs acting in a global framework.

These theoretical and practical criticisms of neoclassical theory have developed over long periods of time, in a wide historical area from the post World Wars (Meier 1995, p.258). For example Keynes's General Theory opened new dimensions in economic theory, implying a fundamental criticism of neoclassical theory, when he focused on real phenomena, such as effective demand and investment, and employment in a monetary production economy. The neoclassical interpretations of Keynes's General Theory also emphasize these new dimensions in economic theory, while reinterpreting, however, Keynes's theory of employment, interest and money. In fact, Luigi Pasinetti always emphasised that Keynes's theory represents a causal model. Such a model could look like as follows: effective demand governs output and employment; with the output given, the demand for money for transactions purposes is also determined; given this, the quantity of money governs, in a final step, the rate of interest (see on this Bortis 1997, pp. 259-72). However, Hicks's neoclassical interpretation of Keynes's General Theory, focused on fictive elements, as is set forth in a severe critique of Hicks's IS-LM – model (Cencini, in Rochon and Rossi, 2003, pp. 295-6). In fact, the IS-LM model integrates Keynes disequilibrium analysis into neoclassical equilibrium analysis where all prices and quantities are determined simultaneously through the parameters, expressing given tastes and given technology and institutions (see Bortis, 1997, pp.259-72). Most importantly, each point on the IS curve represents a *golden age* in the sense of Joan Robinson: the respective rate of profit must have been ruling for a long period of time so as to equate the cost of production of the investment goods, implying this equilibrium profit rate, and the future earings of each investment project, rediscounted at the equilibrium profit rate. Since a *golden age* can

never come into being in the real world, the relationship between quantity of investment and rate of interest (profit) must be well-behaved *in principle*: lower interest rates must be associated with larger quantities of investment. This would produce *a tendency* towards ever changing equilibria, which are, moreover, always accompanied by disequilibria. Now, the capital theoretic debate (see on this Bortis 1997, pp. 281ff.) has shown that there are no 'well-behaved' relationshiphs between factor prices and factor quantities in general and between quantities of capital and investment, and interest and profit rates. Moreover, in a post-Keynesian-Kaleckian vein, the rate of profit is, in a Keynesian *Treatise on Money* vein, *positively* linked with the volume of investment, that is, profit rates increase as investment volumes grow and vice versa. These fundamental criticisms of the IS-LM-diagram imply a death-blow for Samuelson's neoclassical synthesis and open the way for post-Keynesian and classical-Keynesian political economy.

After the second World War various post Keynesian strands grew out of Keynes's General Theory, that is, according to Geoffrey Harcourt, the Keynesian Fundamentalists emphasising uncertainty, the Robinsonian-Kaleckians dealing with cyclical growth and the Neo-Ricardians (disciples of Piero Sraffa) putting to the fore a classical theory of value and distribution with differing conditions of production. Given the deep cleavages between the Keynesian Fundamentalists and the Neo-Ricardians the search for synthesis by the post Keynesians was rendered very difficult (Bortis 1997, ch. 3). However, Luigi Pasinetti has enabled a synthesis between Keynes and Sraffa at the level of Ricardian principles (labour values) as is set out in Bortis's Keynes and the Classics (2003).

The Classical-Keynesian synthesis represents the outcome of these post Keynesian and neo-Ricardian efforts. This theoretical system combines and elaborates the classical theory of value and distribution with Keynes theory of employment, interest and money.

With the classical surplus principle distribution becomes a complex social process, and the problem of the just and fair distribution emerges as an issue of social ethics, in fact of distributive justice which, basically, is about proportions, that is ethically appropriate shares in national income and ethically appropriate income structures, with the wages structure being most important. In the classical system labour constitutes the essence of prices which reflect the social effort undertaken to produce commodities.

Keynes' employment theory implies that, in a monetary production economy, employment is governed by effective demand and is not determined on a labour market. In fact, Keynes was the first political to show that system-caused involuntary unemployment is possible.

The classical-Keynesian elaboration of Keynes's employment theory (Bortis 1997, 2003) leads on to distinguishing two employment mechanisms, that is the internal and the external employment mechanism.

All these classical and Keynesian concepts provide a solid basis social and economic policy for countries aiming at development and economic growth. Given this, classical-Keynesian complements the traditional theory of economic development and is, as such, particularly useful for developing countries wishing to bring about economic development in an orderly way.

Second, the importance of such synthesis has been put to the fore by Joan Robinson (1962, pp. 3-5), who pointed to an important alteration and transformation of the basic concepts of economic science that was brought about by fundamentally new ways of thinking about socio-economic issues. Indeed, classical-Keynesian political economy shows new light on the basic differences existing between classical (Ricardian) and neoclassical (Walrasian) concepts. For example, the notion of exchange in the classical sense is, in fact, differs profoundly from the neoclassical conception of exchange. The classical concept of exchange is, on a fundamental level, based on labour values; this amounts to building up an objective and solid corner-stone to the structure of exchange; equal exchange means exchanging equal labour values, implying all the socio-ethical considerations related to the fixing of reduction coefficients, the wages structure, and the terms of trade. This reference point enables us to define the notion of unequal exchange, when goods embodying some quantity of direct and indirect labour are exchanged against commodities containing a greater or smaller quantity of labour. In the neoclassical view, however, the terms of exchange determined by the market that is by rapidly changing market forces, expressing the aggregation of the preferences of individuals, and sometimes speculation leads to increasing uncertainty about the evolution of market prices. Given this the terms of trade may greatly fluctuate if market prices form the basis of exchange. This may greatly hamper the process of economic development, when, for example, the export earnings of a raw material exporting country greatly vary.

Hence the classical approach puts exchange, and in fact all the great socio-economic problems, on a real and objective basis. Neoclassical economics, however, is based on fragile and volatile behavioural elements (Joan Robinson, 1962, chapter 2). This goes far to explain why marginal theory stands on very shaky foundations; for example, the marginal product of capital (the marginal efficiency of capital) is, in fact, related to future earnings which may be very uncertain. To bring in stability to economic life, the policy maker's reaction is frequently to establish programmed planning.

However, both the market and the planning approach are taking inadequate account of individual and social interests. Both in fact may produce entirely unexpected results: markets associated with rational behaviour may bring about involuntary unemployment and increasing inequalities in income distribution; programmed planning may lead on arbitrary prices and inadequate supplies which do not match the demand of consumers. Once again the need for an alternative to the liberal free market approach and to the socialist programmed planning approach strongly appears.

In the third place, it ought to be mentioned that changes in the approach chosen also lead on to an alteration in the role and the importance of social and economic elements dealt with in economic literature, such as policy making, general and specific, economic for instance, the role played by money and finance, and the concepts of capital and growth. Changing approaches also lead to changes in goals. For example, in the liberal view, the concept of growth was related to the accumulated capital as governed by saving which, in turn, depends upon the size of output. Liberal economic reasoning is thus essentially supply based and, as such, anchored at Say's law in its classical or neoclassical version. All this changes if reality is looked at through Keynesian glasses. Here the importance of effective demand emerges, investment and the investment multiplier, and consumption as being related to income distribution through purchasing power. Specifically, this view acquired a new dimension in recent years when investment increased dramatically in the communications sector, producing a boom which was interpreted to herald a new – communications – economy. However, in recent years, the basic economic concepts also altered in development literature, according to International Labour Organisation report (ILO):

> In the 1950s, the pioneers in development had asked why underdeveloped countries were underdeveloped, and they formulated grand theories and general strategies [to answer the question]. In contrast, the focus in the 1970s and 1980s became increasingly directed to the heterogeneity of the developing countries and to an explanation of differential rates of country performance. Analysis moved from highly aggregated growth models to disaggregated micro models. More emphasis was placed on applied research that was country specific, based on empirical data, and on the application of neoclassical principles to policy issues. In an increasing number of countries, these changes in development thought produced an improvement in agricultural policies, a liberalization of the foreign-trade regime, and professionalism in project appraisal. Instead of the earlier fascination with long- term optimizing models, more attention is now being given to micro aspects of the development process and to the shorter term period. And based on four decades of development experience, efforts are now being made to understand why certain policies were effective in a country. (2004, p.18)

In this thesis, we shall argue, however, that one can understand the development process only

through a macroeconomic approach aimed at understanding the functioning of an economy as a whole. Essentially, this amounts to an attempt to understand the way in which the institutional system functions (Bortis 1997, and 2003). And it is very important to note that the institutional system must not be conceived in the neoclassical way. Indeed, the liberal social scientists, specifically the neoclassical economists, argue that the self-regulating market is situated at the centre of the institutional system and is surrounded by the institutional framework, made up of political, legal, social and cultural institutions, with democracy, good governance, private property and property rights perhaps being the most important. In principle, competitive markets solve all the great economic problems, and institutions must be such as not to hamper the functioning of the market. Moreover, these institutions, associated with appropriate policies: budget equilibrium, tight monetary policy, privatization, competitive market, free trade, would be most conducive to successful development.

Now critical economists, like Ha-Joon Chang (2002 and 2004), argue that the now highly developed countries did not have these liberal institutions and policies when they were developing. Specifically, the now industrialised countries protected their infant industries with tariff barriers with the state pursuing active trade and industrialisation policies, for example through the setting up of model enterprises or technical assistance to already existing enterprises. This amounts to an alternative institutional framework.

However, the fact that market is basically self-regulating was never really questioned, even not during the two decades following up the Second World War, which were, in fact, not entirely dominated by Keynes, but by the neoclassical synthesis which brought together Marshall and Keynes. However, the problem is not to associate Keynes with the neoclassicals as J.R. Hicks and P.A. Samuelson did by means of the IS-LM diagram, but to associate Keynes with the classical (Ricardian) political economy, set out in a modernised form by Sraffa (1960) and Pasinetti (1977, 1981, and 1986) and elaborated by Bortis (1997, 2003). Hence a new synthesis has to be developed, that is classical-Keynesian political economy.

Here, at a fundamental level, all the great problems socio-economic problems – value, distribution, employment - are directly solved through institutions, in fact, through the institutional system (Bortis 1997). And, in the classical-Keynesian view, an entirely different picture of the institutional set-up appears.

There is, in a classical vein, a material basis, the economy, which produces a surplus. This surplus enables a society to have surplus consumption – in excess of socially necessary consumption -, investment, and to build and to run political, legal, social and cultural

institutions, with the educational institutions perhaps being most important. Most importantly, there is not tendency towards full employment and distribution is a social process, and distributional equity emerges as the core problem of social ethics. The central task of the government now is to set up institutions or to favour the coming into being of institutions so that the social individuals can live together in an orderly way and enjoy a maximum scope of freedom. This becomes possible if, most importantly, full employment prevails and distribution is fair and equitable. Indeed, with heavy unemployment and a very unequal distribution of incomes and wealth, life becomes a struggle for survival and may lead to conflicts between social classes, and ethnic and religious formations.

Now, in this view development in a broad sense, social development to wit, consists in building up and continuously improving the institutional framework, i.e. the material basis and the institutional superstructure, always in line with the mentality and the values of the people living on the state territory, taking account of their diversity which, in orderly conditions, enables a mutual enrichment. Economic development, then, consists of setting up and improving the material basis, creating a machine tool industry, for example, to make sure that the gradual replacement of the traditional sector through the modern sector goes on in an orderly way, most importantly at full employment. Eventually, part of the traditional sector has to be maintained for cultural reasons. And, very importantly at present, economic development must go on in harmony with nature.

A fourth point is to suggest that the very important concepts of state intervention and decentralization and the meaning of government cooperation are other concepts that have changed recently and which will have to be recast in the light of classical-Keynesian political economy. Indeed the different levels of the state intervention and decentralization become important quite independently of the working of competitive markets and the requirements that the government should not intervene. According to Sercovich:

> Although this priority is primarily country – specific, it is also common to most developing countries and economies in transition, thus calling for renewed multilateral action. Cooperation among, countries in the policy field may consist of harmonization, coordination or joint assessment, or benchmarking. A salient feature of these three levels of cooperation is the declining need for top-down intervention and centralized execution. In contrast to the first two, experience of policy benchmarking is very limited, especially across regions, where it offers the greatest potential. (1999, p. 53)

In addition based on Streeten: “It has been said that the state has become too big for the small things, and too small for the big thing” (1995, p.3). This is also in line with the humanist

perspective, according to which the basic aim of the state is to realise the Common Good of a society as closely as possible. As a result, as Bortis states:

> This implies putting to use two complementary principles of social ethics regulating the relations between society and individuals, i.e. the principles of subsidiarity and solidarity. According to the principle of subsidiarity the state should not intervene whenever problems can be solved by social institutions or by individuals [. . .]. Hence the principle of subsidiarity ensures that social and individual rights and hence the scope of freedom are as extensive as possible. The principle of solidarity deals with the social preconditions required for the prospering of individuals within society, for example the education system and the social security system, but also a socially acceptable income distribution and full employment. The principle of solidarity requires state intervention in the economic domain, mainly because the market mechanism is not capable of solving the great economic problems, i.e. long-period value, distribution and employment. The proper application of the principles of subsidiarity and solidarity requires a solid theoretical foundation which is to be provided by classical-Keynesian political economy. (1997, p. 403)

Chapter 4 sets forth the main aspects of the social liberal Classical-Keynesian synthesis as a flexible theoretical alternative which is opposed to the rigid theories constructions, represented, on the one hand, by the liberal neoclassical framework, and on the other hand, by the programming-protectionist approach. Those aspects of the Classical-Keynesian synthesis, which allow dealing with foreign direct investment in a wider context, are presented here; this requires taking a comprehensive view of this very complex subject. First, in order to gain perspective, some fundamental issues of the classical-Keynesian synthesis and the wider framework surrounding it are looked at. On the one hand, we have a glance at the Classical foundations of the Classical-Keynesian synthesis, such as the social production system and the natural labour value principle embodied in this systems; this leads on to considering how the distribution of income goes on, based on the surplus principle of distribution, in a real socio-economic system. On the other hand, our considerations focus on Keynesian concepts associated with the monetary theory of production, such as multiplier relationships and the principle of effective demand. This conceptual basis will enable us with our basic question: How do realised results based on the currently applied dominant theories differ from what developing economic countries expected; specifically, how are employment and distribution affected differently, in general and through foreign direct investment?

4.2 Important Mechanisms implied in the Classical - Keynesian Synthesis

In this section, we will study the main dimensions of the mechanisms implied in the Classical-Keynesian synthesis, which represents a flexible theoretical alternative to the neoclassical and the programming-protectionist approach. The Classical-Keynesian system enables us to deal with all the great economic problems, such as distribution, employment and finally, related to this study, investment and FDI and their effect on distribution, employment and hence economic development. The starting point for all our considerations is the social process of production and its interrelations with society through the social surplus arising from this process. Thus, our considerations are related to society and the economy as a whole, and are, in terms of economic theory, essentially of a macroeconomic nature. (One should immediately note the difference with neoclassical economics which starts from the rationally behaving individuals whose actions are, in the liberal, purposefully coordinated by markets in a way that the market equilibrium also represent a social optimum, e.g. a Pareto-optimum.)

In the first place, the distribution mechanism implied in classical-Keynesian political economy is discussed. It is of primary importance to note that distribution is regulated within the social process of production, which has two aspects, that is the interindustrial, Sraffa-Leontief input-output aspect and the vertically integrated, Ricardo-Pasinetti labour aspect. Basically, distribution is regulated by the surplus principle: part of the production is used up by the workers and employees in the profit sector – the classical productive sector – in the form of socially necessary wages and the remainder of the social product, that is the social surplus, is at the disposal of society. With the surplus approach distribution – income shares and structures - is basically regulated by social forces, entrepreneurs and entrepreneurial associations, workers and employees, eventually organised in trade unions, with the state coming in through fixing minimum wages and work conditions. As such the classical surplus approach represents an alternative to the marginalist neoclassical approach to distribution, exemplified by Walrasian-neoclassical theory; here, functional distribution takes place on factor markets. The fact that factor markets exist in neoclassical theory and not in classical-Keynesian theory, represents perhaps the most important difference between neoclassical economics and classical-Keynesian political economy.

The labour principle of value and the uniform rate of profits capture the essence of the distribution mechanism in the classical-Keynesian system which has also social ethical implications since issues of distributive justice are involved here (ethically appropriate income

shares and structures). This is why Luigi Pasinetti (1981) considers the labour value principle a natural principle since it corresponds to the nature of man and of society, including the economy. The labour value principle and the uniform rate of profits refer to the vertically integrated approach as is set forth in Bortis (2003) on the basis of Pasinetti (1981). Prices of production associated to a uniform profit rate emerge, however, from interindustry production models of the Leontief-Sraffa type as are set forth in Pasinetti (1977). The prices of production bring labour values into concrete existence (Bortis 2003) and, as such, depend upon the conditions of production, the various production coefficients, including labour coefficients, in a Leotief-Sraffa system and of income distribution, represented by the uniform rate of profits (Bortis 2003, pp.427-430). In the interindustry approach distribution also appears as a social process that goes on between social classes. This implies that one of the distributional variables, the real wage rate or the profit rate outside the technical production system by social forces. Indeed, with n basic goods there are n production equations and n+ 1 unknown: n-1 relative prices, the real wage rate in terms of the numéraire and the uniform rate of profits. One variable, the real wage rate or the rate of profits can thus be fixed arbitrarily (on this see Pasinetti 1977, p. 73). Now, there are links between the vertically integrated labour approach and the horizontal interindustry approach. This appears from considering the social process of production which, basically, may be seen as an interaction between man (labour) and nature (land) by means of real capital, i.e. tools and machines (Bortis 2003, pp. 433-36). The nature or land aspect of social production is set out in Pasinetti (1977). Here the (Leontief) interindustry flows are pictured: primary goods taken from nature and intermediate goods are transformed into final products in a social and, in part, circular process involving production of commodities by means of commodities – and labour (Sraffa). The labour aspect of production is set forth in Pasinetti (1981 and 1986a): direct and indirect labour, in association with past labour embodied in fixed capital, produce the primary, intermediate and final products (Bortis 2003, pp. 433-36). Now, analytically, the land and labour aspects of the social process of production are linked by the Pasinetti transformation: the vector of direct labour is multiplied by the transposed Leontief- inverse to yield the total (direct and indirect) labour required to produce the various commodities (Bortis 2003, p. 438, relation 19.5; see also relations 4 and 5 below).

Since the i-th column of the Leontief- inverse contains the quantities of each good required directly and indirectly to produce one unit of good i, the i-th element of the n-vector stands for all the labour used directly and indirectly in the whole production system to produce one unit of commodity i. Since production runs from primary, through intermediate goods to

final goods, there is, evidently, vertical integration with the final goods summarising all the 'lower-level' efforts made to produce them. The Pasinetti-transformation now enables us to establish a link between classical political economy (Ricardo and Sraffa) and Keynes that is between the classical theory of value and distribution and Keynes's employment theory. Indeed, the classical (Ricardian) labour model obtained by the Pasinetti transformation determines relative prices and quantities only (Pasinetti 1981, p. 23, note 30). To obtain absolute prices, the money wage rate (w) must be fixed; to determine absolute quantities requires fixing the level of employment (N) (Pasinetti 1981, pp. 32-33, Pasinetti 1986a, pp. 422-23). Now, as mentioned above, in chapter 4 of the General Theory – The Choice of Units – Keynes states: "In dealing with the theory of employment I propose […] to make use of only two fundamental units of quantity, namely, quantities of money-value and quantities of employment. […] We shall call the unit in which the quantity of employment is measured the labour-unit; and the money-wage of a labour-unit we shall call the wage-unit" (1936, p. 41).

Thus, the Pasinetti transformation links the whole body of classical theory to Keynes's employment on the level of fundamental pure theory, i.e. on the level of principles. In doing so, Luigi Pasinetti has laid the long-period foundations for Classical-Keynesian political economy which may be considered a synthesis and an elaboration of the post Keynesian strands of thought. A central problem is to adapt Keynes's short-period theory of employment to the long run to make it compatible which the classical (Ricardian) theory of value and distribution which focuses on stable or slowly changing magnitudes (institutions and technology) and is, as such, of a long-period nature (Bortis 1997, pp. 142-204, and Bortis 2003, pp. 415-23 and pp. 460-67).

As at this stage the distribution plays crucial and fundamental role in economic theory. Indeed, in the preface to his Principles, Ricardo writes: ". . . to determine the laws which regulate . . . distribution, is the principal problem in Political Economy (Ricardo 1951/1821, p. 5)." (Bortis 2003. p.454) In fact, before one can speak about value, distribution must be regulated. This emerges most clearly from Luigi Pasinetti (1977) who showed, as has been remarked above, that the (relative) prices of production depend on production coefficients, including labour coefficients, and on income distribution, that is the rate of profits. (Absolute prices would be determined once the money wage rate is determined). This means that the rate of profits or the real wage rate has to be determined. Ricardo opted for determining the (natural) wage rate. Sraffa suggested that the rate of profits was governed by the interest policy of the central bank and by the social power of the capitalists. However, distribution is not only

important as a precondition for determining value as Ricardo, Sraffa and Pasinetti emphasize; in a Keynesian vein, distribution also is of central importance for the determination of the level of employment and hence involuntary unemployment through the purchasing power of the receivers of incomes. Indeed, as will be seen below, the relationship between distribution and employment is the crucial feature of the super multiplier relation. This neatly links up with Keynes's theory: "[Up] to the point where full employment prevails, the growth of capital depends not at all on a low propensity to consume but is, on the contrary, held back by it. [...] Thus our argument leads towards the conclusion that in contemporary conditions the growth of wealth, so far from being dependent on the abstinence of the rich, as is commonly supposed, is more likely to be impeded by it"(1936, pp. 372-73). And Schumpeter remarks in his obituary on Keynes in the American Economic Review of 1946: '[The Keynesian doctrine] can easily be made to say both that "who tries to save destroys real capital" and that, via saving, "the unequal distribution of income is the ultimate cause of unemployment." This is what the Keynesian Revolution amounts to' (Schumpeter 1946, p. 517). As Bortis declares, the close relationship between Keynes and Sraffa has been perceived by Luigi Pasinetti since the 1950s:

> However, Pasinetti looks at the Keynes-Sraffa issue from another angle and his aim is different in that he focuses on structural change. ….Pasinetti's analysis is based on the fact that an economic system may be considered from different points of view. [One is Sraffa's approach emphasising] the circularity of the production process. [The second aspect] is the point of view of effective demand [from which] one can investigate the final product and immediately relate it to its direct and indirect [labour] requirements (Pasinetti 1986b, pp. 10-11). …In general terms, we have insisted on the fact that Pasinetti's combination of interindustry analysis and vertical integration provides the analytical basis for bringing together of classical and Keynesian elements of economic analysis. (Bortis 2003a, pp. 427, 428 & 429)

Taking the vertically integrated point of view directly takes us to Keynes and Keynesian macroeconomics. However, macroeconomic problems are so complex that only absolutely essential elements, that are principles, have to be taken into account if the analysis is to be kept manageable. Again according to Bortis: "the labour value principle is of fundamental importance, as is the uniform rate of profits as a most powerful tool to organise a monetary production economy. The analytically difficult task consists, therefore, in combining the labour value principle and the uniform profit rate, which are both essential features of a monetary production economy. On the level of principles or of metatheory, this can only be done within a vertically integrated framework if the analysis is to be kept manageable. Relaxing this assumption and introducing prices of production is a matter of economic science operating

through theories. In a classical-Keynesian framework, the theoretical results will not modify qualitatively the conclusions reached on the level of principles. By contrast, the neoclassical principles derived from Samuelson's (1962) surrogate production function break down once we leave the realm of labour values. To deal with these problems, proportions and structures are, in the spirit of Ricardo and Marx, dealt with in the simplest possible way: It is, in fact, assumed that the proportion of circulating to fixed capital is the same in all sectors, although the absolute quantities of labour embodied in fixed and circulating capital respectively differ between final good sectors. This assumption, which will be justified later on, and the fact that the same quantity of labour may be embodied in qualitatively very different goods, ensure the heterogeneity of the various consumption and capital goods. Simultaneously, the fundamental importance of labour appears in a pure form. Only labour values are essential to price, not the accidental conditions of production and exchange which merely modify the labour values and lead to prices of production and to market prices. This is not to say, that the latter are unimportant. Prices of production – and the associated uniform profit rate - and market prices render labour values operable in the real world, though in modified form. Particularly, the uniform rate of profits is a powerful tool to organise monetary production economies because decentralised decision taking regarding prices and quantities is rendered possible and competition may be organised in an orderly way. The labour value principle, however, is part of a system of pure theory enabling us to deal with essential aspects of a monetary production economy" (Bortis 2003a, pp. 429-30).

It is important to note that the synthesis developed on the basis of principles reconstitutes essential elements of the real world and forms the basis for scientific work dealing with phenomena: Hence to postulate uniform ratios of fixed to circulating capital and the labour principle of value is not to criticise the scientific work done by Sraffra, Pasinetti, Steedman and others, on the basis of non-uniform ratios of fixed to circulating capital. In fact, these authors deal with economic phenomena and their models must be realistic in the sense that they reflect these phenomena. However, these notes are on principles, i.e. on the fundamental forces governing economic phenomena. Principles illuminate phenomena from inside and, as such, need not reflect these in a realistic way (Bortis 2003a, p. 430). The classical analysis of social production, value and distribution is dealing with proportions (relative prices and quantities, income shares and structures) has been completed with Keynesian monetary theory, dealing with the scale of economic activity. The Keynesian aspect of the classical-Keynesian synthesis explains the determination of the long-period level of employment and output in a monetary

production economy through effective demand as is captured by the super-multiplier relationship; as will be seen below, this super-multiplier framework will allow us to deal with the effects of foreign direct investment upon a developing economy on the level of principles which, in turn, will enable us to come to grips, approximately, with this immensely complex problem as emerges from chapter 3.

This completes the picture of the various dimensions of the Classical-Keynesian political economy synthesis. Subsequently, we shall argue that this framework of analysis enables each country to manage its specific situation in a flexible way enabling policy makers to take account of diverse and evolving conditions. This is far from the rigid prescriptions of neoclassical free market theory, as are embodied in the Washington consensus for example, and also greatly differs from the programming-protectionist policies. This alternative theoretical system is based on the natural labour principle of value, with labour operating within the social process of production which, in turn, is associated with social cooperation, and humanist behaviour grounded on a social ethical foundation. As Bortis states: "[. . .] It should be noted that the labour value principle and the uniform profit rate are probably the most appropriate starting points for social ethical considerations" (2003a, p.426). Indeed, the ethical dimension is crucial for long-period Classical-Keynesian political economy, a fact which echoes Keynes' famous dictum that economics is, essentially, a moral science. According to Bortis:

> [. . .] the principles governing the economic aspects of the socio-economic-cum-political system made up of institutions and technology. Institutions and technology form a system because the various social and individualistic institutions are complementary and broadly ordered through the famous classical-Marxian, material basis – social superstructure' scheme. To deal with socio-economic system outcomes implies abstracting from the vagaries of the market and even from specific conditions of production which means that the prices of production are proportional to labour values. Hence the subsequent analysis is of a long-period nature: only permanent or slowly evolving factors - technology and institutions - are considered, abstracting thus from more or less rapidly changing short- and medium-term behavioural elements associated with the market place or with business cycles respectively. (Bortis 2003a, pp. 430-31)

This classical-Keynesian labour or social production model stand in sharp opposition to the neoclassical exchange or scarcity model which are both set forth in Pasinetti's Theory of value – a Source of Alternative Paradigms (Pasinetti 1986a) and represent two of the great theoretical options available at present besides the programming-protection approach which, in a way, echoes the economic theory of centrally planned socialism. Based on Bortis we are now going to consider:

> [. . .] the classical view of production as a circular and social as well as a vertically integrated process and its implications for the pure theory of distribution and value. [This is to deal] with proportions (relative prices) and shares (in a given income), [which is complementary to] Keynes's theory of employment [dealing] with the scale aspect of economic activity where absolute (money) prices and quantities are put to the fore. This leads to defining classical and Keynesian macroeconomics. It has already been mentioned that the former is about proportions within production and circulation, for example proportions between industries and sectors, relative prices and income shares, the latter about the scale of economic activity associated with certain levels of employment and involuntary unemployment. . . . [The propositions made here put to the fore] the fundamental importance of the modern founders of Classical-Keynesian political economy, Keynes and Sraffa, who, together with Michal Kalecki [and Roy Harrod], are the great figures of Shackle's Years of High Theory – 1926-1939. Hence classical and Keynesian macroeconomics are to be combined to yield a Monetary Theory of Production as envisaged in Keynes (1933), in contrast to the neoclassical real exchange model (Bortis 2003a, p. 431-32)

At this stage it should be mentioned that money plays an essential role in the classical-Keynesian system:

> The monetary theory of production implies that money is essential in a modern economy because the social process of production and the processes of circulation simply could not go on without money, as Paul Davidson and others have emphasised time and again. The basic reasons are that in a monetary production economy consumption, production and investment plans are always in terms of money; production and investment take time and monetary outlets and receipts do not coincide; in the sphere of exchange, commodities are always exchanged against money [never goods against goods with money as an intermediary]. (Bortis, 2003a, p. 432)

This implies that there are flows of goods and money – moving in the opposite direction – in a monetary production. Moreover, the presence of a central bank and a banking system implies that there is exogenous money (notes and coins issued by the central bank) and endogenous money which comes into being within the banking system. Here, a systematic interactive relation between Government, central bank and the financial institutions is very important, too. This point will be taken up below.

4.2.1 Basic Principles of Value and Distribution in Classical-Keynesian Political Economy

It has already been suggested that the distribution mechanism in Classical-Keynesian political economy operates within the social process of production. To start with, it is important to distinguish between more or less rapidly changing behaviour as takes place in the course of the

business cycle and on the market place and persistent, permanent behaviour which may get institutionalised and may shape subsequently and even determine the behaviour of individuals through setting restrictions. "The institutional system –the material basis and the institutional superstructure – and the behaviour of individual within this system are complementary, and there is mutual interaction. ….the system governs output and employment as a whole, behaviour determines who is employed or unemployed or which enterprises survive in the long term and which enterprises are squeezed out of the system. Since institutions and technology are associated with duration, they constitute in a natural way the persistent or slowly evolving factors governing long –period prices and quantities in Classical-Keynesian political economy" (Bortis 2003, p. 417).

Given this, on the basic level the distribution mechanism is shaped through the labour value principle and the surplus principle which is reflected in the uniform rate of profits. Both principles represent the essential features of the distributional process. These distributional results will be modified through differing conditions of production which are reflected in prices of production which are also come into being within the social process of production. There is a specific socio-economic meaning of this way of looking at the phenomenon of value: only labour, in association with past labour (real capital) and land, creates value, not the conditions of production which, with an equal rate of profits in all sectors, cause the prices of production to deviate from labour values, a fact that has given rise to the transformation problem (Pasinetti 1977, ch. V). In addition, the vagaries of the market bring about deviations from the prices of production and thus modify labour values to a further extent. Again, it is evident that the market forces do not create value and thus cannot govern value as is the case within the neoclassical exchange or preference approach where value is governed by supply and demand. Hence the notions of labour force producing labour values in the form of labour time form together with the price of the labour force, the money wage rate, provide the measurement units and the analytical foundation to come to grips with the issue of value and distribution within the social process of production. This is profoundly Ricardian (Marxian), but also Keynesian (see, for example, Keynes, 1936, chapter 4). "[Hence] theorising on Classical-Keynesian lines at the most fundamental level should be done on the basis of the labour value principle. [Here . . .] labour values and prices of production are not exclusive, but intimately linked and hence complementary. Both are valid on different levels of abstraction. In fact, the labour values are essential or constitutive to prices, and the prices of production bring them into concrete existence though in modified form. This very simple point touches upon most controversial

issues and justifies some remarks on method" (Bortis, 2003, p. 411).

Indeed, the labour value principle represents the essence of the humanist basis upon which the Classical-Keynesian synthesis is grounded on and as such represents a reconstitution of essential elements of an economic phenomenon, i.e. value and price. "[The . . .] labour value principle is employed in a broad humanist sense, not in the spirit of class struggle as was certainly largely justified in the 19th century. ... This does not mean, however, adopting a labour theory of value, which evidently does not hold on the level of appearances. In fact, labour values are modified through the conditions of production leading to prices of production, which, in turn, deviate, from market prices [which are both reflections of appearances]. Hence observed prices are not proportional to labour values which, however, constitute the essence of prices. It is in this sense we put to use the labour value principle, which holds on the fundamental level of analysis where only essentials are considered, and accidentals – market conditions and conditions of production - are abstracted from. [To use the labour principle of value has great advantages because the economic sphere may now be linked to other spheres of social life.]. [Indeed, . . .] the labour value principle and the associated surplus principle allows us to deal in a comprehensive way with the problem of distributive justice as is associated with the structures of wages, profits and rents, and with the size of the surplus comprising profits, ability rents and land rents. [Moreover], the labour value principle may be associated in a straightforward way to the study of social relations, for example between people working in the profit and non-profit sectors respectively. [Finally], also at the level of principles, part of the social surplus over ordinary wages is due to additional labour time of the persons working in the profit sector. This is the quantitative part of the surplus. More importantly, however, is the qualitative part of the social surplus made up of the surplus wages, exceeding ordinary wages. Surplus wages are due to special abilities, of some artisans, managers, surgeons, or lawyers for instance. In part, profits may also be interpreted as reward for good management (Bortis 2003a, pp. 423 & 424).

We now set forth the principles of value and distribution as are emerging from the social process of production based upon Bortis (2003, pp. 436-45). The starting point is provided by two views of the social process of production which have to be integrated: "In horizontal models of the Sraffa-Leontief type primary and intermediate products move between industries to enable, in association with direct labour and fixed capital (past labour), the production of final goods. [Second] In vertical production [Ricardo-Pasinetti's] model, labour is put to the fore. At the different stages of production, labour uses up primary and intermediate products to

produce final products"(Bortis 2003, p. 433). The integration of the horizontal and the vertical view of production will be performed below through the Pasinetti-transformation.

In the following we now present the fundamental classical-Keynesian model. To bring to the open the fundamental causal forces at work, all accidental elements have to leave aside. This requires making two simplifying assumptions. First, a vertically integrated economy will be considered and, second, the conditions of production are assumed to be such that the labour value principle emerges. A very simple fundamental – metaphysical - model picturing essentials will emerge and the conclusions obtained from this model will not be qualitatively modified if the simplifying assumptions are given up to carry out studies on the scientific level. However, the metaphysical model will provide a foundation and a framework for systematic scientific activities. According to Aristotle, metaphysics is the ordering science. Indeed, to have a metaphysical model exhibiting principles is of the greatest importance if the phenomenon considered is very complex since orderly reasoning becomes possible.

Let us now consider how the processes of price formation and distribution take place in principle within the framework of the social process of production. In this process Sraffa-Leontief interindustry prices are transformed into Ricardo-Pasinetti vertically integrated prices proportional to direct and indirect labour (Bortis 2003a, p. 436).

In the following all bold letters represent matrices and vectors, normal letters stand for scalars. The starting point is a Leontief price system, (Bortis, 2003, pp. 436-465):

$$\mathbf{pA} + w_n \, \mathbf{n_d} \, k = \mathbf{p} \qquad (4.1)$$

Here **A** is the broadly triangular Leontief coefficient matrix sketched in Bortis (2003, pp. 433-36): The structure of this matrix emerges from the social and circular process of production which is conceived of as an interaction between man (labour) and nature (land). The land and labour features of production give rise to distinguishing three kinds of basic goods, absolutely necessary for production: land basics, labour basics, and labour-land basics. Land basics are primary products taken from nature, for example iron ore or crude oil, which are made ready for productive use in the form of steel or petrol respectively. Subsequently, land basics or primaries are used to produce intermediate products: wheat, flour, leather, bricks for instance. Primary products and intermediate products represent part of the means of production that are converted into final products, specifically: bread, shoes, houses, various machines and

equipments; generally: private consumptions goods; private and public capital goods; and goods making up for state or public consumption. Labour basics are final products and correspond to the socially necessary consumption goods required to maintain the persons who are active in the ‚profit sector' and who, through the social surplus, enable to build up and to maintain a, non-profit sector', including the state, i.e. the political institutions. Finally, labour-land basics are machine-tools, i.e. machines to make machines, representing past labour and enable the labour force operating in the, profit sector' to enter into contact and to interact with nature through the social process of production, i.e. to extract primary goods, nature or land basics, with the aim of transforming them, passing through intermediate products, into final products, including labour basics (Bortis, 2003, p. 433).

The structure of the coefficient matrix **A** in relation (4.1) can now be described: "[…] Sraffa's land basics are located in the upper left corner [of this matrix]. Land basics are produced with land basics and hence the corresponding transaction table and the coefficient matrix form a square matrix. The output of primary goods is distributed to the industries producing intermediate and final goods. Intermediate goods require as inputs land basics and other intermediate goods. The corresponding coefficients form another square matrix beginning at the lower right-hand corner of the Sraffa land basics matrix. Final goods are produced with land basics and intermediate goods. Consequently, primary products enter the production of all goods; intermediate products enter the production of other intermediates and of final goods. The latter are only outputs. Hence for intermediates some positions to the left of the main Leontief diagonal are positive. By definition, for final goods only the net output vector contains positive elements. The broadly triangular structure of the Leontief matrix thus emerges, with zero positions dominating to the left of the main diagonal"(Bortis 2003a, p. 434).

In the triangular Leontief coefficients matrix **A** in relation (4.1) above (see Bortis 2003a, pp. 434-39):

$$a_{ij} = x_{ij} / X_j \qquad (4.2)$$

indicates the amount of good *i* required to produce a unit of good *j*. In relation (4.1) **p** is the (row) price vector. First, there are the prices of primaries or land basics, subsequently the prices of intermediate products which are followed by the prices of final products, i.e. private and public consumption and investment (capital) goods. To each primary, intermediate and final good corresponds a capital good. "Moreover, among the capital goods there is a particular type,

i.e. machine-tools or machines to make machines [...]. Machine tools are, in association with labour, capable of reproducing themselves and of producing the corresponding investment goods for each industry, that is for all primary, intermediate and final goods industries. Obviously, the machine tool sector is of basic importance for the social process of production" (Bortis 2003a, pp. 434-35). (We may already remark here that, because of the fundamental importance of machine-tools each country, also developing countries, should build up a sector to make machines. And this sector, which is crucial for sustained technological progress in a country, should be in domestic hands; however, foreign finance capital may be put to use as a part of the investments required in this sector.) The price vector "P" multiplied by the columns of the Leontief matrix, "A" yields the value of the means of production used up in the production of all goods. The expression:

$$w_n \, \mathbf{n}_d \, k \qquad (4.3)$$

denotes value added and its distribution between wages and gross profits for all goods.

(We use the symbol k is used here instead of the profit rate and the value of the different capital goods in order to be able to include at a later stage land and labour rent elements – in the case of labour, surplus wages and ability rents - in excess of [socially necessary]wages w_n.) $\mathbf{n}_d$ is the (row) vector of direct labour per unit of output for all products, primary, intermediate and final, in this order. Complex labour is reduced to simple labour through the existing wage structure (whereby, as has already been suggested, the determination of the socially appropriate wage structure constitutes a most complex problem of social ethics). w_n is a scalar denoting the wage rate per unit of simple labour time in terms of money, and k is the mark-up on labour-costs [at normal capacity utilisation] such as to ensure a satisfactory (target or normal) rate of profits on fixed capital and to allow for the depreciation of equipments. The mark-up, k, is the same in all industries and sectors. This implies abstracting from specific conditions of production which means that the proportion between the value of fixed capital and the wage bill (circulating capital) are postulated the same in all sectors, although absolute magnitudes diverge.

Starting from the Leontief interindustry price system the Ricardo-Pasinetti price system based on vertical integration can now be derived. Relation [4.1] may be rewritten as:

$$\mathbf{p}\,(\mathbf{I} - \mathbf{A}) = w_n \, \mathbf{n}_d \, k$$

Where I is a unit matrix (the main diagonal is made up of the element "1", all other positions of this square matrix are "0"). [This equation illustrates nicely how value added arises, i.e. through deducting the goods used up in the process of production from gross output.]

Multiplying on both sides by the Leontief inverse (I - A)-1 and transposing this matrix as well as the [row] vectors **p** and $\mathbf{n_d}$, which now become column vectors, yields:

$$\mathbf{p} = w_n \, \mathbf{[(I - A)^{-1}]' \, n_d} \, k \qquad (4.4)$$

The relation:

$$\mathbf{n = [(I - A)^{-1}]' \, n_d} \qquad (4.5)$$

indicates that the column vector of vertically integrated labour **n** is derived from multiplying the column vector of direct labour $\mathbf{n_d}$ by the transposed Leontief inverse. This procedure could be called the Pasinetti transformation (Pasinetti 1981, pp. 109-12). Each line of the transposed Leontief inverse contains the quantities of all goods required directly and indirectly to produce a unit of the good considered. As a consequence, each [element n_i of the vector **n**] designates the total amount of labour required to produce one unit of a primary, intermediate or final good. (Bortis 2003, pp. 437-38)

Relations (4.1) to (4.5) all exhibit the interaction of man (labour) and nature (land) within the social and circular process of production as is pictured by the classical economists.

This stands in sharp contrast to the neoclassical (linear) view of production leading from factors of production to final output. Combining relations (4.4) and (4.5) yields the Ricardo-Pasinetti prices for final outputs based upon vertical integration.

$$p = w_n \, n \, k \qquad (4.6)$$

Before going on, the implications and the meaning of abstracting from specific conditions of production has to be explained, first technically and subsequently as to the wider meaning. From relations (4.11) and (4.16) below, it emerges that the direct and indirect labour used to produce a [final] (or a primary or intermediate) good, n_i, and the capital good used to produce it – n_{iK} - must be the same, in fact equal to unity as is implied in relation (4.16). (If n_{iK} / n_i were

larger than unity the corresponding price of production would exceed the labour value, and vice versa). Technically, this means that for each good (consumption, intermediate or primary good) the corresponding capital good row of the transposed Leontief inverse in the equation system (4.4) must be multiplied by a specific coefficient so as to make the corresponding ratio n_{iK} / n_i equal to unity (ratios smaller or greater than unity would also be possible), bearing in mind that the absolute values of n_{iK} and n_i may differ widely. This very simple device allows to do analytical work on the level of basic principles while at the same time maintaining the presence of heterogeneous goods which is required to maintain the social character of the process of production; the heterogeneity of goods is also ensured by the fact that a certain quantity of abstract labour may produce widely differing goods. Hence, on the one hand, the abstraction from specific conditions of production to bring out essentials leaves all the crucial characteristics making up the social and circular process of production intact. On the other hand, it is intuitively evident that reintroducing differing conditions of production – that is, differing n_{iK} / n_i– for scientific purposes would not basically alter the conclusions. Precisely, with classical-Keynesian theory, the fundamental principles remain intact when the level of abstraction is lowered to tackle real world problems on the level of phenomena

This is not the case with neoclassical theory: On the basis of Samuelson's surrogate production function, which implies the labour theory of value, there are well-behaved relationships between factor prices and factor quantities; for example, lower interest rates are associated with more real capital and higher capital/output ratios. However, as the capital theoretical debate has shown all neoclassical principles break down once we leave the sphere of principles to consider real world phenomena, for example prices of production.

Moreover, it has already been suggested that to abstract from specific conditions of production means passing from scientific models to metaphysical models (metamodels) embodying principles. Abstracting from all accidentals, which, in this instance also comprise the historically variable conditions of production, enables the theorist to state the principles in the simplest possible way and to draw conclusions which are immediately evident and are, as such, generally accessible to a wider audience, for example historians and policy makers. This evidently favours the integration of political economy into a wider framework of social theory and policy (see for the above Bortis 2003a, pp. 434-39).

All this is of general importance for developing countries all of which are facing extremely complex situations. Specifically, working out classical-Keynesian principles is also important in order to understand the impact of foreign direct investment in a country with a

developing economy. This is particularly true of Iran where the situation is of immense complexity, not only on the economic but also on the political level, national and international.

Let us consider "the macroeconomic counterpart of the sectoral price system obtains if we, first, multiply in relation (4.6) the column vectors p and n by the quantity (row) vector q:

$$Y = w_n N k \tag{4.6a}$$

Here Y is the nominal gross national product *N* the number of workers and employees in the, 'profit sector' if we interpret w_n as the average wage rate.

In the second place, p_c, the money price of a bundle of necessary consumption goods, is selected as a numéraire. This implies that the real social product is $Q = Y/p_c$, a certain number of bundles of necessary consumption goods. We now obtain the Kalecki-Weintraub price equation put to use in Bortis (1997):

$$p_c = w_n n k = w_n (1/A) k \tag{4.7}$$

Overall labour productivity A, is the inverse of the macroeconomic labour coefficient, n, with A = Q/N and n = N/Q, where N is the labour force active in the 'profit sector'. The social product may be measured most appropriately in terms of (productive) labour embodied if the capital composition is uniform. Indeed, if, in relation (4.7) both sides are multiplied by Q and divided through w_n k, the social product is measured by *N*, which may be interpreted as labour time.

[. . .] The prices (4.6) and (4.7) refer only to produced goods and, as such, reflect the social efforts that have been made to produce them. This effort is represented by vertically integrated labour coefficients, n_i for each [final] good i, in the system (4.6) and its macroeconomic equivalent n in (4.7). The effort made to produce good i starts with the production of primaries, with value added being n_{iP}, and, passing through intermediate products (value added is n_{iI}), terminates with the final products, with direct labour in the last stage of production being n_{id}. Hence:

$$n_i = n_{iP} + n_{iI} + n_{id} \tag{4.8}$$

and

$$n = n_P + n_I + n_d \tag{4.9}$$

for all final goods if the n's in (4.9) are conceived of as vectors, and for the economy as a whole, in relation with the social product, if the n's in (4.9) are seen as scalars.

Combining (4.9) with (4.7) yields:

$$p_c = w_n (n_P + n_I + n_d) k \qquad (4.10)$$

This relation implies that with vertical integration of the social process of production value added in primary and intermediate goods is also variable capital in Marx's sense, which greatly simplifies the presentation of price formation. In fact, with vertical integration, labour values enter the final product in a logically distinct sequence, starting with the value added in the fundamental layer of primaries or land basics, going through the intermediate layer and ending up with the final product layer" (Bortis 2003, pp. 439-41).

"These sectoral and macroeconomic price equations imply that distribution is a social and political process synthesised by the mark-up k. The microeconomic and sectoral interpretation of the mark-up k differs, however, from the macroeconomic one. The microeconomic and sectoral mark-up k is made on average total costs at normal capacity utilisation and is such as to comprise target profits, associated with a target rate of profits r*, on invested capital only. Macroeconomically, however, the wage rate w_n conceive socially necessary wages only. This means that the macroeconomic k is larger than its microeconomic and sectoral counterpart. In fact, the macroeconomic mark-up k now governs the social surplus which contains profits and land rents, but also labour rents, made up of surplus wages and labour rents due to exceptional capabilities and, eventually, to privileges.

Given this, equation (4.7) implies a wages share 1/k, made up of socially necessary wages, and a surplus share 1- (1/k) (made up of profits and of land and labour rents).

The social forces determining k are the relative strength of employers and workers, eventually represented by associations, the amount of involuntary unemployment, the political element comes in through state intervention. The above price equations imply that prices and the price level depend upon technology, synthesised by [the labour coefficient n or labour productivity A, and distribution, represented by the wage rate wn and the mark-up k. Specifically, distribution is logically prior to production and price formation. These latter processes can only start if a structure of money wages and a rate of profits are given. The process of distribution occurs on the level of each layer where the social effort of value creation is performed, as can be seen from relation [4.10]" (Bortis 2003a, p. 441). In Pasinetti (1981, pp.

133-38) the distribution and the social effort aspects of the price system are set forth for the natural system.

"These remarks on the nature of prices allow us to assess the influence of land and labour basics on prices. If the conditions of extracting land basics get more difficult the corresponding labour coefficient for primaries, n_P, will increase, and, as a consequence, the prices of all intermediate and final products will rise. This will reduce real wages and may trigger distributional conflicts as indeed happened whenever oil prices rose sharply. The latter implies that labour basics are price determining through income distribution. The wage-price spiral is a case in point.

Two issues remain to be tackled in this section: the significance of the mark-up k, and the fundamental importance of the machine tool sector. To bring out the meaning of the mark-up k, we start by considering the price equations for consumption goods, taking account of the fact that each private or public consumption good is produced by vertically integrated labour assisted by a specific capital good (the same holds for all other goods: private and public investment goods, primary and intermediate goods). The price equation for a consumption good can be written as follows:

$$p_{ic} = w_n\, n_{ic} + r\,(w_n\, n_{iK}\, k)$$

or:

$$p_{ic} = w_n\, n_{ic}\,[1 + (r\, w_n\, n_{iK}\, k) / (w_n\, n_{ic})]$$

and:

$$p_{ic} = w_n\, n_{ic}\,[1 + (r\, n_{iK}\, k) / n_{ic})] \qquad (4.11)$$

Since we abstract from the differing conditions of production to bring out the basic principles, the proportions of fixed to circulating capital, n_{iK} / n_{ic} , are the same in all sectors, although absolute magnitudes may differ as is required with heterogeneous goods. As has been alluded to before, this implies that the mark-up on circulating capital, k, is the same in all industries and sectors. Hence the expression in square brackets of relation (4.11) equals k, which allows us to bring out the economic meaning of the mark-up more precisely for the case that property

incomes consist of profits only:

$$k = 1 + (r\, n_{iK}\, k) / n_i$$

$$k = n_i / (n_i - r\, n_{iK}) \qquad (4.12)$$

$$1/k = (n_i - r\, n_{iK}) / n_i = 1 - r\, (n_{iK} / n_i) \qquad (4.13)$$

and for the economy as a whole:

$$1/k = (n - r\, n_K) / n = 1 - r\, (n_K / n) \qquad (4.14)$$

Relations (4.13) and (4.14) tell us that all values are created by labour [which] is active in the ‚profit sector' and that profits are proportional to past labour embodied in fixed capital goods. Moreover, since, according to relation (4.7) the real wage is in terms of necessary consumption goods (labour basics) distribution must be regulated in the labour basics sector with the price and distribution equations having the same structure as relations (4.11) and (4.13). At this stage, it has to be repeated that normal profits have nothing to do with exploitation but are socially necessary" (Bortis 2003, pp. 441-43).

The same is true of the social surplus which is required to build an orderly set of institutions to reach political, legal, social and cultural aims which, of course, cannot be measured in money terms. Hence the social surplus has to be there to achieve a social ethical aim that is to bring about an orderly and culturally rich and diverse society, within which the social individuals may prosper. Only in alienated circumstances the surplus may become associated with exploitation, for example, to take an extreme case, if the owners of the means of production devoted large parts of the surplus to luxury consumption. Until now the price equations for consumption goods, private and public, have been considered. Let us now briefly consider the price equations for capital goods which are of particular importance in shaping the classical-Keynesian pricing principles.

"[In fact,] the price equations for the capital goods entering the production of consumption goods, primary and intermediate goods have exactly the same structure as the price equations for the consumption goods represented by relation (4.11):

$$p_{iK} = w_n \, n_{iK} \; [1 + (r \, n_{iK}{*} \, k) / n_{iK}] \qquad (4.15)$$

There is one important difference, however. In producing the capital goods required to produce consumption goods, labour is assisted by a specific capital good, i.e. machine tools or machines to make machines (Lowe 1976). In [relation (4.15)] this specific capital good is marked with a star. Hence machine tools assist labour in producing all the capital goods required (in the production of each consumption good labour is assisted by a specific capital good). However, machine tools are also assist labour to produce machine tools. Hence we have a final fundamental equation:

$$p_{iK*} = w_n \, n_{iK*} \, [1 + (r \, n_{iK**} \, k) / n_{iK*}] \qquad (4.16)$$

This relation fixes the proportion between the value of fixed and of circulating capital which must hold in all price equations, [. . . i.e.] n_{iK**} / n_{iK*}. We should recall here that we abstract from the conditions of production in order to put to the fore two essential features of a monetary production economy, i.e. the uniform profit rate and the fact that all value is created by labour. However, the uniform ratio between fixed and circulating capital is not chosen arbitrarily. This ratio is determined in the basic technology determining sector of a monetary production economy, i.e. the machine tool sector. In a way, this is in analogy to the Ricardian proposition that the rate of profits is governed in the agricultural sector which produces the necessary consumption goods.

According to relation (4.16) the ratio of fixed to circulating capital may be unity with absolute values being the same, which would simplify all the price equations set forth above. However, this proportion need not be unity and absolute values of fixed and circulating capital may vary since machine tools may produce machine tools of differing shapes. But even if the absolute values in all the n_{iK}/n_i - proportion were the same the heterogeneity of goods would be possible since machine tools are capable of producing capital goods, including machine tools, of different qualitative shapes which, in turn, can produce qualitatively different consumption goods, always in association with labour of course. In fact, the same quantity of labour may be associated with very different qualitative realisations in the form of heterogeneous goods. This is in analogy to Pasinetti (1981) [on structural change and economic growth] where the vertically integrated labour coefficients are associated with differing and changing structures”

(Bortis 2003, pp. 443-44).

The second important component required to construct a theory of income distribution within the framework of the Classical-Keynesian synthesis is to justify the uniform profit rate. There are various advantages associated with a uniform profit rate. In fact: "At a fundamental level the uniform (normal, target, satisfactory) profit rate is a highly important social institution, which greatly contributes to the good and proper functioning of a monetary production economy" (Bortis 2003, p. 425).

Indeed, we shall see below, that the difference between realised and normal profits governs the investment behaviour of entrepreneurs. If realised profits exceed normal profits investment will increase, and vice versa. The difference between realised and normal profits is also of importance for deciding whether foreign investment is desirable or not, and to what extent. This is also a point to be taken up below. Moreover, the uniform rate of profits also regulates the sectoral structure of an economy; a long as the realised profit rate exceeds the normal rate of profits in some sector, financial and real capital will flow into the sector in question, and vice. A stable normal rate of profits would thus create a tendency towards a structural equilibrium, contributing thus part of the classical proportions problem (the determination of relative quantities). "[Moreover, the] classical notion [of a normal profit rate] is also fundamentally important for the project of combining Keynesian and Sraffian (classical) elements of analysis. [. . .] Most importantly, the normal rate of profits r* and distribution in general are a crucial determinant of the scale of economic activity as is suggested in Bortis (1997, pp. 142-204). Finally, interests and profits, seen as parts of the social surplus, may be associated without difficulties with a theory of endogenous money.

The normal rate of profits and profits in general are also important for micro-cum-macro reasons (see also Bortis 1997, pp. 158-75). Profits provide a source of own funds for investment. At a given normal rate of profits, firms introducing better techniques of production and/or new products strengthen their competitive position; moreover, in a Schumpeterian vein, these firms will get profits above the normal level which constitute a kind of ability rent. In this sense, profits are also a reward for good management. Finally, the rate of profits usually contains a risk-premium. Hence the normal rate of profits renders decentralised decision taking regarding prices, and quantities possible and is, as such, fundamental for the orderly functioning of a monetary production economy. The associated normal prices do not stand in contradiction to the labour values but render these operable, though in an imperfect way" (Bortis 2003a, p. 425).

This leads to a third step in view of establishing a basic framework for distribution mechanism implied in the Classical-Keynesian system of Political Economy, that is the significance of the prices of production. "Indeed, Labour values are basic principles that cannot be rendered operable in the real world directly, i.e. in their pure form. In the real world, we need workable, though imperfect, approximations to labour values and associated profit rates. These are given by normal prices and the normal rate of profits. This implies that there is no contradiction between Ricardian-Marxian labour values and Sraffian prices of production. In the latter differing conditions of production, which are abstracted from in the former, are taken into account in order to render labour values operable" (Bortis, 2003, pp. 425-426).

"[. . . When] the determination of the social surplus and of the scale of activity is considered, absolute prices and quantities move to the fore, as is natural in a monetary production economy where all economic calculations are in money terms and where commodities are always exchanged against money (Bortis, 2003, pp. 450).

The scale aspect will be taken up in the next section. Here, we continue to consider the proportions aspect of the classical-Keynesian system in relation with income distribution (Bortis 2003, 448-60). To start with, it has to be recalled that "the regulation of distribution is a precondition for production, and for price and income formation. The structure of money wages and the normal (target, satisfactory) profit or hierarchy of profit rates both enable monetary costs and hence prices to come into being (Bortis 2003, p. 450). "In fact, the wage structure and the normal profit rate are both required to represent the efforts undertaken within the social process of production in the form of prices of production, to regulate distribution at each stage of the vertically integrated process that transforms primary products into final goods and, simultaneously, to organise the social process of production, that is, to bring about the appropriate structures or proportions, and to render possible competition in the classical sense, that is, to create a tendency of realised profit rates towards a uniform profit rate. For these reasons the average money wage rate, w_n, and the mark-up, k, which is, in turn, governed by the normal rate of profits, must be predetermined and, consequently, appear at the end of the price vector in system (4.17 below. Indeed, once distribution is determined, the prices of intermediate products at each stage of vertical production leading from primary to final products are known, and so are the final product prices p_i (i = 1, ..., m) appearing in this system. In the fundamental model exhibiting principles, these prices are proportional to labour values and reflect the social effort that has been made to produce the final goods.

Incomes are thus formed simultaneously with prices. This leads to monetary flows

associated with the formation and the spending of incomes. These aspects of the process of production are exhibited by the price system (4.17), which, like all the other equations and equation systems set forth in this section, is taken in a slightly elaborated form from Pasinetti (1986a) and also follows from the third section above.

Price system equation:

$$\begin{bmatrix} 1 & 0 & \cdots & 0 & -n_1 \\ 0 & 1 & \cdots & 0 & -n_2 \\ \vdots & \vdots & \ddots & \vdots & \vdots \\ 0 & 0 & \cdots & 1 & -n_m \\ -c_1 & -c_2 & \cdots & -c_m & 1 \end{bmatrix} \times \begin{bmatrix} p_1 \\ p_2 \\ \vdots \\ p_m \\ w_n k \end{bmatrix} = 0 \tag{4.17}$$

Source: Bortis 2003, p. 451

The number of final goods produced in an economy is m. These goods are for private and state consumption and investment. Some of them may be exported, and imports may be equal to, fall short of or exceed exports. [As already suggested] the final goods consist of labour basics (necessary consumption goods), labour-land basics (machine tools) and non-basics. The $p_1, \ldots,$ p_m represent the corresponding prices of production [which are proportional to values and express these values in money terms]. The average nominal income produced by a worker (a labour unit) in the 'profit sector' is $w_n k$, which equals nominal average labour productivity pA. w_n is the money wage rate and k the mark-up over prime costs at normal capacity utilisation. In a vertically integrated economy wage costs equal prime costs since labour comprises direct and indirect labour. p is the money price of a bundle of necessary consumption goods and stands, as such, for the general price level.

A = Q/*N* is labour productivity in real terms. The size of the social product, Q, is expressed by the number of bundles of necessary consumption goods and *N* is the labour force in the 'profit sector'. In this sector a qualitative and quantitative surplus over wages occurs, which, in nominal terms, equals $w_n(k-1)$ and accrues to capital, in the form of profits, and to land owners and to specially skilled or organised labour, in the form of rents. Since working time is assumed to be given, *N* stands either for the number of workers and employees or for working time measured in hours, in months, or in years. As already suggested, those working in the 'non-profit sector' in the widest sense (for example civil servants, teachers in state schools, entertainers and artists), while not economically productive, are of course socially and

politically productive; if appropriately organised, the 'non-profit sector' ought to contribute to the good and proper running of society and of the state. This point has been particularly emphasised by the political economists of the German Historical School in the late nineteenth and in the early twentieth century.

The n_i (= N_i/Q_{if}) are the vertically integrated labour coefficients comprising direct and indirect labour time, Ni, for example man years, in relation to the full-employment output (Qif) of good i. The indirect part of N_i is embodied in primary and intermediate products. The c_i (= Qif/Nf) represent demand coefficients, which indicate how the average nominal income, $w_n k$, or total income in real terms, N_f, that is, in terms of labour time, is spent. Part of income is consumed, and part is paid in taxes and saved. Since saving equals investment in long-period equilibrium (Bortis, 1997, pp. 81-9), the demand coefficients ci relate to the demand for private and public consumption and investment goods. Multiplying the first m rows in system (4.17) yields a corresponding number of sectoral price equations. These equations picture the formation of prices within enterprises and the payment of incomes to households. The price equations contained in system (4.17) are all based on vertical integration and, therefore, correspond to the equation system (4.6):

$$p_i = w_n \, n_i \, k = w_n \, (1/A_i) \, k \qquad (4.18)$$

with i = 1, 2, ..., m and where Ai is sectoral labour productivity Qi/Ni.

These prices represent the essential features of the classical theory of value and distribution. In their being proportional to the quantity of labour embodied directly and indirectly in the production of one unit of output, they reflect the social effort that has been made to produce a commodity. Hence prices, fundamentally, are not indicators of scarcity as is the case with exchange-based neoclassical theory. In the classical view, goods can always be produced if the labour required is devoted to the production of these goods - this is a tenet of Pasinetti's work. To this a Keynesian argument adds: with the scale of economic activity being governed by effective demand (see below), the possibility of permanent involuntary unemployment arises. In such a situation, it would be possible to produce more of all commodities if effective demand increased. It is plain that it is entirely inappropriate to speak of the prices as scarcity indicators while part of the fundamental factor of production, that is, labour, remains idle.

In relations (4.18), the level of money wages, w_n, determines the value of the various

commodities in money terms. Money prices and money wages are proportional and this has implications for the theory of inflation: distributional conflicts may give rise to wage-price spirals. With prices, given, workers and employees in the profit sector may attempt to increase the wages share through imposing higher money wages. This would reduce the mark-up, k. If entrepreneurs want to maintain their income share, determined by the prevailing normal rate of profits for example, they will put up prices, starting thus the wage-price spiral.

The labour value principle gives rise to a distributional issue associated with the notion of distributive justice. This emerges from the set of relative prices that can be derived from the absolute prices (4.18):

$$p_i/p_j = n_i/n_j \qquad (4.18A)$$

[. . .] In the system of absolute prices (18) the determination of the surplus over wages (k) is associated with another dimension of distributive justice, that is, the determination of various shares in a given income. Since, in a Ricardian vein, price formation relates to the most difficult conditions of production, the surplus over normal or ordinary wages w_n is made up of various elements: normal profits and differential rents, that is, rents on land, but also rents on special skills, for instance of sportsmen, physicians and lawyers, and privileges associated with the corporative organisation of certain professions. Hence the mark-up, k, governs the shares of [various surplus components in income, including the share of surplus wages over socially necessary wages]"(Bortis 2003, pp. 450-53).

Labour values are an extremely useful starting point to deal with social issues, most importantly the relationships between social classes, ethnic and religious groups, power relations, eventually resulting in class struggles, if alienation in the form of heavy unemployment and a very unequal distribution of incomes prevails. However, the labour value principle may also be used to deal with issues of social ethics, for example, cooperative and harmonious relations between social, ethnic and religious groups, and ethically appropriate shares of wages, profits and rents based on the social importance and the economic functions exercised by workers and employees, capitalists and landowners and, very importantly, wages structures based upon the evaluation of work places. Wages structures are of course related to the classical reduction coefficients which express complex labour, for example the work done by an engineer, as a multiple of simple unqualified labour. How many hours of simple labour should one hour of an engineer's work be worth? Such issues can only be solved through a

careful evaluation of work places.

However, as already suggested, the labour principle cannot be directly applied to the real world. This principle must come into concrete existence through the prices of production, which, in a Sraffian vein, depend upon the conditions of production (production coefficients of the Leontief type, a_{ij}, and direct labour coefficients n_{dj}), and upon income distribution – the money wage rate and the rate of profits in the case of absolute prices and the rate of profits if relative prices are considered). Indeed, labour values do not come spontaneously into concrete existence; they "would have to be calculated by the central planning bureau and to be imposed upon the firms. In principle, the vector of direct labour has to be multiplied by the Leontief inverse (relations 4.4 and 4.5). Such calculations are necessarily more or less imprecise"(Bortis 2003, p. 426). At present, the problem would not be the computing capacity of large computers but the conception and collection of the data required to calculate the Leontief coefficients which, moreover, are continuously evolving.

"As a consequence, a heavily distorted price system comes into being which is still more distorted through subsidies. Some firms realise 'profits', others make losses, which, perhaps, partly explains the interfirm debt-credit relations that occurred in the socialist economies. Moreover, the introduction of new products and new production technologies as a rule disturbs the plan. Hence the technological stagnation above all in the consumer goods industries in socialist economies and the fact that product quality frequently was not in line with consumers' wants which, in turn, led to stocks piling up. All this suggests that Sraffa's prices of production are not only very important theoretically because they provide a neat solution to the transformation problem if production is seen as a social and circular process. Sraffa prices are also of immense practical relevance" (Bortis 2003a, p. 426).

Given this, the practical advantages of the prices of production are immense, indeed, "because decentralised decision taking regarding prices and quantities is now possible. Normal prices, in fact, emerge from the normal cost calculation carried out within individual firms. These represent historical realisations of the theoretical normal prices of the Sraffa type, which are principles. Firms may also decide on the quality of products and on the techniques of production to be used"(Bortis 2003a, p. 426).

The practical advantages of the prices of production are intimately linked with the practical significance of the normal rate of profits, which is embodied in the prices of production. In the first place, normal profit rates and prices of production and their relation to realised profits and market prices are important for investment decisions under uncertainty. If

realised profits exceed persistently normal prices, hence if market prices are above the prices of production - expressed by prices based upon normal cost calculation – for some period of time, entrepreneurs will invest more, and vice versa. This reflects, as Keynes insisted upon, the way in which entrepreneurs deal with uncertainty: "It would be foolish, in forming our expectations, to attach great weight to matters which are very uncertain. It is reasonable, therefore, to be guided to a considerable degree by the facts about which we feel somewhat confident . . . . For this reason the facts of the existing situation enter, in a sense disproportionately, into the formation of our long-term expectations; our usual practice being to take the existing situation and to project it into the future, modified only to the extent that we have more or less definite reasons for expecting a change" (Keynes 1936/1973, p. 148). "Moreover, the uniform profit rate (r*) in association with the prices of production are powerful social tools. To organise competition in the classical sense: capital circulates between sectors to bring about a tendency towards the equal profit rate; simultaneously, these capital flows steered by r* tend to create a tendency toward a fully adjusted situation, i.e. stock equilibrium, characterised by normal prices and quantities. As such, r* and the normal prices contribute to governing structures or proportions between vertically integrated final goods sectors and, subsequently, in horizontal interindustry models" (Bortis 2003, p. 425).

As has been suggested above, "labour values are basic principles which cannot be rendered operable in the real world directly, that is, in their pure form. In the real world we need workable, though imperfect approximations to labour values and associated profit rates. These are given by normal prices [the prices of production] and the normal rate of profits" (Bortis 203, p. 425). However, the labour value principle and the uniform profit rate are both of the highest importance. Indeed, "[. . .] the labour value principle and the uniform profit rate are probably the most appropriate starting points for social ethical considerations. We may indeed, as Luigi Pasinetti does, start from a natural state of affairs where two important social ethical postulates are, in principle, fulfilled: first, distributive justice is brought about through an ethically appropriate wages structure and a socially appropriate uniform rate; second, there is full employment in the sense that there is no system caused involuntary unemployment (there may, however, be structural unemployment due to disproportions between sectors of production). Socioeconomic reality may now be seen as an alienated deviation from the social ethical norm (Bortis 1997, pp. 39-53). The latter serves as a reference and a starting point to study specific problems. For example, if there is heavy involuntary unemployment, there may be a pressure on the wages of less qualified persons. Consequently, profits may get associated

with exploitation. Such deviations from the ethically desirable natural state may become institutionalised and hence normal. Inversely, the natural state of affairs may be appropriately considered the ethically desirable form of the – alienated – normal state. In theoretical work this means that the same variables and parameters may refer to an alienated or to a natural state of affairs. Looked at in this way, all the scientific work in the social sciences, be it theoretical, empirical or historical now involves an ethical dimension. As Keynes reminded us: 'The social sciences are essentially moral sciences' " (Bortis, 2003, pp. 426-427).

4.2.2 The Classical-Keynesian Political Economy's Employment Mechanism

The level of employment is the next important social and economic problem that has to be considered here within the framework of Classical-Keynesian political economy. In our globalising world, dominated by the neo-liberal free market doctrine and with almost unrestricted capitalism in the spheres of production and finance, associated with risk and uncertainty for individuals and collectives worldwide, employment has permanently emerged as a main, perhaps the most important, problem in all societies. The failure of World Employment Programmes under free market conditions, with liberal (neoclassical) theory predicting full employment in competitive conditions, represented a puzzle and created ambiguities in developed and, even more, in countries with a developing economy. Already in the late 1970s Louis Emmerij and Dharam Ghai remarked that "the experience of the World Employment Programme … has not produced the expected results" (Cairncross and Puri 1979, p.56). After the Second World War when the former colonies and dependent countries gained political and economic independence new government responsibilities arose in countries with a developing economy. In this context the employment was, at first, given considerable attention, mainly under the influence of the wave of Keynesianism which swept through the world in the 1950s and 60s. Two new concepts gained considerable attention in this time-period, productivity and efficiency. Both were associated with the endeavour to achieve high growth rates in view of increasing per capita income in the developing economies.

The situation changed drastically with the monetarist-neoclassical revolution in the early seventies, triggered off by the inflation caused brought about by the oil price shock. In fact, the Monetarists argued that increasing the quantity of money, did not lead to lower interest rates and higher investment volumes, as Keynes thought, but simply resulted in inflation. The neoclassical vision of a self-regulating competitive market economy subsequently gained

momentum, particularly after the downfall of Socialism in Eastern Europe and in the Soviet Union. Presently, neo-liberal doctrine leads on to a widely unrestricted capitalism, resulting in high involuntary unemployment, and a more unequal distribution of incomes and wealth. As has been suggested already, some developing countries attempt to counter difficult situations through adopting a policy sharply opposed to Neo-liberalism that is a mixture of protectionism and programming.

Given this, the employment programmes carried out on the basis of these doctrines faced deep-going contradictions between theories and complex real situations. This initiated thinking about the nature of the gaps between theory and reality and looking for alternatives. However, in the absence of a realistic, robust, and, at the same time, flexible approach, policy makers in developing countries were forced to adopt inflexible, risky and fallacious theories (Foley, 2006, p. 3), embodying a poor and 'one-dimensional' conception of man, such as the conventional protective-programming or laissez-faire approaches to theorising and policy making. This gap between theory and reality can only be closed through an alternative approach. As suggested by Bortis such an approach should not be based on the neoclassical synthesis, that is bringing together Marshall and Keynes, but through combining Keynes with the classical economists, Ricardo in the first place (Bortis 2003, pp. 415-16). This implies abandoning the neoclassical-Marshallian exchange framework and to set up a monetary theory of production. Marshall had indeed not taken up Walras's real exchange model (C-C' or C-M-C'), but had opted for a monetary theory of exchange: M - C … MP … C'- M' (here, MP is Piero Sraffa's mysterious process which links the factor markets M-C in a linear way to the final product markets C'-M'). Keynes, however, in spite of the Marshallian clothing of the General Theory, deliberately aimed at working out a monetary theory of production, embedding his principle of effective demand in classical labour framework (Keynes 1973/1933: A monetary theory of production). "Indeed direct and indirect labour produces the social product, which is measured by labour commanded (Keynes 1936/1973, pp. 37-45); capital or past labour constitutes the environment within which labour works (ibid., p. 213)"(Bortis 2003, p. 416). This point has been worked most clearly by Luigi Pasinetti who cleared the way for bringing together Classical and Keynesian element of economic analysis. It has already been suggested that the Pasinetti Transformation (Bortis 2003, p. 438) links the Leontief-Sraffa nature aspect of production to the Ricardo-Pasinetti labour aspect. From the latter the link with Keynes can be definitely established. In fact, "the classical (Ricardian) labour model obtained by the Pasinetti transformation determines relative prices and quantities only (Pasinetti 1981, p. 23, note 30).

To obtain absolute prices, the money wage rate (w) must be fixed; to determine absolute quantities requires fixing the level of employment (N) (Pasinetti 1981, pp. 32/33, Pasinetti 1986a, pp. 422/23). Now, in chapter 4 of the General Theory – The Choice of Units – Keynes states: 'In dealing with the theory of employment I propose […] to make use of only two fundamental units of quantity, namely, quantities of money-value and quantities of employment. […] We shall call the unit in which the quantity of employment is measured the labour-unit; and the money-wage of a labour-unit we shall call the wage-unit' (Keynes 1973/1936, p. 41). Thus, the labour model emerging from the Pasinetti transformation links the whole body of classical theory to Keynes's employment theory and, as such, closes the gap between Keynes and Sraffa on the level of fundamental pure theory, i.e. on the level of principles. In doing so, Luigi Pasinetti has laid the long-period foundations for Classical-Keynesian political economy which may be considered a synthesis and an elaboration of the post Keynesian strands of thought. […] A central problem is to adapt Keynes's short-period theory of employment to the long run to make it compatible with the classical (Ricardian) theory of value and distribution which focuses on stable or slowly changing magnitudes (institutions and technology) and is, as such, of a long-period nature" (Bortis 1997, pp. 142-204, and Bortis 2003a, pp. 415-23 and pp. 460-67).

Hence a real, middle way, alternative to the neoclassical free and competitive market and the (socialist) protectionist and programming approaches can only consist of the social liberal classical-Keynesian approach to economic theorizing and policy making (Bortis 1997, 2003). This represents a robust, and, at the same time, flexible theoretical system to deal with the immensely complex problems that all countries, especially developing economies are facing. It has already been suggested that the impact of foreign direct investment upon a developing economy can only be evaluated if the functioning of an economy as a whole is considered. Hence we shall not consider a market economy and the evaluation of individual projects but a monetary production economy and the impact, in principle, of FDI on employment and distribution in the main. Our considerations will, essentially, be based on Bortis (1979, 1997 and 2003a).

The essential feature of a monetary production economy is neatly represented by the famous Marxian sequence where the social process of production stands in the centre giving rise to flows of goods and money; these flows represent processes of circulation.

$$M - C \ldots P \ldots C' - M' \qquad (4.19)$$

"In the first stage, producers dispose of money and finance M (G in orig.) and buy means of production, i.e. commodities and labour force, C (W in original). These are transformed into final products C' (W') in the vertically integrated labour view of the social process of production P which implies the horizontal land aspect of production. The final goods C' are transformed into money M' (G'). At this second stage of circulation M' – effective demand in money terms - governs C', the amount of final goods that may be exchanged against money" (Bortis 2003, p. 445).

This monetary theory of production stands, first, in sharp contrast to the neoclassical-Walrasian vision which exhibits a real exchange economy (C-C' or C-M-C') and, second, differs essentially from Marshall monetary theory of exchange, where on each market suppliers and buyers exchange one good, valued in money: M-C … MP … C'-M', where M = M', governed by the Cambridge equation M = k PQ and MP represents Sraffa's mysterious process linking factor markets (M-C) to the product markets (C'-M').

The monetary theory of production pictured by the sequence (4.19) exhibits two aspects, the proportions aspect and the scale aspect. The proportions aspect is related to distributional proportions and to relative prices. Indeed, before "production can start, distribution must be regulated: the normal (satisfactory, target) profit rate used in the price calculation of firms, and a wages structure, ideally based upon an evaluation of work places, must be given. [Given this] the determination of the wage, profit and rent structures and the corresponding shares in national income [emerges as the] central problem of distributive justice, which, in turn, forms the kernel of social and political ethics"(Bortis 2003a, pp. 445-46).

"[In fact, the] distribution aspect is associated with the evaluation of labour and, consequently, with the wages structure which, in turn, represents a particular dimension of distributive justice. With the technical conditions of production and the socially necessary direct and indirect labour time given, a rise in n_i / n_j signifies that labour producing good i is valued relatively higher than labour in sector j. As a consequence, the money wage rate i will raise relative to the rate j. It should be evident that the determination of the wages structure is an immensely complex issue of distributive justice, with various factors playing a role, the evaluation of work places within enterprises and trade-union activity perhaps being most important. Presumably, the most important factor leading to a distortion of the wage structure is involuntary unemployment as is indicated by the emergence of the working poor and of precarious work places in times of prolonged crisis" (Bortis 2003a, p.453).

As production goes on a new set of proportions comes into being, "[that is, relative] prices and shares in a given income. The spending of incomes determines a new set of proportions: absolute and relative quantities, the latter giving rise to specific proportions that must hold between final product sectors, for example between the consumption and the investment good sectors (hence if wages are entirely consumed and profits saved and equal investment, the wages sum in the investment goods sector must equal profits in the consumption goods sector). [. . .] The processes of distribution and formation of values or prices, which go on within the vertically integrated process of production, are now completed and the process of circulation of final goods and of money may start. The latter gives rise to real and monetary flows between enterprises, households, the social sphere, where most diverse associations are located, mostly non-profit organisations, and the state. …The level of economic activity, that is the scale of output (C', i.e. the social product Q) and of the associated level of employment (N), is governed by effective demand (M'). The employment level so determined is associated with a definite level of involuntary - system-governed – unemployment" (Bortis 2003a, pp. 446-47).

Before going on it may be mentioned that the possibility of involuntary unemployment and the labour value principle lead on to a specific meaning of prices. Given the fact that, on the level of principles, prices in their being "proportional to the quantity of labour embodied directly and indirectly in the production of one unit of output reflect the social effort that has been made to produce a commodity. Hence [classical-Keynesian prices] are not indicators of scarcity as is the case with neoclassical exchange-based theory. In the classical view goods can always be produced if the labour required is devoted to the production of the goods in question […]. To this, a Keynesian argument adds. With the scale of activity being governed is by effective demand [the] possibility of permanent involuntary unemployment occurs. In such a situation, it would be possible to produce more of all commodities if effective demand increased. It is evident, that is entirely inappropriate to speak of the prices as scarcity indicators while part of the fundamental factor of production, that is, labour, lies idle" (Bortis 2003a, p. 452).

Now, it has already been suggested that Pasinetti's labour model, which is about proportions, determines relative prices and quantities only. To determine absolute prices, the money wage has to be determined, determining absolute quantities requires the determination of the level of employment. The determination of absolute prices has been considered above in relation with monetary flows associated with the formation of prices and with the regulation of income distribution. Here, we now consider the proportions associated with the quantity flow to

prepare for the all important determination of the employment level. Both, the determination of relative and absolute quantities are crucial for evaluating the impact, in principle, of foreign direct investment upon an economy, a developing economy in our case. The quantity flows of a monetary production economy are captured by the equation system (4.20) seen together with the price systems (4.1) and (4.17) renders visible the social role of money which, as has been suggested above, represents the values created by productive labour and is, as such, a social institution which renders possible the social processes of production and circulation of goods and services within society at large. As just mentioned the quantity flows depicted below are about proportions, that is about relative quantities. "In accordance with Pasinetti (1981) we assume that full employment prevails. This assumption will be given up below where Keynes's principle of effective demand comes in to determine the long-period scale of economic activity. [that is the level of output and employment]" (Bortis 2003, p. 456).

Production system equations:

$$\begin{bmatrix} 1 & 0 & \cdots & 0 & -c_1 \\ 0 & 1 & \cdots & 0 & -c_2 \\ \vdots & \vdots & \ddots & \vdots & \vdots \\ 0 & 0 & \cdots & 1 & -c_m \\ -n_1 & -n_2 & \cdots & -n_m & 1 \end{bmatrix} \times \begin{bmatrix} Q_{1f} \\ Q_{2f} \\ \vdots \\ Q_{mf} \\ N_f \end{bmatrix} = 0 \tag{4.20}$$

Source: Bortis 2003, p. 457

"Here N_f represents the – full employment – labour force active in the profit sector. The (full employment) quantity of profit sector labour (N_f) represents the pivot of the quantity system. N seen as labour time has, in fact, two aspects. On the one hand, Nf, as labour commanded, measures the value of output or the level of incomes, which, as has been suggested above, implies that the nominal social product must be divided by $w_n k$ or pA, (that is nominal average income which equals labour productivity in money terms), to obtain a measure the real social product in terms of labour; this is appropriate from the social point of view since profit sector labour creates all value, including surplus value; moreover, this procedure is in line with the Ricardian-Sraffian tenet that distribution must be regulated before the problem of value can be tackled (the nominal average w_n and, thus, the wages structure and the normal or target rate of profits and, consequently, the mark-up k must be known before production can start). While labour time (value) is the real measure of output, money represents value and is, as such, a

social institution, which enables the social processes of production and circulation to function at all. To be able to fulfil its social function money must be legally anchored, specifically the obligation to accept money as the ultimate means of payment or of clearing debts must be legally fixed. Hence, money is not 'the most easily exchangeable commodity' of the neoclassical real exchange model, but is a socio-economic and legal institution established by the state.

The spending coefficients ci indicate how full employment (real) income Nf is spent and thus determines the full employment quantities Qif of private and public consumption and investment goods, that is the structure of production which is also a matter of proportions:

$$Q_{if} = c_i N_f \qquad (4.21)$$

with $i = 1, 2, \quad m$.

Equations (4.21) imply that in a monetary production economy goods valued at labour time (Q_{if}) are, ultimately, exchanged against labour time (real income measured in labour time), not against other goods as is the case in the neoclassical exchange model. In a way, profit sector labour, assisted by past labour (capital), represents the economic basis of a society which produces the social surplus; consequently, effective demand originates from four sources: households, enterprises, society and the state. The quantity system (4.20) seen together with the price system (4.17) renders visible the social role of money which, as has been suggested above, represents the values created by productive labour and is, as such, a social institution which renders possible the social processes of production and circulation of goods and services within society at large. On the other hand, N_f represents labour embodied in the quantities of the various goods produced and, consequently, in the social product. The vertically integrated coefficients of direct and indirect labour (n_i) and the quantities demanded (determined by relations 21) govern the distribution of labour between the different sectors of production:

$$n_1 Q_{1f} + n_2 Q_{2f} + ... + n_m Q_{im} = \sum N_i = N_f \qquad (4.22)$$

where the

$$n_i = N_i/Q_{if} \qquad (4.23)$$

represent the labour coefficients, that is the amount of direct and indirect labour required to produce a unit of output. As such, labour embodied represents the social effort required to produce the final goods and hence the social product.

In this view, N_f not only stands for productive labour, but also for the economic sphere of society. Indeed N_f represents the material basis of a society with social production as its core. The social surplus enables society to accumulate capital, to realise technical progress through saving labour and to erect a social, political, legal and cultural superstructure. This is reflected by the fact that the goods appearing in system (4.20) and in the definitions (4.21) and (4.22) include private and public consumption and investment goods.

Mathematically, the dependence of one equation on the others implies that the determinant of the equation systems (4.17) and (4.20) is zero (this condition has been established by Luigi Pasinetti (1981, for example on p. 32):

$$c_1 n_1 + c_2 n_2 + ... + c_m n_m - 1 = 0 \qquad (4.24)$$

If account is taken of the definition of the ci and ni coefficients (definitions 21 and 23), this condition indicates, once again, the distribution of labour across the vertically integrated sectors of production:

$$N_1/N_f + N_2/N_f + ... + N_m/N_f = 1 \qquad (4.25)$$

The sectoral distribution of profit sector labour emerges as the basic element of socio-economic structure and of the proportions aspect of classical-Keynesian political economy. According to condition (4.25) this distribution depends upon demand (c_i) and upon direct and indirect labour requirements (n_i)" (Bortis 2003a, pp. 456-59).

Incidentally, condition (4.24) is important for evaluating the impact, in principle, of foreign direct investment upon an economy. Indeed, if demand is large – the demand coefficient c_i is high in some sector – and if there is not enough direct and indirect labour in the sector in question, then the realised rate of profits is likely to exceed the normal – reference – profit rate. In this case, FDI may be beneficial to a country because it may relieve bottlenecks.

Conditions (4.24) and (4.25) may highlight another aspect of the impact of foreign direct investment. If, for example, FDI leads to a more unequal income distribution then it is likely that the demand for necessary consumption goods may diminish and demand for luxury goods

increase. This would be reflected in changes of the corresponding demand coefficients in condition (4.24) and in the corresponding redistribution of labour in definition (4.25).

Now, we turn to the most important effect of foreign direct investment. How does, in fact, foreign direct investment influence, in principle, the level of output and employment? Before being able to suggest a probable answer to this question the way in which output and employment are governed in principle has to be tackled. In fact, it is the independence in principle of the proportions and of the scale aspect in social production and circulation which provides the clue for bringing together classical and Keynesian elements of economic theory on a long-period basis (Bortis 1997, pp. 150-52 and Bortis 2003, pp. 460-67). (In the real world, proportions, that is structures, and scale will, as a rule, not be independent if the scale of economic activity durably varies. This is, in fact, due to Engel's Law, which states that the proportion of necessaries diminishes as incomes rise, and vice versa.)

If now the "quantity vector in system (4.20) is multiplied by a scalar smaller than unity, 1-u say, - u being the ratio of involuntary unemployment to the productive full employment labour force - all the quantities are reduced correspondingly and a permanent involuntary unemployment of 100u percent would come into being, while all the formal properties of the quantity system would be preserved. This means that the coefficient matrix of the quantity system (4.20) would remain formally unchanged and that the vector of normal quantities would now be given by

$$[Q_1, Q_2, ..., Q_m, N] \ , \tag{4.26}$$

with

$$N < N_f \tag{4.27}$$

Let us recall here that N stands for profit sector employment. Given this, condition (4.27) indicates the possibility of normal or long-period equilibrium employment being below full employment, i.e. the possibility of long-period or permanent involuntary unemployment which is determined by the socioeconomic system, i.e. all the institutions pertaining to the economic basis of a society, and to the political, legal, social and cultural superstructure erected on this basis. Hence, the normal quantities and prices entering the present analysis are embedded in the real world and differ from Pasinetti's natural quantities, and prices, which relate to an ethically desirable situation. Given this, all the magnitudes considered in this section are, in a classical vein, governed by technology and institutions and are, as such, constant or slowly evolving if

the real world set in historical time is taken into the picture (see Bortis 1997, 199-204). But let us recall, once again, that the present suggestions are located at the level of principles, independent of space and time.

The employment scalar (1-u) or, conversely, the long-period unemployment rate (u) are defined as follows:

$$1\text{-}u = N/N_f \tag{4.28}$$

$$u = (N_f - N)/N_f \tag{4.29}$$

where N is the institutionally governed long-period employment equilibrium to which corresponds a long-period equilibrium output Q smaller than the full employment output Q_f. Since N is linked to Q through labour productivity at any moment of time: Q = AN, these definitions could also be written in terms of Q. At this stage, we may mention that that two conditions must be fulfilled at the profit sector employment level N_f : first, entrepreneurs realise the normal (target, satisfactory) profit rate, and, second, given a certain ratio of profit sector to non-profit sector employment, there is no involuntary unemployment in a society. Hence $N_f - N$ only refers to involuntary unemployment in the profit sector which falls short of overall or social involuntary unemployment. Now, if, for some reason, N increases involuntary unemployment will diminish in the profit and in the non-profit sector since the rising social surplus will allow additional employment in the latter. This is, of course, valid only on the level of principles. In the real world employment may first rise in the non-profit sector, for example, if the state launches a public work programme. In principle, the spending of the incomes thus created will, through multiplier effects, lead to an over proportional increase in employment in the profit sector (see the super multiplier relation (4.37) below, and Bortis 1997, ch. 4)" (Bortis 2003, pp. 461-62).

Definitions (4.27) and (4.28) imply, as has already been suggested, that the structure of final output does not change as the level of employment varies. This, of course, is only valid as long as principles – independent of space and time – are considered. Considering principles enables to separate the analysis of the pure (classical) proportions model (previous section) and the pure (Keynesian) scale model. In the real world (of phenomena) structures (proportions) will, of course, change as the level of employment or the scale of economic activity varies.

The basic classical-Keynesian model exhibiting principles can now be represented,

whereby the following representation is based upon (unpublished Porto paper on Luigi Pasinetti). It may be recalled here that principles tell us how the causal forces work in pure form, independent of space and time and hence independent of specific institutions and types of behaviour, although certain types of institutions and behavioural pattern are implied by the principles to be considered. The starting point is the equilibrium between macroeconomic supply and demand, whereby supply is on the left and the various demand components to the right:

$$AN = Q = wN + c_s (P+R) + I + G + X - \pi M \qquad (4.30)$$

In this definition total supply equals total demand, whereby demand governs supply. Supply is given by the gross domestic product Q, which equals labour productivity A times employment in the profit sector *N*. The real wage rate is $w = w_n / p$, that is, the money wage rate w_n divided by the money price of a bundle of necessary consumption goods p. Normal or socially necessary wages wN are supposed to be entirely consumed. The surplus is made up of profits P and of land and labour rents R which are made up of two components: labour rents proper, so to speak, accruing on account of special abilities and dispositions, and surplus wages out of which non-necessary consumption is made, but also consumption for cultural and social purposes; in addition, part of surplus wages is paid on taxes, with saving appearing, as a rule, as a residual; c_s is the fraction of the surplus (privately) consumed. I is gross investment, G state expenditures, π stands for the terms of trade $[X/M = (e\, p_M)/p_X]$, p_X represents export prices in domestic currency, p_M import prices in foreign currency, e is the exchange rate, and X and M are export and import quantities respectively.

Imports M as a fraction b of GDP or domestic income Q = Y are of two kinds. Necessary imports $M_1 = b_1 Q$ (raw materials, necessary consumption goods, machines to produce necessaries) are related to production, while non-necessary imports $M_2 = b_2 Q$ are related to consumption out of the surplus.

$$M = b\,Q = M_1 + M_2 = b_1 Q + b_2 Q = (b_1 + b_2)\, Q \qquad (4.31)$$

This equation is of particular importance for countries with a developing economy. Here exports are, as a rule, of a limited size. Simultaneously, however, the import coefficients ($b_1 + b_2$) are both likely to be large relative to exports. The coefficient of non-necessary imports (b_2) is large because of unequal distribution of incomes and wealth and the cultural dependence of

the high-income classes on the West, that is on Western luxury consumption pattern. The coefficient (b1) is large because of technical dependence on abroad. Now, this combination of low exports and high import dependence may result in a low level of economic activity as will be seen below when the external employment mechanism will be considered.

In the price equation the mark-up k governs the size of the surplus.

$$p = (w_n/A)\ k \qquad (4.32)$$

Distribution, i.e. the division of domestic income into ordinary, normal or socially necessary wages and the surplus (profits, land rents and labour – ability – rents, including surplus wages) and the structure of normal wages, profits, land and labour rents is, ideally and naturally, a social ethical issue of immense complexity associated with the issue of distributive justice:

$$W/Y = 1/k \quad \text{and} \quad (P+R)/Y = 1-(1/k) \qquad (4.33)$$

In the real world, distribution may be, and, as a rule, is governed by alienated elements deviating from the natural, that is conflicts between social classes, whereby the socio-economically and politically dominating classes tend to dominate the struggle over income distribution.

In the long run, the volume of gross investment I is governed by trend GDP (Q) and its evolution, with Q, in turn, being determined by the whole socio-economic-cum-technological structure. (The single investment project depends, however, on more or less certain expectations about the future.)

$$I = (g+d)\ v\ Q = (g+d)\ K \qquad (4.34)$$

v = K/Q is the capital coefficient, hence the long-period volume of gross investment 'I' represents derived or induced demand; only the capacity effect of investment is taken into account in a situation in which overall long-period effective demand equals long-term aggregate supply. The fact that, in the long run, investment is derived demand is of crucial importance for evaluating the impact of foreign investment upon an economy. This will be analysed in details below.

Net trend investment (g K) is governed by the long-period or trend growth rate g of the autonomous variables, G and X (see for some implications, Bortis 1997, pp. 155-75 and 204-220). 'Replacement' investment (d K) depends on the depreciation ratio d, that is, the fraction of the total capital stock to be replaced for physical, economic and technological reasons. The coefficient d indicates, therefore, the extent of the technical dynamism of the entrepreneurs in the sense of Schumpeter, i.e. regarding the introduction of new techniques of production and of new products. Saving (private and state saving, t being the tax rate)

$$I = S = sQ + tQ - G \tag{4.35}$$

adjusts to investment through changes in output. This is particularly evident if we consider ratios:

$$s + t - (G/Q) = (g + d)\, v \tag{4.36}$$

Hence relation (4.35) represents an equilibrium on the "goods market". In fact, saving makes available the resources – labour and past labour, that is capital – required to produce the investment goods. However, investment is already financed before saving occurs. In fact, investment is financed by financial resources through the banking system. This implies that, in a monetary economy, investment is already financed and hence determined before the act of saving occurs.

Given the equilibrium of the balance on current account, a higher output can only be achieved if government expenditure increases, or, if private consumption increases, because of a decline in the saving/income ratio s or in the tax/income ratio t. Government expenditures (or exports) are of particular importance because they set economic activity into motion. The level of government expenditures G greatly contributes to determining the scale of economic activity. This is evident from our basic relation, the supermultiplier relation, which can be derived from equations (4.31) to (4.34).

$$Q = \frac{G + X}{z_S\,[1 - (1/k)] + \pi\,(b_1 + b_2) - (g + d)\, v} \tag{4.37}$$

$$z_S = 1 - c_S = s_S + t_S \tag{4.38}$$

Relation (4.36), the supermultiplier relation, shows how output Q and employment N are governed in principle. Hence this relation represents the pure theory of output and employment in a monetary production economy. In fact, relation (4.37) may be applied to any historical situation. This explains the flexibility of the classical-Keynesian approach which deals with the real world and not with hypothetical or normative equilibrium situations as is the case with neoclassical economics, or simply normative thinking within the framework of socialist doctrine.

Definition (4.38) represents the leakage coefficient z_s , which indicates the fraction of the surplus over ordinary wages that is not consumed, the fraction consumed being c_s. Consequently, the leakage coefficient is the sum of the fractions of the surplus paid for taxes (t_s) and saved (s_s). Since the long-period consumption coefficient c_s and the long-period tax coefficient ts are both determined by institutions - consumption habits and tax laws -, the long-period saving propensity s_s is a pure residual varying with the normal level of output and employment, given the rate of profits as is implied in the mark-up (Bortis 1997, pp. 166-68). This is perfectly analogous to Keynes's short-period theory of saving but different from the Pasinetti equation where, given the level of employment, the savings propensity of the capitalists and the rate of growth determine the rate of profits in a Keynesian *Treatise on Money* way (see again Bortis 1997, pp. 166-68).

Following Hicks, equation (4.37) may conveniently be called a supermultiplier relation "which can be applied to any given level of [autonomous demand components] to discover the equilibrium level of output [Q] which corresponds to it (Hicks 1950, [*A Theory of the Trade Cycle*], p. 62). Hence the autonomous demand components, G and X, set economic activity in motion, similarly to the expenditure of rents by the landlords in Quesnay's extended tableau économique (on this see Oncken 1902, [*Geschichte der Nationalökonomie*], p. 394).

Once output and employment are determined through the supermultiplier relation (4.37), the output and employment scalar 1-u (definition 4.28) is also fixed. In principle, the normal quantities corresponding to a specific output and employment level obtain if the full employment quantity vector in the quantity system (4.20) is multiplied by the employment scalar. The determination of normal output and employment is equivalent to fixing the output and employment trend around which cyclical fluctuations occur (Bortis 1997, pp. 149-51). It has already been suggested that the position of the output and employment trend is of

considerable socio-economic and political importance because this determines the extent of long-period – system governed – permanent involuntary unemployment. The latter is, in turn, an important element governing the social and political climate in a country. Methodologically speaking, the supermultiplier relation (4.37) represents, as suggested already, the pure long-period Keynesian employment theory, picturing how output and employment are determined in principle by the various demand variables and parameters on the right-hand side of this equation (Bortis 1997, pp. 142-204). In a way, this relation represents the pure theory of employment determining what is – probably – essential about employment determination in a monetary production economy (see on this the methodological introduction in Bortis 2003, pp. 411-15). Determination in principle of some socio-economic phenomenon attempts to capture the essential features of the causal mechanism at work, which are timeless and invariable. Moreover, in a pure or 'ideal-type' model, the ceteris paribus clause is automatically implied, which is to say that the predetermined variables on the right-hand side of the supermultiplier relation (4.37) are considered independent of each other. This, as a rule, will not be the case if some real world situation is considered.

In principle, normal output Q, and, hence, trend employment N, are positively linked to the autonomous variables G and X, and to the gross investment-output ratio $I/Q = (g+d)v$. This ratio depends on the rate of growth of the autonomous variables (G+X), g, which is also the rate of growth of long-period or normal output and employment, and upon the replacement coefficient d. In an open economy, the rate of growth of exports is crucial as Nicholas Kaldor has always insisted upon (see on this Bortis 1997, pp. 155-56, 185-89 and 190-98). The (Schumpeterian) d is an indicator of the technical dynamism of entrepreneurs. The effect of exports (X) on output and employment will be particularly strong if exports mainly consist of high-quality manufactured products with a large value added, i.e. a high content of direct and indirect labour (Kaldor 1985, pp. 57-79). However, normal output will be lower if, given exports X, the technological and cultural dependence on the outside world is strong, as would be reflected in large import coefficients b_1 and b_2, and if the terms of trade (π) are unfavourable, which would show up in a high value of π. Very importantly, normal output (Q) is negatively linked with the property share in income, $1–(1/k)$, and with the leakage coefficient, z_s, associated with this share; as a rule, z_s will be larger if the distribution of property income is more unequal. Given government expenditures and gross investment, a higher leakage out of income ($z_s[1–(1/k)]$) reduces effective demand, because consumption is diminished. Fundamentally, unemployment occurs because the saving-income ratio, s_s [1-

(1/k)], exceeds the investment-output ratio, $(g+d)v$, at full employment. Full employment could only be maintained if private and/or public consumption were increased. A redistribution of incomes, i.e. raising the share of normal wages (1/k), would lead to higher private consumption through enhancing spending power. In principle, a higher level of public expenditures, G, would require a tax increase: the tax rate, t_s, would have to be raised to preserve budget equilibrium, which would reduce the saving coefficient s_s. If these measures are not undertaken, output, employment, and tax receipts will decline, and, given government expenditures, budget deficits will occur. These will reduce the saving ratio until it equals the investment ratio at some long-period equilibrium level of output and employment involving persistent involuntary unemployment. Hence the negative association between distribution and employment emerges, because the property share and the saving and the leakage ratio associated with it are too high; and s_s, and thus z_s will be the higher the more unequally property income is distributed. Thus, the notion of unequal income distribution has a double dimension: the property share is high, and property income is itself unequally distributed. This leads to a high leakage out of income, given by $z_s[1-(1/k)]$ to which corresponds a reduced level of output and employment.

This crucially important relationship between unequal distribution and involuntary unemployment represents, according to Schumpeter, the essence of the Keynesian revolution: "[The Keynesian doctrine] can easily be made to say both that ‘who tries to save destroys real capital’ and that, via saving, ‘the unequal distribution of income is the ultimate cause of unemployment.’ This is what the Keynesian Revolution amounts to" (Schumpeter [AER] 1946, [John Maynard Keynes – Obituary], p. 517). Indeed, Keynes held that the "outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes. [Up] to the point where full employment prevails, the growth of capital depends not at all on a low propensity to consume but is, on the contrary, held back by it [and] measures for the redistribution of incomes in a way likely to raise the propensity to consume may prove positively favourable to the growth of capital" (Keynes 1936, pp. 372-73). Hence the inverse long-period link between employment and distribution is the crucial feature of the supermultiplier relation. This fact is of the greatest importance for all economies, specifically for developing economies as will become evident somewhat in the present chapter (see Bortis 2003a, pp. 466-67).

4.3 Internal and External Employment Mechanism

The deeper economic meaning of the supermultiplier relation emerges more clearly if this relation is considered as the synthesis of two different mechanisms governing output and employment: the internal and the external employment mechanisms. Both mechanisms are important to understand the functioning of a monetary production economy and to evaluate the impact of foreign investment upon a country with a developing economy.

"The term internal employment mechanism suggests that this mechanism describes what is going on inside an economy with respect to the determination of output and employment. The starting point is a familiar macroeconomic equilibrium condition:

$$(1 - c)\, Q = (s + t)\, Q = z\, Q = G + I \qquad (4.39)$$

or

$$z\, Q - G = S = I. \qquad (4.39a)$$

"In these relations the familiar notations hold: Q is gross domestic product, G equals government expenditures, S is saving, I = investment, c, s, and t are the ratios of consumption, saving and taxes to gross domestic product.

Equation (4.39) states that leakages equal injections. This is equivalent to saying that private and public saving equals investment (4.39a); public saving would imply a budget surplus, dissaving a public deficit. Normal investment is governed by the evolution of 'trend' output (equation 35 above I = (g +d) v Q). Combining the latter with equation (4.39) and putting the investment-output ratio (g + d) v equal to i yields:

$$Q_i = \frac{G}{1 - c - i} = \frac{1}{m}\, G\ , \qquad (4.40)$$

where Q_i stands for normal gross domestic product, governed by the internal employment mechanism, i.e. by the institutions governing normal government expenditures, the consumption-income ratio (c) and the normal investment-output ratio, for instance the government and political parties (G), consumption behaviour and income distribution (c), and the technical dynamism of entrepreneurs (d). The expression 1/m could be termed the 'internal' or 'government expenditures' multiplier, where m is the difference between the leakage and the

gross investment-output ratio; m may differ from the average tax rate t by the ratio of a chronic budget deficit or surplus to gross [domestic] income" (Bortis 1997, p. 190). Hence if it is postulated that the state budget is in equilibrium in the long run relation (40) becomes:

$$Q_i = \frac{G}{1 - c - i} = \frac{1}{t} G \ , \qquad (4.40a)$$

This relation shows that, according to the internal employment mechanism, the economy is set into motion through government expenditures G. Indeed, these expenditures set into motion a cumulative process of production for consumption and investment goods. How this works in principle can be seen best from an alternative way of writing relation (4.40a):

$$Qi = G + (c + i)\, G + (c + i)2\, G + (c + i)3\, G + (c + i)4\, G + (c + i)5\, G + \ldots \qquad (4.40b)$$

Government expenditures create incomes, out of which a fraction c is consumed and out of which a fraction i must be invested in order to enable the permanent production and reproduction of the state expenditures. Hence consumption and investment out of G leads on to the production of consumption and investment goods and to new incomes; this leads on to additional consumption and investment, and so on. Purely formally, multiplying on both sides of relation (4.40b) by (c + i) yields

$$(c + i)\, Qi = (c + i)\, G + (c + i)2\, G + (c + i)3\, G + (c + i)4\, G + (c + i)5\, G + \ldots \qquad (4.40c)$$

which, if subtracted from (4.40b), yields, in turn, the multiplier based on the internal employment mechanism (4.40a).

The principle associated to function of the internal employment mechanism, simple as it looks, is extremely difficult to realise in a given situation, above all in countries with a developing economy. Indeed, setting up the socially appropriate structure of government expenditures G and its size, requires a vision of man, society and the state (Bortis 1997, chapter 6), and this vision will be shaped decisively through its religious foundations. Government expenditures are, for example, to be used to set up a general infrastructure in traffic and communication, a judiciary system, internal and external security, and, perhaps most importantly, an appropriate education system. In economically developing countries the institutional system associated with government expenditures is not something given, the

functioning of which has to be perfected. Here, the institutional system is evolving in the process of transformation from a traditional to a modern society. To successfully effect this transformation requires a very solid economic theory (Bortis 1997 and 2003) and a strong political leadership which is above partial and party interests (Bortis 1997, pp. 401-10).

While the internal employment mechanism rests on the fundamental macroeconomic equilibrium condition given by saving equal investment (S = I), the external employment mechanism is based on the foreign balance equation:

$$p_X X = e\, p_M M \tag{4.41}$$

Here X and M are the quantities exported and imported, expressed in terms of some representative commodity respectively, and p_X and p_M are the prices of these commodities in domestic and foreign currency – US dollars for example - respectively; e represents the exchange rate; hence the money value of both exports and imports in relation (4.41) is expressed in domestic currency. Dividing by p_X on both side of this relation yields:

$$X = \pi M \tag{4.42}$$

where π represents the terms of trade:

$$\pi = (e\, p_M) / p_X = X / M \tag{4.43}$$

(see also relation (4.30) above).

Obviously, the terms of trade are favourable if π is low, and vice versa. (The terms of trade have a specific effect on the level of employment as has been seen when discussing the meaning of the supermultiplier relation (4.37) above.)

Now, taking account of relation (4.31) above, expression (4.42) can be written as

$$X = \pi\, b\, Q\ (= \pi M) \tag{4.44}$$

where the import coefficient b encompasses both necessary and non-necessary imports (see relation (4.31) above).

From this expression the fundamental relation exhibiting the external employment mechanism may be derived:

$$Q_e = \frac{1}{\pi b} X \ , \qquad (4.45)$$

"[Here $\mathbf{Q}_e$] is trend gross national product, determined by the external employment mechanism, i.e. by the institutions which govern the volume of trend exports, and the terms of trade and the import coefficient, i.e. the export multiplier l/πb. The volume of normal exports might depend upon the state of technology, the education system and the degree of aggressiveness on world markets. The export multiplier is the larger, the more favourable the terms of trade (π relatively small) and the less country depends upon foreign goods and services; this is reflected in a low value of the import coefficient b relative to exports" (Bortis 1997, p. 191).

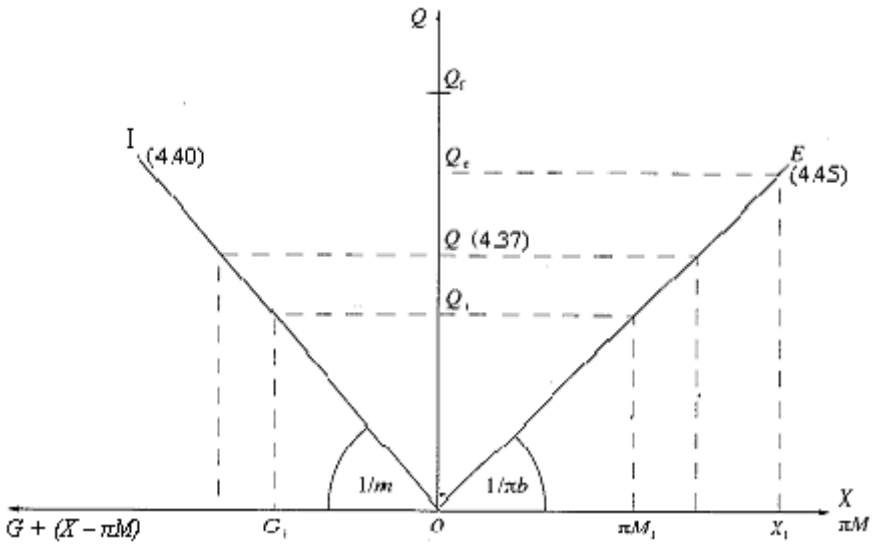
"Equation (4.45) exhibits the employment or scale effect of international trade for a particular country […]: the volume of employment and output [Qe] depends not only on the size, but also on the structure of exports. Given the volume of exports, exporters of labour - intensive industrial goods and services, possibly embodying advanced technologies, enjoy higher levels of employment than countries exporting land-intensive raw materials and agricultural products and low-technology, standard industrial products. Moreover, successful exporters of labour-intensive goods of high quality enjoy more favourable terms of trade (π is low as real wages increase with labour productivity) and are, as a rule, less dependent (b is low relative to X) on the outside world than exporters of land-intensive goods" (Bortis 1997, p. 191).

"The differing outcomes of the employment effect of international trade already point to important implications for foreign investment. If foreign investment takes place in the primary goods sector, particularly in the oil-sector, in view of exporting a large part of output, the employment will be limited and the terms of trade unfavourable. In case the terms of trade are favourable, revenues are likely to be distributed very unevenly, a large part of the revenues are probably saved and will flow into the financial sector. This implies that imports from the industrially advanced countries will be low and relatively few work places will be created in these countries. This relation between unequal distribution and low employment levels is in line with the central feature of the supermultiplier relation (4.37) above.

There is no reason why Q_i should equal Q_e. Given this, the employment mechanism which yields the smaller value of gross domestic product will, at first, govern economic activity. But there is also a mechanism which combines Q_i and Q_e. The result is normal output Q, governed by the supermultiplier (figure 4.2). Given normal government expenditures (G_1)

and the multiplier 1/m [see relation 40], the internal employment mechanism determines the 'trend' output level Qi. On the other hand, exports (X_1) and the export multiplier govern the trend output level Q_e through the external employment mechanism. In figure (4.2) Q_i falls short of Q_e. The internal employment mechanism therefore governs economic activity. The external mechanism is redundant which implies that an export surplus occurs" (Bortis 1997, pp. 191-92).

Figure 4.1: Supermultiplier analyses, external mechanism



Source: Bortis 1997, p 192

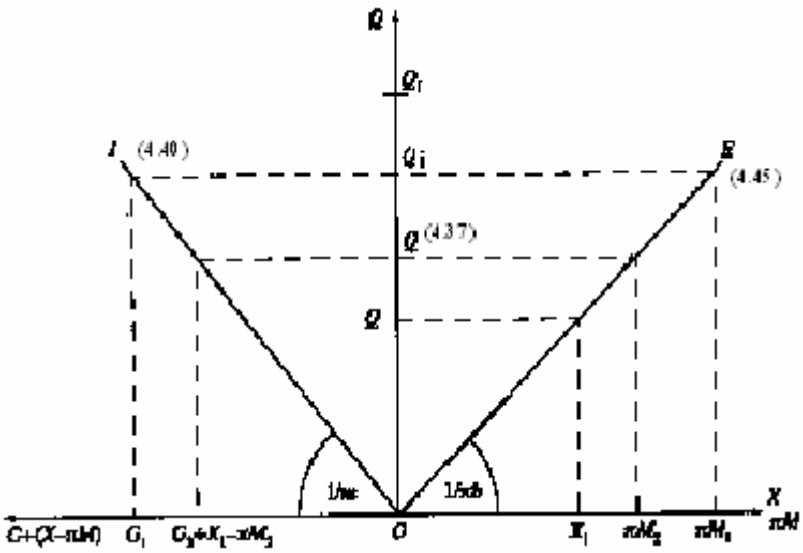
Hence exports (X_1) exceed imports associated with the output level Q_i, i.e. πM_1. The export surplus influences the internal equilibrium position, however. Equation (4.40) must be rewritten as follows (Bortis 1997, p. 1):

$$Q_i = \frac{1}{m} (G + X - \pi M) \qquad (4.37)$$

"Taking account of relations [4.44] or [4.45], this expression is equivalent to the supermultiplier relation [4.37] which thus appears as a synthesis of the internal and external employment mechanisms. [As has already been suggested] the former is based upon the 'equilibrium' condition S = I, the latter on X= π M. The supermultiplier takes account of both conditions: this relation combines the long-period equivalent of the Keynesian saving-investment multiplier [equation 40 or 40a] and the foreign trade multiplier [equation 4.45]. In the above figure this synthesis is reflected in an institutionally governed 'equilibrium' or normal

output Q which simultaneously satisfies the internal and the external constraints on output, set by effective demand. The above does not imply, however, that both multipliers stand on the same footing: 'it may have been unfortunate that the very success of Keynes' [saving-investment multiplier] in explaining unemployment in a depression - essentially a short period analysis - diverted attention from the "foreign trade multiplier", which over longer periods, is a far more important principle for explaining the growth and rhythm of industrial development (Kaldor 1974, p. 210; on this, see also Kaldor 1986).

Figure 4.2: Supermultiplier analyses, internal mechanism



Source: Bortis 1997, p 193

Indeed, from figure [4.3] it emerges that a country in which the external equilibrium exceeds the overall (supermultiplier) equilibrium ($Q_e > Q$) is in a most comfortable position. First, the supermultiplier 'equilibrium' is associated with a chronic surplus on the current account which imp1ies that foreign exchange reserves grow steadily. Second, Q may adjust to the external equilibrium (Q_e) if domestic demand is stimulated. For example, private consumption may be raised through redistributing income; this would be reflected in a lower level of the leakage z and thus of m. The 'internal' multiplier 1/m rises and Q gets nearer to Q_e. The same result obtains if normal government expenditures are raised. Taken together, this implies a permanent increase in private and public consumption which means that prosperity is increasing. It is not very difficult to identify countries which, in practice, enjoy or have enjoyed a dominance of the external employment mechanism. Germany, Japan and Switzerland, as mentioned above, are obvious cases in point. The picture changes dramatically if the external employment

mechanism restricts internally governed normal economic activity. This becomes evident from figure [4.3] which is exactly analogous to figure [4.2]. Given normal government expenditures (G_1) and the multiplier 1/m, the internal employment mechanism (equation 4.40) leads to the output level Q_i which is linked up with a deficit on the current account ($X_1 < \pi M_1$).

This deficit reduces domestic demand. In principle, national income gradually declines so as to approach the supermultiplier equilibrium Q which is compatible with both the internal and the external employment mechanism. However, at Q, there is still a chronic deficit on current account: trend imports (πM_2) exceed trend exports (X_1).

Consequently, foreign exchange reserves gradually decline and/or foreign indebtedness steadily increases. Once the debt burden becomes too heavy, long-run equilibrium output Q has to be forced down in order to be compatible with the external constraint set by Q_e. This adjustment has to be brought about by a permanent reduction of internal demand: government expenditures have to be depressed below their trend level G_2, and private consumption demand has to be diminished. The average propensity to consume (c) declines and the leakage z = 1 -c rises; the latter reduces the multiplier l/m and flattens the line OI in figure [4.3]. A reduction in private consumption demand can be brought about by raising the normal saving coefficients (s_P, s_W) and/or by redistributing income in favour of normal property income. The latter will be reflected in a higher value of the average mark-up, k and thus of the leakage z. Finally, investment demand may also be reduced. As can be seen from equation [4.34] above, this might be done by lowering the drop-out ratio of fixed capital (d). This implies that the renewal and hence the modernization of the capital stock is slowed down.

The attempts to adjust the supermultiplier equilibrium to the foreign exchange constraint are equivalent to austerity policies. This type of economic policy has to be pursued in many countries all over the world because economic activity is ultimately governed by the external employment mechanism. In most cases, this is linked with very great hardship, mainly because of high levels of unemployment which are reflected in a considerable difference between Q_e and Q_f, the full employment level.

The external employment mechanism plays a crucial role because it ultimately governs economic activity under 'free trade' conditions, and the supermultiplier equilibrium Q has to adjust sooner or later to the external equilibrium Q_e. However, It makes a tremendous difference whether an upward adjustment is possible (initially $Q < Q_e$ holds - figure 4.2) or whether a downward adjustment has to be enforced through austerity policies (initially $Q > Q_e$ prevails - figure 4.3)" (Bortis 1997, pp. 193-94).

The crucial role of FDI emerges most forcefully here. If foreign direct investment enhances exports, above all manufactured exports, then FDI would be highly beneficial to the recipient country, whether developed or developing. However, this conclusion only holds if FDI is associated with a transfer of technology and know-how as has been the case with FDI carried out by the traditional multinational enterprises. With the FDI carried out by transnational enterprises, the situation is entirely different, however. Indeed, within transnational enterprises a world-wide division of labour occurs, such that, in the countries only part of the product is produced, normally in view of taking advantage of low wages, with the parts being assembled in the home country and exported from there. Hence within the framework of transnationals the home country keeps the control of technology and of the know how and the higher-qualified work places. The recipient countries, frequently, very low-wage developing countries have to be content with second and third rate work places and with no addition to technological know-how and higher qualified work places. This implies a growing dependence of the recipient countries of FDI from the respective home countries.

If, however, FDI primary takes place in the primary goods sectors and in infrastructure, then all the problems associated with the Dutch disease, mainly the difficulty to start or to carry on at a reasonable pace industrialization, given the fact that primaries are exported and industrial goods and services imported. Now two sets of preliminary remarks regarding the policy conclusions associated to the external employment mechanism are to be made. The first is related to the link between import regulation, and full employment, the second concerns the relationship existing between, foreign debt and employment.

Under 'free trade' conditions, the level of economic activity is ultimately governed by the external employment mechanism (Q has to adjust to Q_e). If Q_e is below the full employment level Q_f it is impossible to reach full employment without incurring a deficit on the current account. This holds for countries which are, initially, in a favourable position with respect to the foreign balance: Q is below Q_e [figure 4.2] and for countries where Q exceeds Q_e [figure 4.3]. Therefore, given normal exports (X) and the terms of trade (π), governed by world effective demand and by a complex set of domestic and foreign institutions, the import coefficient (b) has to adjust if full employment is to be achieved. (Bortis 1997, pp. 194-95)

This can be shown through taking up a distinction between two kinds of imports as has been made above:

$$M = b\,Q = (b_1 + b_2)\,Q \qquad (4.46)$$

It has already been suggested that "b_1 Q are the imports necessary to the process of production. To produce a given output Q, each country must import certain goods which cannot be domestically produced for institutional reasons linked up with the presently prevailing international division of labour which has developed historically, i.e. certain equipment and spare parts, or for natural reasons: certain raw materials and necessary consumption goods. Without these goods, output could simply not be produced. In Sraffian terms, b_1Q could be called imports of basic goods" (Bortis 1997, p.195). In fact, three kinds of basic goods may be distinguished: labour-basics, made up of necessary consumption goods; land-basics, raw materials and energy resources; and land-labour basics, consisting of machines tools on the basis of which all the necessary equipment may be constructed (see on this Bortis 2003, pp. 433-36). "Hence the import coefficient b_1 is a technical coefficient indicating the fraction of [gross domestic] product that has to be imported in order to render production possible at all"(Bortis 1997, p. 195).

"[However, besides] the necessary imports there are also imports which are related to non-necessary consumption (public and private) in the widest sense. To simplify, b_2Q could be termed luxury imports. These are related to the use of the surplus […] accruing from the process of production. Cars, video recorders, television sets, certain types of food and drink are examples. Hence, the coefficient b_2 reflects dependence on abroad at the social and cultural level. 'International demonstration effects' which are linked with the desire to imitate Western consumption styles certainly play an important role in determining b2 in many [economically] underdeveloped countries, including the formerly socialist countries.Taking account of definitions (4.32) and (4.45), the foreign balance equation can be written as

$$X = \pi\,(b_1+b_2)\,Q \qquad (4.47)$$

[Now, if] normal output Q is to be raised above Qe to approach the full employment level Qf (figures 4.3 and 4.3), the import coefficient $b = b_1+b_2$ must be reduced to preserve the -fundamental- equilibrium of the foreign balance with exports and the terms of trade given: in the long run, exports have to pay for imports because steadily increasing indebtedness leads into insuperable difficulties (Bortis 1979). However, the coefficient b_1, which indicates necessary imports as a fraction of national product, cannot be reduced: necessary imports have to stay in line with Q. Therefore, b_2 and thus luxury imports have to be reduced correspondingly if a full-employment policy is pursued; in the real world this implies

appropriate institutional changes. This conclusion is inevitable if account is taken of the states of affairs mapped out in figures [4.2] and [4.3] above" (Bortis 1997, pp. 195-196).

Given this Bortis now points to the conflict situation existing in a free-market system and the trade policies that have to be pursued in practice to obtain the full employment aim: "[In fact,] full employment policies in open economies require a certain 'official' protectionism with respect to luxury imports. It is very important to note that this does not imply a reduction in the volume of international trade (on this, see Cripps and Godley 1978). Quite the contrary: once the major trading partners enjoy positions of near-full employment, the volume of international trade may, based upon the principle of comparative advantage (liked with the 'structure effect' of international trade), expand at will, thus raising welfare everywhere. However, to secure full employment, the 'employment' or 'scale' effect of international trade represented by the external employment mechanism (equation 4.45) has to be accounted for; this is a necessary social precondition for enjoying the welfare effects of international trade" (Bortis 1997, p.196).

To approach full employment means so to speak moving along a traverse from a given trend to a higher trend. The rate of growth has thus to exceed the trend rate of growth, which is the growth rate of the autonomous variables (see the supermultiplier relation 4.37 above). This implies that, in principle, the realised profit rate exceeds the normal profit rate as is associated with the institutional system equilibrium pictured by the supermultiplier relation. In such a situation foreign direct investment would be highly profitable to the recipient country. In fact, foreign direct investment would add to domestic investment since the profit rate is above normal. This implies that FDI could contribute to reach full employment more rapidly. However, an important condition has to be fulfilled: given exports, government expenditures must now grow above the trend rate of growth so as to determine the growth rate associated with the traverse path. In a way the state has to prepare the soil through higher expenditures such that FDI may bear fruit that is to create new investment opportunities such that FDI may add to domestic investment.

The second problem to be touched upon here relates to foreign indebtedness to which the problem of FDI is also directly connected. In this context it "is convenient to distinguish between two phases of indebtedness. In the first, debt is gradually built up. Interest payments and repayment of debt are negligible in relation to new capital inflows. The second phase is characterized by high debt levels; the debt service is now high relative to new capital inflows. The problems arising from growing indebtedness can be considered with the help of equation [4.47] and figures [4.2 and 4.3]. In the first phase, creditor countries enjoy export surpluses

$$X > \pi M \tag{4.42a}$$

The fact that finance in whatever shape (aid, public credit, private investment) has flowed from creditor to debtor countries (in the case of aid we ought to speak of donor and receiving countries) results in an export surplus and in a favourable impact upon output and employment in the creditor countries (equation 4.37 and figures 4.2 and 4.3). Presumably, these export surpluses were an important reason underlying the sustained upswing of the world economy in the fifties and sixties. The debtor countries, on the other hand, enjoy, in the first phase, the privilege of being able to import more than they export:

$$X < \pi M \tag{4.42b}$$

Whether the import surplus which, formally, is equivalent to additional saving, is invested or is used for private and public consumption is [a question dealt with in] (Bortis 1979, chapters III, IV)" [This issue will be taken up below] Hence, in the first phase of borrowing and lending the growth of indebtedness is favourable to both creditors and debtors. The situation changes radically in phase two where the debt service, interest payments and repayment of debt due, dominate the picture" (Bortis 1997, pp. 196-197).

Of course, to the interest payments transferred profits arising from FDI must be added. These profits tend to grow rapidly for various reasons: the technique of transfer pricing practised by foreign investors in order to shift profits to tax havens; this practice gains particular importance of financial foreign capital comes to dominate over real capital flows as is the case with M&A's (mergers and acquisitions), the importance of which has grown rapidly since the breakdown of the socialist economies; profits on foreign direct investment are also high because of the superior technology which is embodied in these investments and the relatively low wages levels prevailing in many countries with a developing economy; this means that income distribution becomes more unequal, which, according to the supermultiplier relation (4.37) above reduces output and employment, and hence profitable investment opportunities; the latter, in turn, enhances the danger of FDI squeezing part of domestic investment out of the process of production.

"[If now financial] gross capital flows from creditor to debtor countries (ΔB) are not sufficiently high, the debtor countries are forced to achieve an export surplus in order to obtain the foreign exchange required to service the debt, which means that these countries can dispose of fewer goods. As a consequence, the creditor countries now incur a deficit on current account

which, according to the theory of the supermultiplier, has persistent negative effects upon employment and output. The uncomfortable situation of the debtor countries can be understood best if the foreign balance (4.42) is written as

$$X+B-(i+\partial)D= \pi\ (b1+b2)Q. \qquad (4.48)$$

Here, *B* is the annual inflow of foreign finance (including aid) gross of interest payments and of debt repayment, *D* is the foreign debt and $i+\partial$ represents debt service (interest payments and repayments of debt due) as a fraction of foreign debt. The obligation to service the foreign debt reduces the amount of foreign exchange available (export earnings and new capital inflows). Less foreign exchange is now available to buy imports. Now, it is very difficult to reduce import coefficient b_2 (luxury imports as a fraction of national income). This coefficient is governed by a complex set of social and cultural factors and presumably also depends upon the distribution of income. In many underdeveloped countries, most people getting very high property incomes usually practise a Western lifestyle on a grand scale. Institutionalized habits like these cannot be changed easily. The import coefficient b_1 related to necessary imports cannot be changed readily either since it takes time to restructure the real capital stock and the methods of production associated with it. The only variable that can adjust to the reduction of available foreign exchange is national output (Q). Hence the scarcity of foreign exchange leads to increasing unemployment in debtor countries because goods required in the process of production cannot be imported.

Several factors may aggravate this situation. First, due to foreign dependence the import coefficients b_1 and b_2 are, as a rule, very high in many underdeveloped debtor countries. Second, it is difficult to export manufactured products to creditor countries because of the heavy unemployment there. As a consequence, the terms of trade are likely to worsen (π in equation 4.48 rises), mainly because of desperate attempts to export agricultural products, raw materials or standard industrial goods at ever lower prices; this rests on the argument set forth within the context of the Kaldorian cumulative process" (Bortis 1997, p. 197).

On this processes Kaldor begins by saying: "The 'principle of cumulative causation whereby some regions gain at the expense of others, leading to increasing inequalities between relatively prosperous and relatively poor areas [is of the highest importance in monetary production economies where the principle of effective demand and the law of increasing returns to scale feature prominently]" (Kaldor 1985, pp. 74–5). And he continues: "If imbalances arise in trade, because one industrial center's exports are larger than its imports,

whereas with the other centers imports exceed exports, the export surplus area will tend to expand production because realized receipts will exceed planned receipts causing producers to expand; this will cause imports to rise (since the use of imported commodities will expand in line with [domestically produced ones]), causing the export surplus to diminish, and hence the excess of realized over planned receipts to diminish, until a balance is reached, with exports equaling imports. In the other countries, the reverse process takes place: output and incomes will be reduced in successive steps until imports are reduced to the level of exports . . . However, under the general assumption of increasing returns, this is not the end of the story. If we started with the arbitrary assumption that the various industrial centres expanded at the same rate, we now have a situation in which one of the centres at least grows at a faster rate than the others. Hence its productivity rate will be accelerated and unless its domestic absorption (meaning its domestic consumption and investment) keeps pace with its faster productivity growth, its export surplus will reappear, giving rise to another push, making for faster growth rates for itself and slower growth rates for the others" (Kaldor 1985, pp. 73–4).

"Important side effects may accompany [such processes], e.g. the ruthless destruction of the natural environment in many debtor countries and worsening social conditions, above all work conditions. Moreover, the debt service ratio $i+\partial$ is bound to increase, owing to high interest rates in creditor countries and to increased short-term borrowing. If overall indebtedness is high, new capital inflows (B) will, as a rule, diminish due to a decline of confidence of the creditor countries regarding the capacity to repay of the debtor countries, reducing further foreign exchange availability. Finally, there is capital flight from many heavily indebted countries: B declines. This occurs for a host of political, social and economic reasons, the lack of investment opportunities and heavy inflation being perhaps most important. All these elements result in a heavy decline of normal output [equations 4.37 and 4.48]. The dramatic consequences for long-period employment are only too visible in many debtor countries: these countries are virtually strangled by the scarcity of foreign exchange" (Bortis 1997, pp. 197-98).

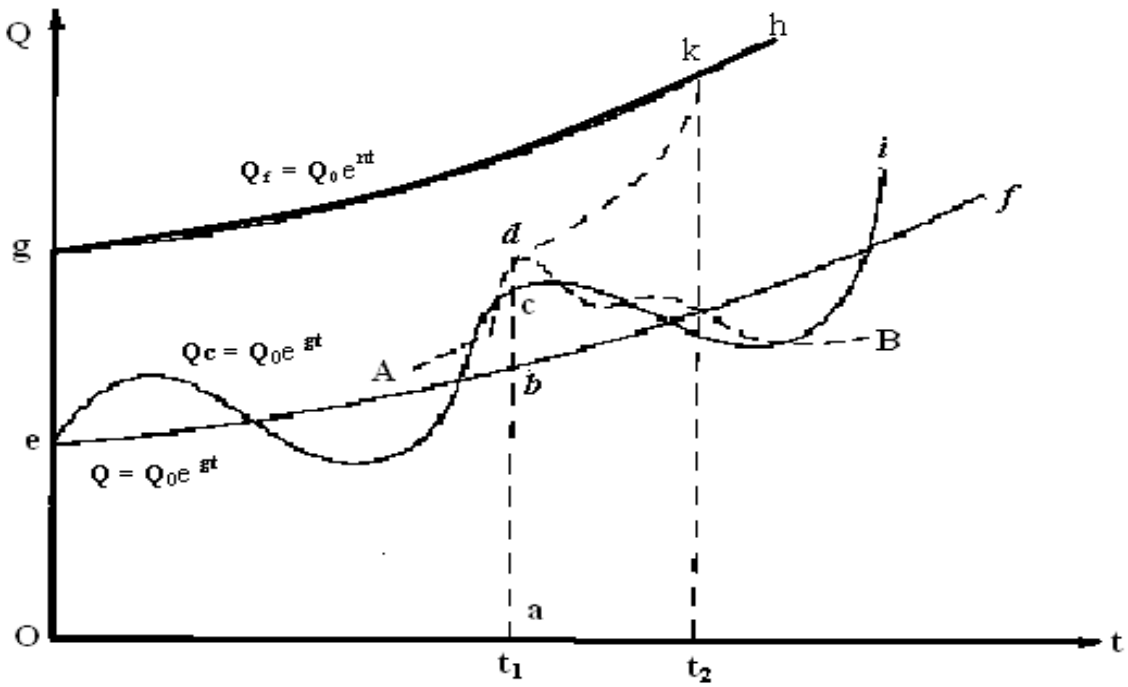
In certain cases FDIs may reinforce these processes. For example, if, as a consequence of inflowing financial capital, M&As take place, subsequently leading on to more unequal income distribution and thereby negatively affecting employment, or, if investment opportunities are limited and incoming foreign investment squeezes out domestic investment. These issues will be taken up below.

It appears that in order to evaluate the impact of FDI on some country with a developing

economy a very solid theoretical framework is required. This is the reason why, in the following, the relationship between long-period multiplier analysis, and the short- and medium term is briefly considered. The central aim is to make some remarks upon FDI and the business cycle.

"[In fact,] long-period variables (normal employment or normal prices for instance), which represent outcomes of the socioeconomic system, cannot be observed directly since the persistently acting causal forces act simultaneously with medium [business cycle]- and short-period forces to fully determine specific phenomena. At any moment, long-period magnitudes governed by the system are superseded by medium- and short-term behavioural outcomes. This point can be illustrated with the help of figure 4.4.

Figure 4.3: The socioeconomic system of outcomes



Source: Bortis 1997, p. 85 Figure 1.

What can be directly observed is the whole of output Q (ad at t_1) which results from short-period entrepreneurial behaviour based upon short- period expectations: expected effective demand leads entrepreneurs to produce corresponding output quantities, hence to use existing capacities to a certain degree; the system governs a short-period equilibrium position determined by autonomous expenditures and the Keynesian multiplier. Abstracting from varying degrees of capacity utilization, capacity output Qc (ac at t_1) obtains, i.e. the normal

output that could be produced with existing capacities. Capacity output is governed by the past investment (accumulation) behaviour of entrepreneurs; this we denote medium-term behaviour because of the gradual revision of investment plans that takes place on the basis of comparisons between expected 'and realized results. Opposed to the behavioura1 outcomes is the outcome of the functioning of the institutional system, i.e. normal output Q(ab at t_1,) to which correspond normal prices (see Bortis 1997, chapter 4, pp. 175-80) both of which cannot be observed directly. If now total output is above (long-period) normal output, as is the case at period t_1,then the short-period deviation *cd* and the medium-period deviation bc have to be subtracted, in order that the long-period trend output ab may be obtained. Contrariwise, if total output is below the long-period trend the short- and medium-period deviations have to be added to output actually observed so as to get trend output. Hence the 'trend' line *ef* is an invisible demarcation line telling us that *ab* is that part of output governed by long-period forces and that *bd* is determined by medium and short-period factors. Similarly, long-run normal prices never appear in a pure form. These are always accompanied, so to speak, by deviations from normal prices as brought about by cyclical movements of an economy or by short-term vagaries of the market. The same reasoning also applies to independent (predetermined) variables and parameters: exports, government expenditures, leakages out of income, the capital-output ratio, the import coefficient, the coefficients of production and profit rates may deviate temporarily from their respective (institutionally governed) long-period values which are constant or change but slowly. The fact that, owing to institutional change, normal magnitudes evolve is of some importance here: the institutionally governed normal variables are not equivalent to statistical trends. The former result from the functioning of the socioeconomic and political system at any moment of time; the latter are an average of past and present realized variables representing short- and medium-term behavioural outcomes" (Bortis 1997, pp. 84-86).

Throughout this thesis we deal with long-period issues, including the impact of FDI upon distribution and employment, associated to the functioning of the institutional system as is summarised by the supermultiplier relation (4.37) above. At this stage, however, some remarks are to be made on the role FDIs might play in the course of the business cycle. These remarks will be based on fig. 4.4 above. Here, the supermultiplier picturing the functioning of the institutional system is associated with the trend output *ef*. The movement of the business cycle, however, is pictured by the curve *ei*. Here, capacity output Q_c – the output at which capacities are normally – is based upon the investment behaviour of entrepreneurs which shapes the business. How the business cycle works in principle can be explained by a variant of the

supermultiplier, that is relation (4.37a) below. In this relation profit rates and growth rates and, consequently, profit and investment volumes diverge from their respective normal or institutionalised level as are exhibited in the supermultiplier relation (4.37). In fact, k_r in relation (4.37a) now stands for the realised mark-up associated with a realised profit rate r_r, and the realised profit rate r_r implies a realised investment volume given by: $I_r = (g_r + d)\, v\, Q_c$.

The cyclical movement may now be interpreted as an interaction between the income effect of investment and the capacity effect of investment (on this see Bortis 1997, pp. 204-14). The income effect of investment rests on the double-sided relationship between investment and profit volumes, or between growth rates and profit rates, respectively mark-ups. In the cyclical upswing, with productive capacities given at any moment of time, rising investment volumes and growth rates lead on to higher profit volumes, profit rates and mark-ups. In relation (4.37a) this shows up in a

$$Q_c = \frac{G + X}{z_S\,[1 - (1 / k_r)] + \pi\,(b_1 + b_2) - (g_r + d)\, v} \qquad (4.37a)$$

larger growth rate gr and in larger mark-up k_r . However, higher profit rates will induce entrepreneurs to invest more. Thus, the income effect of investment results in a cumulative process driving the economy upwards. Now, with investment volumes remaining on a high level, capacity output Q_c. that is the productive potential of an economy, increases rapidly. This implies a rise in macroeconomic supply respective to effective demand, which exercises a pressure on prices, mark-ups and profit rates - k_r in relation (4.37a) declines. Given this, entrepreneurs invest less, which means that the realised growth rate, g_r in (4.37a), is reduced. These tendencies go on as capacity output Q_c continues to rise. This brings about a turning point in the cyclical movement and initiates the slowdown of the economy. The income effect of investment based on the double-sided relationship between investment and profits now works in the opposite direction: realised profit rates diminish; entrepreneurs invest less which, in turn, negatively affects profits. These now fall below their normal level. However, simultaneously, capacity output Qc grows more slowly or even declines. Smaller capacities reduce supply which means that the capacity effect now results in a gradual rise of profit and growth rates and of profit and investment volumes. Once the normal profit level is reached, the economy will pick up to initiate a new upswing.

Now, how does foreign direct investment influence the business cycle?

It is likely that, in principle, FDI will dampen the cyclical movements, a fact which

would be beneficial to the recipient economy. In terms of the above analysis we may say that, probably, more foreign capital will flow into an economy during the cyclical upswing since profits are rising. This implies that the capacity effect of investment works out more rapidly: Q_c increases faster with FDI and reduces the intensity of the income effect through exercising a downward pressure on profits. This emerges from relation (4.37a) and fig. 4.4 above. This implies that the turning point of the cycle will be reached earlier than would have been the case in the absence of foreign investment. In the downswing with profits and domestic investment declining, foreign investment will, as a rule, also be reduced, too. However, with foreign capital still coming in, capacity output Q_c will fall less rapidly than would have been in case of a no FDI taking place. Thus, at the bottom of the cycle, when the realised rate of profits equals the trend rate again and the economy is about to pick up, capacity output will be at a lower distance from trend output (see fig. 4.4 above).

Hence, as has been suggested above, FDI has a beneficial effect upon the recipient economy in the course of the business cycle because fluctuations of output and employment are reduced. However, the crucial issue is how FDI affect the level of the trend around which cyclical fluctuations take place. It is the long-period effects of foreign direct investment upon the recipient economy which are of fundamental importance. This is one of the subject matters of the next section where we now gather the fundamental elements of our analysis. Indeed, we now present the mechanism of investment determination, including foreign direct investment, in relation to the fundamental issues in a monetary production economy that is income distribution and employment.

4.3.1 The Investment Mechanism, Distribution of Income and the Level of Employment

Studies on the effects of foreign direct investment (FDI) on the processes of growth and development have recently, that is since the breakdown of the Socialist economies in 1991, obtained an important position in economic research. In the classical view, Say's law solved the employment problem. Due to the fact that saving, however large in volume, was always invested, general overproduction of goods and, consequently, involuntary unemployment were seen to be impossible. Structural problems were accounted for by a uniform profit rate which produced a tendency towards a structural equilibrium: financial and real capital was flowing into sectors where the realised rate of profits exceeded the (uniform) normal rate, and vice versa. With a tendency for the scale and structure of the problem to be solved, high rates of

growth, associated to some inequality of income distribution (high profits), and (structurally) even development could come into being. Basically saving governed capital accumulation (Bortis 1997, p. 131).

Previously, it has been suggested that with neoclassical economists the content of Say's law – full employment – was realised through a smooth functioning of the various markets, particularly the labour market and the market for new capital goods in the Marshallian version of neoclassicism: unemployment leads to a fall of wages in the labour market, which is transmitted to the market for new capital goods through a rise in profits and larger investment volumes; in fact the investment-profit curve – I(r) - is shifted upwards; employment, output, and incomes increase, and so does saving; this process goes on until full employment is reached. In the Walrasian version of neoclassicism Say's Law operates through Walras's Law: if n-1 markets are in equilibrium, the nth market is in equilibrium, too. Socialists concentrated on central planning of prices and quantities with income distribution playing an important role. A derived version of socialism is the programming-cum-protectionism approach mentioned above and in previous chapters.

Keynes, on the contrary, rejected both capitalism and socialism. And while, in his *General Theory,* he adopted the core idea of mercantilism, stating that in a monetary economy it is demand which governs economic activity, not supply, he rejected the mercantilist means to reach a higher employment level that is an aggressive foreign trade policy, exhibited by the aim of maximising a country's surplus of exports over imports. In Keynes's hands, the principle of effective demand was expressed in investment and the investment multiplier which, in principle, governed economic activity. To establish his theory, "Keynes's main task consisted of showing that, somewhere, there was a failure in the market mechanism. He concluded that the capital market did, not function in the neoclassical way: an act of saving does not lead to a reduction in the rate of interest and thus to a higher volume of investment. Keynes argued that more saving meant less demand for consumption goods. The volume of saving passively adjusts to investment through a change in the level of output. Compared with neoclassical economics, this implies a fundamental change: equilibria are established through quantity adjustments, not through price variations. This is captured by the multiplier relation [Q = (1/s) I], which summarizes short-period theory of employment" (Bortis 1997, p. 132).

In the above, it has been suggested, in a Keynesian and Ricardian vein, that distribution (of income and wealth) and employment are the most important socio-economic problems. However, the economic policies pursued were not successful in solving these problems. One

might even speak of alienated performances in the sense that the situation has become substantially worse since the oil price shock of the early 1970s, above all in countries with a developing economy. Indeed, as is well known, more than one third of the world population are living in misery, with less than two US dollars per day, per person, (about 44% of 6,199 million people in 2002, table 3.10), where 68.0% of world income was allocated to developed economies with 20 % of the world population in 1970. The proportion rose to 81% income for 16.0 % of the world population in 2000 (table 3.11). Moreover, out of a working population of about three billion one third, approximately, is unemployed or underemployed. The bad policy performances are due to partial and rigid, one might even say dogmatic and fundamentalist, theories of the neoclassical type, but also to programming-protectionist theories of the socialist type. As Buckley suggests, ideologically based, largely normative models have substituted for to the search for problem solving theories, that is theories providing the most plausible explanation to a phenomenon (Buckley 1995). "The point now is that some understanding of the functioning of society as a whole is required if some specific policy action is to be undertaken, for example a change in taxation may be influence distribution which, in turn, may affect the long –period employment level, which is directly or indirectly governed by all socioeconomic and political institutions" (Bortis 1997, p.73).

This is to say, that, to deal with the impact of investment, specifically foreign direct investment, upon economic growth and upon economic development in general, and on employment and distribution in particular, requires considering the functioning of the socio-economic and technical system as a whole. This implies taking up the classical approach, basis upon the material basis – institutional superstructure scheme, and complementing it through the Keynesian notion of effective demand.

Historically speaking, there have been positive and negative attitudes to economic growth and development in relation with the role and the effects of foreign direct investment. Cost-benefit analysis of foreign investment has been carried, take account, in a first step, of private profitability, and, subsequently, eventually also of social costs and benefits. Basically, however, this neoclassical approach was based upon methodological individualism, neglecting thus global effects of foreign investment on society and the economy as a whole, with the effects upon employment and distribution being most important. This neoclassical way of proceeding may have made economic science richer in size, while at the same time ignoring the responsibility to find solutions for the immense social and economic problems persisting all over the world, particularly in countries with a developing economy.

However, the classical-Keynesian synthesis, which exhibits the essential elements of a monetary production economy, has, in this situation undoubtedly an important role to play. Indeed, this system of political economy can provide the basis to moving into the right direction in view of solving as far as is humanly possible the great socio-economic and political issues of the day. As has been suggested above, this basis consists of the classical approach to social production, value and distribution and of the Keynesian preoccupation with the scale of economic activity, governed through effective demand and exhibited through multiplier relationships. In the classical-Keynesian system of political economy, the volume of investment, domestic and foreign, associated to income distribution, the evolution of output and employment, and to the technical dynamism of entrepreneurs plays a central role. Classical-Keynesian political economy essentially deals with the functioning of the socio-economic system made up of technology and institutions situated in the material basis and in the institutional superstructure. In terms of fig. 4.4 one above this means dealing with the trend, that is with trend output and employment, and with trend investment. These trend quantities or volumes form together with the normal prices (relation 4.32 above), a system equilibrium, around which behavioural outcomes are located, business cycles in the medium term and certain degrees of capacity utilisation in the short term (fig 4.3 above). The classical-Keynesian system equilibrium obviously stands in sharp contrast to the neoclassical equilibrium which is a behavioural equilibrium (with Walras rational, utility and profit maximising individuals bring about a general equilibrium). The elements of behavioural outcomes, investment projects, most importantly are always associated with uncertainty which implies that the aggregate of behavioural outcomes, whether classical-Keynesian or neoclassical, are also associated with uncertainty. The volume of trend investment, however, is associated with near-certainty because it is associated with the technological-institutional system, and the purpose of institutions is precisely to bring about permanence, stability and certainty. Therefore, in the following we deal with trend or normal investment volumes as are governed by the socio-economic system, and foreign direct investment is evaluated on the basis of its impact on the volume of trend investment. Normal or trend investment is a crucial factor in a monetary production economy in view of solving the great socio-economic problems. Its significance is summarised in Bortis:

"Normal or trend gross investment is directly associated with the maintenance and expansion of the normal capital stock K required for the production of the normal output Q:

$$I = (g+d)v\,Q \qquad (4.34)$$

where g is the trend growth rate of the economic system, a weighted average of the trend rates of growth of the autonomous variables, i.e. normal government expenditures G and normal exports X [see relation 4.37 above and Bortis 1997, p. 155]; d represents the fraction of the normal capital stock which is annually replaced and υ stands for the normal capital coefficient K/Q. Normal investment is thus related to the functioning of the entire social system, encompassing technology and institutions. Hence, technology and institutions determine the normal or long period investment volume through the principle of effective demand [the social product Q appearing in relation 4.34 is determined by the supermultiplier relation 4.37 above]. Therefore, investment, which is autonomous in the short run, represents derived demand in the long run. This is a central tenet of relation [4.34]. (2003, p. 464)

We have now put together all the elements needed to deal with the impact of foreign investment on economic development.

4.3.2 Foreign Investment and Economic Development

The Harrod-Domar growth equation

$$g = s/v \tag{4.49}$$

(s = average saving-income ratio and v = capital coefficient) has played a crucial role in the discussion on the impact of foreign investment on economic development. This discussion has been shaped by the fact that this relation, in spite of its Keynesian flavour, is of a distinctly neoclassical nature. In fact, on the right-hand side of equation (4.49) it is the saving-income ratio, which appears to determine the investment-income rate. This is equivalent to Say's Law according to one variant of which saving governs investment. Given this, foreign investment will, as a rule, add to domestic investment – governed through domestic saving – to result in a higher rate of growth and thereby foster economic development. This point has been forcefully put by Rosenstein-Rodan (1961): "The purpose of an international resource program of aid [and foreign resources in general, including foreign direct investment] to underdeveloped countries is to accelerate their economic development up to a point where a satisfactory rate of growth can be achieved on a self-sustaining basis" (p. 81). The underlying idea is that an underdeveloped country would, at first, borrow and favour the inflow of foreign direct investment. However, as the target rate of growth is gradually approached, the inflow of foreign resources would gradually decline and eventually become negative, which would be

equivalent with repayment of foreign debt; as a general rule, foreign borrowing is profitable to the recipient country if the rate of growth exceeds the rate of interest (Rosenstein-Rodan 1961). This optimistic view is in line with the optimistic neoclassical-Keynesian view, based upon Samuelson's neoclassical synthesis that prevailed after World War Two until the early seventies approximately. From the mid-seventies onward macro-economic analysis have been gradually abandoned to be replaced by purely neoclassical method of focussing upon the profitability of the individual projects. Cost-benefit analyses have been established, mostly taking account of direct – private – costs and benefits of a project. Sometimes, however, social cost-benefit analyses have been set up, a most prominent instance being the Manuel of Industrial Project Analysis in Developing Countries (Little and Mirrlees 1968).

In a classical-Keynesian perspective, this optimistic picture no longer holds. Investment opportunities are limited and, as a consequence, foreign investment may have a positive or a negative impact upon the overall volume of investment and, thereby upon the rate of growth, according to the circumstances. In fact, foreign resources, specifically foreign direct investment, may add to domestic investment if circumstances are favourable; or FDI may displace domestic investment in unfavourable conditions. This can be shown by comparing the target or normal profit rate (r_n) and realised profit rates (r_r). In a classical view, there exists a unique, institutionally determined profit rate for the economic as a whole and there is, in principle, a tendency towards realising this profit rate in all sectors of production. We may already mention at this stage that this assumption is important for the evaluation of FDI. Indeed, a realised rate of profit above the desired rate of profit in certain sectors indicates that these sectors constitutes bottlenecks, which may thus be relieved through an inflow of FDI. Contrariwise, if the profit rate in sector i is below the general target rate, FDI will, as a rule, drive out domestic investment because of the superior technology embodied in foreign direct investment: labour productivity associated with FDI is usually so high that wages and profit may be higher and prices lower than is the case with domestic investment.

Of course, the following analysis, like all other theoretical expositions set forth in this thesis, relates to principles only, that is to fundamental pure theory. As has been already suggested, theoretical fundamentals picture how the basic causal force work in principle, that is independently of specific institutions and concrete historical situations. The latter subsequently come in to modify the conclusions obtained by theory; and, it may already be stated at this stage, that, in the case of Iran, the modifications of theoretical conclusion through political elements, also elements of foreign policy, are absolutely crucial. These issues will be briefly

taken up in chapter V. In what follow we take up the impact of FDI upon an economy which is governed by the internal employment mechanism where investment opportunities govern the volume of domestic and of foreign investment that may be undertaken.

4.3.3 The Internal Employment Mechanism and FDI at the Level of Principles:

The starting point to compare the realised and the normal profit rate on a macroeconomic level is the supermultiplier relation (4.37) above. To bring out the essential features of our analysis of macroeconomic desirability of FDI it is postulated that the social surplus consists but of profits. Hence there two income categories only: wages and profits, whereby profits may include land rents considered as profits on investments in land. The assumption that wages are entirely consumed, as is contained in the supermultiplier relation is maintained. Hence saving and tax payments are out of profits only. In the following desired or normal magnitudes carry the suffix n, and realised volumes are marked with a r. First, we have the normal rate of profits (r_n), which, in equilibrium, equals the realised rate

$$r_r = r_n \tag{4.50}$$

This definition implies that there is a structural equilibrium in the sense that the normal profit rate is realised in each sector of production. In a way, definition (4.50) implies a macroeconomic equilibrium in the sense of a structural equilibrium. There is no tendency for capital to move from one sector to another.

Bearing in mind the investment equation (4.35) and that the surplus consists of profits only and assuming that the foreign balance is in equilibrium, a very simple relationship between realised profits r_r and realised investment I_r can now be derived:

$$r_r = \frac{g+d}{z_P} \left(1 + \frac{G}{I_r} \right) \tag{4.51}$$

The economic meaning of this relation is that, in macroeconomic equilibrium, saving and taxes, which are out of profits only ($z_P = s_P + t_P$), must equal investment and government expenditures; indeed, since $I_r/(g+d)$ equals K_c relation (4.51) can be written as

$$z_P\, r_r\, K_c = z_P\, P_c = I_r + G \tag{4.51a}$$

Moreover, it must be noted that government expenditures G, the trend rate of growth (of G) and the depreciation ratio d, as well as the leakage out of the surplus – consisting of profits in a wider sense – z_P are all institutionally determined. Hence these magnitudes are all given and may, in way, be considered parameters. The realised investment volume I_r, however, depends upon the investment behaviour of entrepreneurs, and the realised profit rate r_r results from this investment behaviour. Given this, relation (4.51) exhibits a downward sloping relationship between the realised profit rate – the dependent variable – and the volume of investment undertaken by domestic and foreign entrepreneurs – the independent variable. The reason why, in the long run, realised the unique macroeconomic profit rate declines if the investment increases is very important. The reason is, in fact, provided by effective demand and not by the marginal productivity of investment. This follows from the supermultiplier relation (4.37) and from relation (4.51), which is based upon the supermultiplier relation. The crucial point is that relation (4.51) is a long-period relationship. This implies that only the capacity effect of investment is considered. This emerges most appropriately from considering the long period investment equation (4.34) which links normal or trend investment I to normal or trend output Q. This equation now ought to be rewritten as:

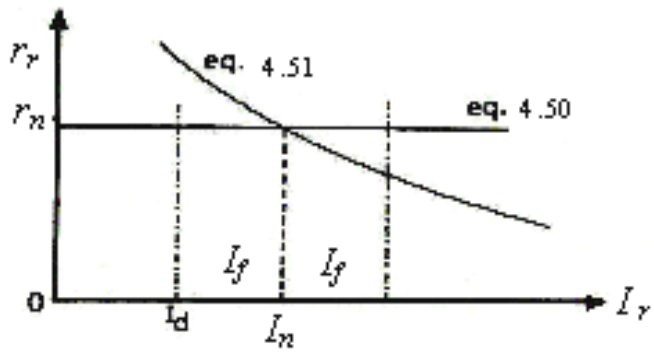
$$I_r = (g + d)\ v\ Q_c \qquad (4.34a)$$

This relation exhibits the fact that each level of realised investment I_r, if undertaken over several short turn periods of time, results in a certain level of capacity output Q_c. Now, if capacity output Qc is larger than the normal output Q – as governed by supermultiplier relation – then the higher output can only be sold if prices, profits, and profit rates are set below the normal level. Given the money wage rate, a fall of prices leads to a higher real wage rate; a rise in money wages with given prices would produce the same result. Now, a raising real wage or an increasing wages in domestic income will rise effective demand. The reason is that, in a post Keynesian vein, the propensity to consume out of wages is higher than the propensity to consume out of profits – in relation (4.51) above it is postulated that wages are entirely consumed and that the fraction of profits consumed is $c_P = 1 - z_P$. The fact that the inverse relationship between long-period realised profits and long-period realised is based upon the principle of effective demand is crucially important to evaluate the impact, in principle, of foreign investment upon the recipient economy. And of equal importance is the fact that

effective demand and thus employment are directly related to the distribution of income.

We are now in a position to evaluate the impact of foreign direct investment upon domestic investment and hence upon output and employment. The starting point is relation (4.50) which, as has been suggested above, tells us that a structural macroeconomic equilibrium of the classical type has come into being: the normal profit rate is the same everywhere which implies that the structures of investment, capital, output and employment are given. Equation (4.51) links the realised rate of profit to the amount of investment, which is undertaken by all entrepreneurs, domestic and foreign. Since the realised rate of profit is a downward sloping function of investment I, it follows that there is only one level of investment which, if it is maintained over several short-run periods, will bring about equality between the realised (r_r) and the desired rate of profit (r_n). This can be seen from the following diagram (which is taken from Bortis 1979, p. 115):

Figure 4.4: Domestic and Foreign Investment



Source: Bortis 1979, p. 115

In fact, it is the investment volume I_n, in this figure which equalises the normal and the realised rate of profit. At the same time I_n is associated with a specific long-period equilibrium level of employment and output as is exhibited by the supermultiplier relation (4.37) above. Hence I_n in figure 4.5 is linked with a specific trend level of output and employment (see fig. 4.4 above, and Bortis 1997, p. 150, fig. 3). The significance of the long-period relationship between realised profits and investment volumes (fig. 4.5 above) now emerges more clearly. This relationship, in fact, pictures how long-period macroeconomic adjustment processes go on in principle. More concretely, relation (4.51) is about the gradual adjustment of capacity output and the corresponding employment level to the (equilibrium) normal level of output and employment implied by a given trend line as pictured, for example, in fig. 4.5 above or Bortis

(1997, p. 150, fig. 3). It is crucial to insist that this adjustment process is of a macroeconomic nature. This has an important implication. Indeed, if the realised rate of profits exceeds the normal rate of profits for the economy as a whole, this is the case for each sector, too:

$$r_{ri} > r_n \tag{4.50a}$$

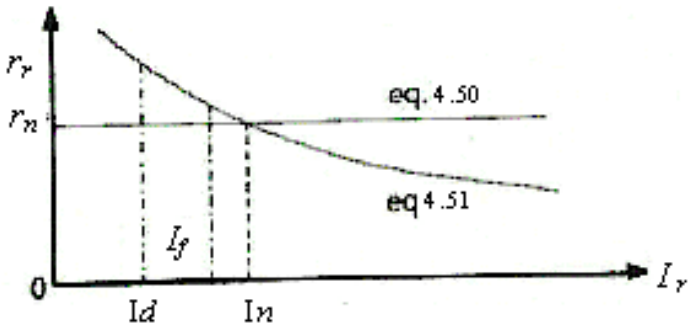
Given this situation, foreign direct investment will, in principle, be profitable to the recipient economy in all sectors of production. Let us now consider three cases regarding the macroeconomic effects of FDI in a recipient economy (in part, see on the following Bortis 1979, pp. 115 ff.). Suppose, first, that, prior to the inflow of foreign capital, the economy we consider has been in a state of long-run equilibrium where realised profits (P_r) equalled desired or normal profits (P_n). The amount of investment undertaken by domestic entrepreneurs thus corresponded to I_n. Now, foreign resources amounting to I_f start flowing annually into the country we consider. By assumption, all of them are invested, either by the government of the borrowing country or by foreign entrepreneurs. The new level of investment is thus given by $I_n + I_f$. But if this investment volume is maintained over a certain long-run period of time, then the realised rate of profit will fall short of the normal rate - only if income were redistributed in favour of workers would effective demand be sufficient to buy the output produced by the increased capacities. However, if the distribution of income remains the same, that is, if the normal profit rate r_n in fig.4.5 above is maintained, the volume of total investment, that is domestic investment I_d and foreign investment I_f, that can be maintained in the long run will be I_n. At this investment level the profit expectations of all entrepreneurs that is in all sectors of production, will be realised again, since the uniform realised profit rate will equal the uniform normal rate. However, foreign investment I_f has now displaced domestic investment to the same amount, implying that I_n now equals $I_d + I_f$. I_n the case considered foreign investment is obviously not beneficial to the recipient country since foreign investment, due, as a rule, to superior technologies embodied in it, squeezes out domestic investment to the same amount. The same domestic product will be produced, but the national product will be reduced because of profit transfers to the countries of origin of FDI. But there may other negative effects, most importantly those related to distribution. Indeed, if the technology embodied in FDIs is much superior to the technology embodied in domestic investment, perhaps taking place largely in the traditional sector, then foreign investors may be in a position to hire the best workers and employees on the domestic labour market, to pay higher wages as a consequence, and yet the

may realise higher profit rates. The distribution of incomes may thus become more unequal because of the inflow of FDI. In fig.4.5 above this will show up in an upward shift of the normal profit line. Normal investment and, consequently, domestic investment will be reduced further. In the supermultiplier relation (4.37) above a more unequal income distribution will be reflected in a higher macro-economic mark up and surplus coefficient k. The share of property incomes [l – (1/k)] will increase. Possibly, the surplus will be more unequally distributed. This, in turn, may result in a higher leakage coefficient z_s in the supermultiplier relation (4.37), this being due to a larger fraction of the surplus saved. As a consequence output and employment will decline if the income distribution becomes more unequal. In the above discussion of the supermultiplier relation, it has been suggested that the main reason for this to happen was the reduced effective demand due to a reduced spending power of the working population.

Hence the conclusion to be drawn from the analysis carried out so far is that, if the economy under consideration has, prior to the inflow of foreign capital, been in a long-run equilibrium and if the whole of the foreign resource inflow is invested, an annual inflow of foreign capital amounting to If will entail a reduction of total investment equal to the same amount. This is due to the fact that in a capitalist economy where entrepreneurs aim at realising a normal rate of profit investment opportunities are limited by effective demand.

In the second case we consider, we give up the assumption that the economy under consideration is in a long-run equilibrium prior to the inflow of foreign capital. Suppose that investment and employment are at a level such that realised profits exceed desired profits. In terms of the supermuliplier analysis, capacity output Q_c and the associated level of employment N_c in relation (4.37a) above would be below the normal levels of output and employment – Q and N – as exhibited by the supermultiplier relation (4.37) above. Consequently, the amount of domestic investment – I_d - undertaken falls short of trend or normal investment I_n. Let us represent the initial situation with the help of diagram 4.6 below:

Figure 4.5: Long time investment equilibrium



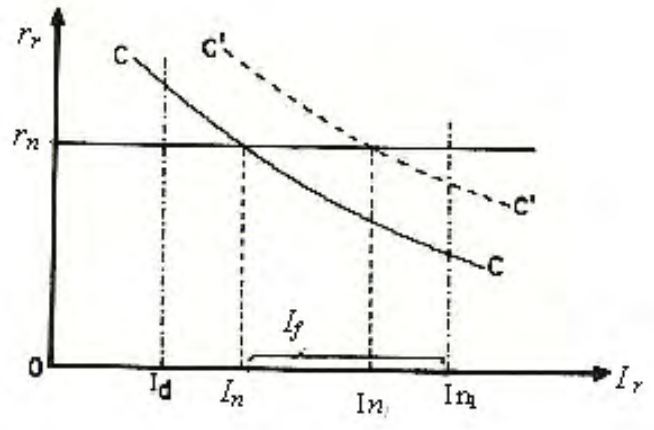
Source: Bortis 1979, p. 118

Domestic investment, prior to the inflow of foreign capital, equals I_d. Now, an annual inflow of foreign resources amounting to I_f occurs. Nevertheless, domestic entrepreneurs still have incentives to invest more, because total investment, $I_d + I_f$, falls short of I_n, the normal or equilibrium level of investment which would bring about equality between the normal and the realised rate of profit. Therefore, the possibility that foreign capital can be a genuine addition to domestic investment exists. The reason is, of course, that there are investment opportunities, which, for some reason, have not yet been exploited by domestic entrepreneurs; one reason could be a shortage of financial means; more importantly, the average labour productivity of the economy considered is simply not high enough to produce a surplus above socially necessary wages which is large enough to bring about a higher level of domestic investment. On the other hand, it is easy to see what would happen if, prior to the inflow of foreign capital, I_d were already to exceed I_n. Domestic investment would then have to decline by an amount larger than I_f. In the analysis carried out so far, the level of government expenditures, G, has been considered independent of increases in the level of investment and employment as, at least temporarily, caused by an inflow of foreign resources. This assumption is now given up which leads on to considering a third scenario: The economy we consider is, initially, in a long-run equilibrium position. The level of output and employment is governed by the supermultiplier relation (4.37) above. A permanent annual inflow of foreign capital will, if invested, cause employment to increase as is evident from the investment equation [4.34] above. Now, the additional output produced by foreign capital may have various effects. For example, a large part of the output produced by foreign capital and domestic labour may exported without imports rising significantly. As can be seen from various stages of the above classical-

Keynesian analysis, rising exports leading on to an export surplus have in any case a favourable impact upon output and employment. This conclusion follows, for example, from figures 4.5 and 4.6 above, from the supermultiplier equation (4.37) or else from relation (4.45) which pictures the external employment mechanism. Moreover, increases in long-period output and employment brought about by foreign investment may lead on to tax receipts rising permanently. This, in turn, may enable a permanent rise in government expenditures: G increases. According to the internal employment mechanism pictured by relations (4.40) and (4.40a) output and employment will rise as a consequence.

From the supermultiplier relation (4.37) follows that a permanent increase in government expenditures and in exports – leading on to export surplus - must result in a higher permanent equilibrium level of investment, output and employment. In terms of figure 4.6 this shows up in an upward shift of the long-period output trend e*f*. What might happen if foreign investment enhances exports and government expenditures through increases in output and employment, may perhaps be illustrated best with the help of figure (4.6) below (taken from Bortis 1979, p. 119), based on relations (4.50) and (4.51) – whereby it should be born in mind that the export surplus (X – πM > 0) must now be added to G in relation (4.51):

Figure 4.6: Foreign investment as a complementary resource



Source: Bortis 1979, p. 119

Initially, equation (4.51) is represented by curve CC. Domestic investment equals I_n. Then an amount I_f of foreign capital starts flowing annually into the country we consider. All of it is invested. The new level of investment is thus given by Ir_1. The additional output created by foreign investment causes, for the reasons given above, autonomous expenditures – government expenditures plus an export surplus [G + (X-πM)] – to increase. Curve CC

therefore shifts upwards to a new level C'C'. The equilibrium level of investment is now given by In_1. In order to bring about equality between the realised and the normal rate of profit, domestic investment has to be reduced by $Ir_1 - In_1 = I_n - I_d$, where I_d is the new equilibrium level of domestic investment. It is obvious that this reduction in domestic investment is smaller than the cutback in domestic investment which would have been necessary, had there been no increase in the level of autonomous expenditures.

We conclude these considerations upon the internal employment mechanism by a comment sometimes made upon the desirability of investment in general and upon foreign direct investment specifically. In a neoclassical Say's Law vein it is sometimes claimed that "investing today, enables to harvest tomorrow". This statement really implies that all that is saved can be invested, whereby, of course, the investment projects having the highest rate of return should be realised first, and subsequently those with lower profit rates. As has been mentioned repeatedly in the above, it is this neoclassical marginal productivity view of investment and capital accumulation which lies at the heart of the liberal free market claim that foreign investment is always highly desirable. In the above on the internal employment effect and FDI we have argued that in a classical-Keynesian view where no tendency towards full employment exists investment opportunities are limited and, consequently, it is possible that foreign investment may drive out domestic investment. In a classical-Keynesian perspective specific conditions have to be fulfilled if foreign investment is to have a positive impact upon the recipient economy. Specifically, government expenditures must be sufficiently high and the distribution of incomes not too unequal if foreign direct investment is to make a positive contribution to an economy, specifically to a developing economy, where, due to a large traditional sector, FDI, as a rule, embodies technologies which are far superior to the technologies in use domestically. Hence, from a classical-Keynesian point of view, the above dictum must be basically modified: "investing today indeed enables to harvest tomorrow, but, first, the soil must be appropriately prepared". What does "preparing the soil appropriately" mean? It means that, before FDI can be allowed entering a country, in general and with a developing economy in particular, sufficient effective demand must be created, either by stepping up government expenditures and/or improving the distribution of incomes and wealth so as to enhance the spending power of the working population. This conclusion directly follows from relations (4.50) and (4.51), and from fig 4.6 above. Increasing government expenditures G results in a rightward shift of the CC-curve which pictures relation (4.51), and bringing about a more equal income distribution is reflected by a downward shift of the normal

profit line, reducing thus profits which are only partly consumed, and increasing real wages which are entirely consumed. Both lead to a higher level of normal investment which, through the supermultiplier relation (4.37) is transformed into larger volumes of output and employment. Of course, the conclusion that higher levels of government expenditures and a more equal distribution of incomes results in higher levels of output and employment, through FDI complementing domestic investment, also follows from the supermultiplier (4.37): a rising G and a lower surplus share [1-(1/k)] both result in larger Q and N. This is enhanced through a more equal distribution of the surplus which will show up in a lower leakage coefficient z_s , implying that a larger fraction of the surplus is being consumed. The above analysis is at the level of principles which are all very simple and, in fact, easy to understand. The art of political economy consists in fact of choosing the most appropriate approach that is to select the most plausible set of principles. While principles are always of great simplicity, the realisation of principles in the real world is of immense complexity. We shall deal with this issue somewhat more extensively in chapter V below. At this stage, we may already mention that deciding upon the size and the structure of government expenditures is a matter of extreme complexity requiring a vision of the society and the state to be built up. Indeed, in the long run, the central task of the state consists in building up institutions – in the domains of education, general infrastructure, law and justice, and so on – or to favour the coming into being of institutions such that the institutional system as a whole is conceived in a way which brings about the largest possible scope of freedom for the social individuals and for collectives. (see on the above Bortis 1979, p. 119)

4.3.4 The External Employment Mechanism and Foreign Direct Investment

On the basis of the external employment mechanism exports are directly linked to output and employment. This has been already alluded to in the preceding, mainly in the context of the supermultiplier relation (4.37) which embodies the external employment mechanism and of relation (4.45), which exhibits this mechanism. The external employment mechanism is also put to the fore in fig.4.2 above where economic activity is governed by foreign trade relations.

However, it is of paramount importance whether a country mainly exports manufactured products (or services) of high quality, and predominantly imports primary products (agricultural products, raw materials, energy resources) and, eventually, standard industrial products, or vice versa. The problem is that manufactured products and services are labour-

intensive, whilst primaries are essentially land-intensive. This implies that the successful exporters of high-quality manufactured product, while importing primaries, will tend to have high levels of employment, and vice versa. As a consequence, a contradictory situation comes into being. Countries well endowed with natural resources are, as a rule, relatively poor, and very dependent upon imports, precisely of manufactured products, with levels of unemployment being relatively high. This phenomenon has been termed "Dutch disease" by Nicholas Kaldor around 1970, following up the discovery of natural gas in the Netherlands, which was mostly exported, with manufactured products being imported as a counterpart, causing thus employment problems in the Dutch manufactured sector. On the other hand, countries poorly endowed with natural resources, or not all, are relatively rich, sometimes even very rich, while being import dependent in an other way, that is relative to primary products. Japan and Switzerland are perhaps the prime examples of this category of countries.

The Kaldorian distinction between countries and regions producing predominantly manufactured products (or services) and those relying is of the greatest importance for economic development in relation with foreign direct investment. As a rule, the highly industrialised countries do not undertake investment projects in the manufacturing sector of countries producing primaries, but invest in infrastructure, plantations, and, above, in mining and energy resources, oil being the prime example. Indeed, for the industrialised countries the producers of primaries have a double function: first, they have to deliver the primary inputs required to produce industrial and service goods, and, second, these countries or regions are markets for the final products produced in the industrialised countries. Given the fact that, in monetary production economies, effective demand and hence the size of the markets are limited, it is understandable that the industrialised countries do no want to set competitors for producing manufactured goods, so as eventually to loose work places.

Given this, FDI may have a negative impact in many countries, specifically in developing countries. FDIs do not lead on to higher exports, but produce for the domestic market. As has been suggested above, this may lead on displacing domestic investment. Moreover, and this is very important, in a developing economy where the traditional sector is still important, FDI, as a rule, leads on to using advanced machinery and equipment that cannot be produced domestically. As a result the import coefficient b_1 relating to the import of necessary goods to be put to use in the process of production increases, leading on to a higher import dependence of the recipient country of FDI (see the import relation 4.31 above). Moreover, as has also been suggested already, FDI through the use of advanced technologies brings about rises in labour

productivity. In a dual economy, with a large traditional sector, wages are relatively low, however. Now, even if foreign investors pay higher wages than those prevailing in the traditional sector, profits will, as a rule, go up sharply on account of the higher labour productivity. The more unequal distribution of incomes resulting from FDI will almost certainly lead on to an increase of the import coefficient b_2 (relation 4.31) on account of the import of non-necessary – luxury – products. Hence FDI may lead on to a considerable increase of the overall import coefficient. From the supermultiplier relation (4.37) and from the relation picturing the external employment mechanism it follows immediately that output and employment will be reduced. Indeed, a higher import coefficient implies that a larger fraction of domestic income is spent on foreign goods.

Given this struggle for work places, it is extremely difficult for developing countries to attract foreign direct investment leading on to the production of manufactured goods or services to be exported. Specifically, this is true for developing countries producing primary products, oil and raw materials in particular. Given this, the question as to the development strategy for developing countries producing primary products, specifically oil, arises.

To suggest a tentative answer to this query, we take up and develop somewhat an idea formulated by Mohamed Mossadeq, Prime Minister of Iran from 1951 to 1953. Imagine there are two Iran, Iran I without oil, and Iran II with oil. In principle, Iran II must develop in the same way as Iran I, with oil being a supplement, a kind of rent provided by nature adding to the wealth of a country. Thus, in the end, Iran II would be, as it should be, richer than Iran I. It is well known that Mossadeq was not permitted to realise his idea. And, presently, almost all producers of primaries are in a more or less difficult situation, mainly regarding employment and a distribution, which, as Maynard Keynes has argued time and again, are the fundamental socio-economic problems of our times. In terms of what has been said above, Mossadeq's idea could be elaborated as follows. Developing countries in general and primary producers in particular, ought to develop according the internal development mechanism (see, for example, Bortis 1997, pp.319-26). This mechanism is exhibited by relations (4.40) and (4.40a). The latter equation with a tax coefficient (t) such that the government budget is always in equilibrium is particularly revealing. This relation can, in fact, be rewritten as

$$G = t\, Q_i \qquad (4.40d)$$

This long-period relation states that government expenditures set economic activity into motion

through creating a cumulative demand for consumption and investment goods. This process of cumulative demand creation is exhibited by relation (4.40b) above. (As has already been suggested, this is in analogy to the spending of rents by the landlords in Quesnay's fundamental (zig-zag) Tableau Economique.)

However, relation (4.40) also tells that government expenditures G create the tax revenues t Q_i required to finance these expenditures, precisely through setting economic activity into motion. (Again this is in analogy to Keynes's proposition that investment financed through invest able funds through the banking system creates the saving required to finance investment in real terms, that is to set free the resources required to produce the investment goods.) These tax revenues enable the government to spend the amount of G every year without causing inflation. Seen in this way the tax system is the backbone of a monetary production economy.

The internal employment exhibited by relation (4.40a) implies that development policy is, in a first step, employment policy. G has to be gradually increased in a way so as to reach full employment as quickly as possible. In terms of figure 4.3 above this means shifting the output trend upwards until full employment output is reached. To reach full employment output in a minimum of time one should rely on traditional technologies. Only once full employment is reached should the modern sector be gradually expanded. Here, it is of the greatest importance to put to use government spending policy and an incomes (distribution) policy in a way to preserve full employment. This means continuously creating the effective demand required to absorb output which is increasing through the introduction of modern techniques of production that is through expanding the modern sector.

Hence government expenditures and a solid taxation system are crucial to the internal employment and development mechanism. These government spending policies should be complemented by an institutionalised incomes policy and an appropriated management of foreign trade relations. A permanent incomes policy is required to maintain, given the tax and the investment ratio (see relation (4.41a) above, a consumption ratio compatible with full employment. In other words, an incomes policy is continuously required to maintain the purchasing power of the working population such that full employment may be maintained. However, the internal employment mechanism also requires a permanent management of the foreign trade relations such as to bring an equilibrium of the foreign balance in the long run. What this implies can best be seen by combining the foreign balance relation (4.42) with the import equation (4.31):

$$X = \pi (b_1 + b_2) Q \qquad (4.42a)$$

In the above it has already been stated that the import coefficient b_1 is related to the necessary goods required in the process of production (land basics: raw materials and energy resources, labour basics: necessary consumption goods, and land-labour-basics: necessary machines and equipment). The import coefficient b_2, however, relates to non-necessary imports related to consumption out of the surplus. Now, if given exports X, development and employment policies are being pursued to raise output and employment in order to gradually approach their full employment levels, import increase as is evident from relation (4.42a) and a deficit in the foreign balance comes into being. Now, the coefficient b1 cannot be reduced since it relates to necessary imports - required in production – which must be imported. The only way to preserve the equilibrium of the balance on current account in the long run is to reduce, always given X, the coefficient b_2 relating to non-necessary imports. Of course, the management of foreign trade relations would be greatly facilitated by the existence of a supranational currency – Keynes's Bancor – which would force surplus countries to spend their accumulated Bancor balances; this would gradually bring about foreign balance equilibria world wide (Keynes, Collected Works, vol. XXV).

At this stage it must be mentioned, however, that, under the prevailing world economic order, the internal employment mechanism (relation 4.41a) is politically exceedingly difficult to manage in an open economy (see on the following Bortis 2003b, p. 75). There is, first, an inherent difficulty. The internal employment mechanism in fact requires establishing socially sound proportions between state and the private sector, reflected by the ratio G/Q, and a socially acceptable distribution of incomes, such that economic activity is near to, or, ideally at, the full employment level, or that a long-period tendency towards establishing full employment is established. And, second, internal policies must be such that the external balance ($X = \pi M$) is broadly preserved. This is, as a rule, simply not possible in a world where free trade advances on a global level.

Given the enormous difficulties associated with the internal employment mechanism it is understandable that, with the creation of large free-trade areas and with globalisation, more and more countries rely upon the external employment mechanism to secure levels of employment as high as possible. As has been suggest above, the employment effect of foreign trade will be particularly strong if the bulk of exports consists of high-quality industrial products and

services and if imports are, in the main, made up of primary goods as is necessarily the case with the successful exporters just mentioned and with the terms of trade being favourable. High-quality industrial goods and services are, as Nicholas Kaldor has emphasised time and again, labour-intensive - if account is taken of direct and indirect labour – while primaries are land-intensive.

Now, and this is a crucial point, "there is a contradiction between the external and the internal employment mechanism at the world level. In fact, world economic activity (Q_W) must be governed by the internal employment mechanism (relation [4.40e] below) since the world as a whole is a closed system. The share of world economic activity attributed to each country is, however, governed by the external employment mechanism (relation [4.46] above). Hereby, the shares in world industrial production and services activities are, of course, of particular importance.

$$Q_W = \frac{G}{z_s[1-\frac{1}{k})]-(g+d)v} \tag{4.41e}$$

In order to successfully set to work the external employment mechanism, countries and regions have to offer favourable conditions in order to attract firms, which create additional work places and, subsequently, export the bulk of their production. The work force has to be of good quality, but wages not too high, the infrastructure should be in a good state and should be available at low costs to the users, public services, education in the main, should be of high quality, but taxes not too high. Taxes may, in turn, be lowered if state activities are privatised. Given the endeavour to create, in each country, a favourable environment for exporting firms, it is likely that government expenditures stagnate or even decline at the world level. Even more importantly, income distribution has become markedly more unequal in the last twenty years or so [see for example Galbraith and Berner, 2001]. According to relation [4.40e] a more unequal income distribution and stagnating or eventually declining government expenditures both imply that, in principle, long-period world economic activity – output and employment - remains more or less constant or even declines. As a consequence, the struggle for world market shares, mainly of industrial goods and services, will intensify. Through the external employment mechanism the successful exports of high-quality industrial goods and services may nevertheless enjoy a satisfactory, even a booming economic situation. The losers, however, will be precipitated into the abyss of mass unemployment and of social and political instability.

Owing to the law of increasing returns and to the principle of effective demand, Kaldorian cumulative processes may be set into motion resulting in larger inequalities of income, wealth and employment opportunities worldwide" (Bortis 2003b, p. 76).

This desperate struggle for world market share and work places in order to realise profits explains the endeavour of all countries, above all of developing countries to attract foreign direct investment. In doing so it is hoped that the enterprises in question export most of what they produce domestically. In chapter II above it has been suggested that this struggle for world market shares and work places has considerably intensified since the early 1990s, that is following up the breakdown of the socialist systems.

4.4 Foreign direct investment, cycles and structures

In order to complete the picture we mention here two instances where foreign investment may be beneficial to the recipient economy. Both have already been alluded to, so that we may be very brief here. First, while discussing fig. 3 and relation (4.36a) it has been mentioned that foreign direct investment dampens the amplitude of the cycle because FDI strengthens the capacity effect of investment while not influencing the income effect of investment. For example, in the cyclical upswing, capacities, that is supply, grow faster with FDI flowing into a country, slowing thus down the upswing.

Second, if the realised rate of profits exceeds the normal rate in some sectors (j for example), then

$$r_{rj} > r_n \tag{4.50b}$$

foreign direct investment will of course have a positive impact on the recipient economy. In fact, in this case foreign investment contributes to relieving bottlenecks. This is of course of particular importance in the sectors producing basic goods required in the social process of production: machine tools, special machinery and equipment, raw materials and energy resources, and, of course, necessary consumption goods.

4.5 Uncertainty and Foreign Direct Investment

Until now we have considered investment volumes as are determined by the functioning of the system. This type of analysis is associated with determinism and certainty, where objectively

given factors, institutions and technology govern prices and quantities, and employment levels. The entire classical-Keynesian system, the proportions and the scale effect, has been presented above and has, subsequently, been applied to analyse the impact, in principle, of FDI on the recipient economy. In this subsection we turn to considering individual investment project which are associated with uncertainty and expectations. It will emerge from this analysis, that when there are no substantial investment opportunities (see the discussion of figures 4.5, 4.6, and 4.7 above), uncertainty related to individual investment projects will come dominate system caused certainty, put to the fore in the above, and change the nature of FDI. In fact, financial capital relating to mergers and acquisitions (M&As) starts dominating the picture at the expense of real capital. Simultaneously, this means that financial capital associated to M&As tends to acquire already existing enterprises, possibly, very profitable ones. This means that risk and uncertainty are minimised. FDI in the usual of real capital is, however, with new capital investments, and, consequently, associated with possibly high degrees of risk and uncertainty. A passage taken from Bortis (1997) suggests that, in normal circumstances, there is very considerable risk and uncertainty in the different spheres of a monetary production economy: "On the behavioural level, there is permanent uncertainty in the long run regarding the structure of the composite trend variables. Most importantly, uncertainty is about the firms which are producing trend output: which firms will drop out after some period of time? Which firms will survive in the long run? How will market shares develop in the long run? Closely linked to this question is the way in which technical progress is introduced. It is likely that technically dynamic firms will succeed in enlarging their market shares and vice versa. On all this, there is considerable long-period uncertainty. Since technical change is uneven, there is uncertainty about the evolution of normal prices in many areas of production. Structural change is bound to lead to permanent uncertainty for individual economic agents, although the global magnitudes of the supermultiplier relation may be quite stable or may change regularly: with a regularly evolving trend volume of employment determined by the supermultiplier mechanism the question as to whom is going to be employed or structurally or involuntarily unemployed is linked with permanent uncertainty for each individual acting within a given institutional set-up. Similarly, given the volume and the structure of trend output and long-run Engel curves, no firm, even if well established, can be certain about its still being in the market in ten years' time. Finally, the permanent presence of uncertainty induces individuals to hold part of wealth in the form of money with far-reaching consequences on the level of economic activity.

In the medium term, there is uncertainty as to the amplitude of the business cycle. The

size of the adjustment parameter q [which indicates the strength of the reaction of investors regarding the difference between realised and normal profits] plays a crucial role here: if entrepreneurs rely heavily on the income effect of investment, q largely depends upon (subjective) psychological factors, i.e. optimism or pessimism. A large q, implying very optimistic entrepreneurs in the upswing and vice versa, will lead to extreme cycles: behavioural and system outcomes will diverge widely. There will be considerable uncertainty about who will be additionally employed in a business cycle upswing and about who will lose his job in a downswing.

In a monetary production economy the amplitude of the cycles is crucially dependent upon the financial sector: part of investment required in the upswing is financed by borrowing. If banks provide too much finance, cycles may get extreme. In the cyclical downswing, the financial sector may get into difficulties since incomes may no longer be sufficient to repay debts. Banks may now get over-cautious and restrict lending to enterprises, which will enhance the downswing since bankruptcies then increase.

In the medium term various structural adjustments occur. In the first place, the structure of the economy has to adjust to the growth rate corresponding to the prevailing cyclical situation: in the upswing the realized rate of growth will exceed the trend growth [or normal] rate and vice versa during the upswing, the output of the investment goods sector tends to be larger than the production of consumption goods, and vice versa in the downturn. Moreover, structural adjustments take place in the medium term because realized profits deviate from target rates in the various sectors of an economy: realized mark-ups differ from desired ones or medium-term normal prices do not coincide with estimated long-period normal prices. Sectors with [realised mark-ups exceeding normal ones, and vice versa]: capacities tend to adjust to long-run effective demand at the sectoral level. There is thus a continuing tendency for actually existing capacity output to move towards a fully adjusted situation. Through the supermultiplier mechanism the institutional system determines at any 'moment of time a long-period equilibrium output […] which is associated with a fully adjusted situation; at the sectoral level this implies that there is in each sector of production a [normal capacity output and a normal price]. The long-period aspect of reality is, however, a point of reference only, from which various deviations occur at any moment of time. For example, past investment decisions of entrepreneurs result in (socially) in appropriate normal capacities in the present: capacity output brought about by past accumulation does not correspond to a fully adjusted situation. In some sectors of production, normal capacities are below those corresponding to a fully [adjusted

situation and vice versa]. In the former sectors, market prices and realized mark-ups will exceed their corresponding normal levels, or capacity utilization will be more than normal if firms stick to normal prices; the contrary will hold in the latter sectors. Such a situation will produce a medium-term tendency towards the long-period fully adjusted situation.

Structural adjustments raise the question as to which enterprises will produce a given output determined by effective demand. This implies a high degree of uncertainty for many entrepreneurs and workers, as emerges from the situation depicted in figure 4.8. The long-period equilibrium output (implied by the fully adjusted situation) in a certain sector is x*. This leaves room for, say, n enterprises each of which could produce an output of x*/n at the lowest possible costs, i.e. using the best technique of production. Suppose now that there are n+ m enterprises in the sector considered [which produce a capacity output above the normal output]; this implies that market prices are below long-period normal prices and/or capacity utilization is below the standard level. In the process of structural adjustment m enterprises tend be squeezed out of the market. If all the n+m producers are of approximately equal strength, it will be highly uncertain as to which of them will go bankrupt. (The situation would be quite different if there were some well-established enterprises, having accumulated considerable financial reserves in the past, and which would be in a position to 'knock out' financially weaker firms by selling their output at exceptionally low prices for some time, thus incurring losses.)

Hence, given the long-period normal output and the corresponding structure of the output governed by trend sectoral demand, there is a high degree of subjective uncertainty as to who is going to produce the given output. Uncertainty increases, if fully adjusted sector sizes change in the course of time owing to variations in sectoral demand based on Engel's law. In the context of structural changes uncertainty also comes into play because of the simple fact that production takes time. While production takes place, there are changes in demand and in technology going on. The expectations of some entrepreneurs will be disappointed. Others will find their expectations over fulfilled. On the macroeconomic level this type of subjective uncertainty relates to the question as to who is going to be unemployed temporarily if rapid structural change is going on in an economy. In a monetary production economy the structural changes taking place in the medium term are crucially shaped by the financial sector: banks decide to a considerable extent which firms get finance and which do not. For the individual entrepreneur this is an additional source of uncertainty.

Finally, uncertainty may enter the picture in the short run through temporary objective

and subjective factors which act simultaneously with the objective and subjective medium- and long-term forces mentioned before. […] Some examples may illustrate what is meant by temporary objective and subjective factors. For instance, it is well known that, in some economies, rapidly growing exports and favourable terms of trade greatly contributed to securing high levels of output and employment. Switzerland is a case in point. The persistent export strength of the Swiss economy during the last forty years rests on objective (permanent) factors […]. The state of confidence in Swiss export strength remaining intact was very strong, and uncertainty about this fact was almost entirely absent. However, in 1978, a temporary objective factor which was unforeseeable and thus highly uncertain threatened this happy state of affairs. The value of the dollar on foreign exchange markets declined rapidly. Various dollar-holders wanted to get rid of US money and massively bought Swiss francs. Within a few weeks the value of the Swiss franc had increased sharply with respect to other currencies. The whole of the Swiss export industry seemed threatened by this unforeseeable short-run event. Export orders started to decline. However, the government and the Swiss National Bank stepped in promptly. The 'quantity of money' was permitted to increase quickly (to buy dollars) and, most importantly, a negative interest rate of 40 per cent p.a. was levied on incoming foreign capital exceeding a certain amount. Within a few weeks, the Swiss franc had returned to its (estimated) normal level, and owing to their permanent ability to export, Swiss entrepreneurs continued to enjoy steadily rising export volumes, at least until recently. This example illustrates how objective 'long-term factors devoid of uncertainty and a highly uncertain objective short-term factor act simultaneously. Other uncertain objective short-term factors are related to the behaviour of consumers and to the unexpected changes in the techniques of production. A temporary change in the behaviour of consumers will be favourable to some entrepreneurs and damaging to others. Even in times of prosperity, there are enterprises experiencing difficulties in selling their output because consumers' behaviour has changed or has been anticipated wrongly. Similarly, in a boom period, an innovation introduced quickly by large firms may threaten the existence of the weaker producers. Subjective temporary factors linked with a high degree of uncertainty mainly come in through speculation. As is well known, speculative activities develop because there is uncertainty as to the evolution of market prices. This is particularly true of goods the prices of which are demand- determined (raw materials, agricultural products, old masters, bonds and shares). The purpose of speculation is to get the highest possible return on financial capital, that is to appropriate a certain share of the social surplus of an economy. To this end, money is held for speculative purposes. Keynes was the

first to set forth systematically the link between uncertainty and speculative money-holding (Keynes 1973a). This leads to a consideration of an important connection existing between a short-period behavioural factor (speculation) and the long- period system-governed fully adjusted situation which includes trend levels of output and employment. The fully adjusted situation implies that individuals persistently aim at holding a certain part of wealth in the form of money, the amount of which is associated with normal (target, satisfactory) profit rates or normal own-rates of interest and with normal prices for all goods, produced and not reproducible. Behavioural outcomes, including short-run speculative waves, always deviate from these reference points which constitute the fundamentals financial analysts speak about. For example, if speculators consider that any increase in share prices also represents an increase in wealth, then less than the normal amount of money will be held and shares will be bought. With share prices rising short-run profit rates realized on the stock exchange exceed the normal long-run rate of return. This attracts even more speculative money which is eventually augmented by bank credits. A cumulative upward process may now set in which may be reversed by some external event, a political crisis in an important country for example, or by changing expectations. Given this, the point of time at which the reversal of the upward movement occurs is highly uncertain. If speculative activities have been largely financed by bank credits the whole of the financial system may be threatened in the downswing of share prices. Keynes clearly perceived (chapter 12 of the General Theory) that speculative waves may not only harm the financial system but may also greatly hamper entrepreneurship. Why, in fact, work hard for many years, introduce new techniques, develop new products and do research and development if huge rates of return can be realized by stock exchange activities within very short periods of time? However, it seems rational that firms would rather invest realized profits on the stock exchange instead of buying new machines or intensifying research and development activities if uncertainty about the future is very high. Financial activities linked with speculation […] may thus negatively influence the process of production […]. In the course of capitalist development excessive speculation has, time and again, dominated production, heralding, as a rule, a slump. The latter reflects the fact that the long-period forces or fundamentals associated with the socioeconomic system ultimately determine economic activity […]. In the long run, temporary market prices are attracted by the permanent or slowly changing normal prices, and actual output and employment levels resulting from aggregate behaviour 'fluctuate' around the corresponding norma11eve1s, governed by the socioeconomic system.

Excessive speculation going on in the short run will as a rule not only impair production but also heavily influence income distribution; this will have long-period effects across the supermu1tip1ier mechanism: a higher share of property incomes will reduce the volume of economic activity in the long run […]. In 'The end of laissez-faire' Keynes mentions this point: Many of the greatest economic evils of our time are the fruits of risk, uncertainty, and ignorance. It is because particular individuals, fortunate in situation and abilities, are able to take advantage of uncertainty and ignorance, and also because big business is often a lottery, that great inequalities of wealth come about; and these same factors are also the cause of the unemployment of labour, or the disappointment of reasonable business expectations, and of the impairment of efficiency and production (Keynes 1972b, p. 291)" (Bortis 1997, pp. 224-29).

This passage and, above all, Keynes remark point to the immense importance of uncertainty and ignorance in very complex modern monetary production economies. If modern economies were self-regulating, competitive markets would create large areas of certainty, reducing thus the importance of uncertainty. However, in modern monetary production economies there is, as has been extensively argued above on the basis of Bortis (1997, 2003), no tendency towards full employment at all. This implies that competition remains no longer sound, as would be the kind with price/quality competition. In fact, with heavy unemployment competition becomes more and more a struggle for market shares and even for survival. This has very important consequences for the credit policy of banks and of the behaviour of the financial sector in general. In fact, a tendency develops to direct financial resources (bank credits, new shares) towards islands of certainty that is to large and well-established enterprises. The probability that such enterprises will emerge as winners in the competitive struggle for survival is, in normal circumstances, very high. Such developments are an aspect of a concentration process which is indeed going on actually. Given the high levels of unemployment prevailing in almost all countries in the world, also in highly industrialised countries, the position of employers gets very strong indeed, whilst workers and employees find themselves in a weaker power. This has consequences for distribution which tends to become more unequal, a phenomenon observed worldwide. From the above presentation of the classical-Keynesian model, specifically from the supermultiplier relation (4.37), follows that, in principle, a more unequal distribution of incomes implies a reduction of purchasing power which results in higher involuntary unemployment.

The impact of uncertainty on individual investment projects, enterprises, workers and employees, reaches dramatic proportions through the relationship between the financial sector

and the real sector. The notions of real and financial sector have been coined by Keynes in his Treatise on Money (Keynes 1930/1971), vol. I: The Pure Theory of Money, ch. 15: The Industrial Circulation and the Financial Circulation. In General Theory terms, money circulating in the real sector (industrial circulation) is for transaction purposes in relation with newly produced goods and the intermediate goods required to produce the final goods within the social process of production; money circulating in the financial sector becomes money held for speculative and precautionary motives. One could add here that the latter is also part of the wealth held by the wealth-holder in liquid form, that is in terms of money.

At this stage, a short remark on the nature of money is in order here. In fact, we consider money as a representative of value, which need not have value itself as is the case with modern money (bank notes or scriptural money). Given this, (money) prices express, in principle, values in terms of money; in the above representation of the classical-Keynesian system these values are labour values; consequently, the price expresses values in money terms, as is evident from the price equation (4.32) for example. Hence as long as money circulates in the industrial (or production) sphere money is always associated with some value that is a real counterpart in the form of goods and services. This ceases to be the case once money moves to the financial sphere.

Now, it is certainly appropriate and even necessary that there is a certain amount of money in the financial sector for precautionary motives. Individuals and collectives - associations, enterprises, public institutions – all need some liquid means in order to face unforeseeable situations. There is, however, in a monetary economy a persistent and inherent tendency for money creation. In fact, investment is financed by funds – cash and time deposits - located in the banking system. Some of these funds belong to the investing enterprises, other are borrowed through credits or issues of new shares, for example, for example.

At this stage, it is important to note that the financing of investment occurs before savings are made. Indeed, in a Keynesian vein, investment is, in the short run, an autonomous variable which sets economic activity into motion, with the multiplier linking investment to the incomes – the domestic income - created in the social process of production and to the final goods emerging from the social process of production, that is domestic output (see on this the detailed presentation of the classical-Keynesian system above). This implies that, in Keynes's view, investment determines saving: $I = s\,Q$, which, in a similar way is also implied in the – long-period - supermultiplier relation (4.37) above; saving adjusts to investment through variations in output and employment. Seen in this way the macroeconomic equilibrium condition $S = I$

states that saving 'finances' investment in real terms. In fact, the task of saving is to provide real – not financial - resources, basically a part of the labour force in a monetary production economy to produce investment goods, and not goods for private and public consumption (see again the classical Keynesian system set forth above).

As a rule, the financial resources available in the banking system – mainly various types of deposit to which new saving adds – by far exceed saving and, consequently, investment. Moreover, the financial resources in the financial sector are constantly augmented through the capacity of the banking system to create money on the basis of bank credits, with credits leading on to new deposits. This increases still further the excess of finance over saving and investment. Moreover, saving themselves become deposits which, in part, become long-term deposits, according to the decisions taken by the holders of deposits; these long-term deposits constitute another addition to investible resources. Now, these financial resources divide into two parts. Those put to use to finance – new investment – equal to saving - flow into the real economy to become part of Keynes's industrial circulation, which, at present, is simply called the economic circuit. A much larger part is directed towards the financial sector proper, however, and thereby enters Keynes's financial circulation. Indeed, it is well known that 97.5% of all transactions worldwide relate to the financial circulation and that, equally worldwide, the quantity of liquid resources in the financial sphere has expanded by a factor of 40 in the last 30 years (40 times the initial quantity of money!); however, in the same period of time the initial quantity of goods and services has been multiplied by a factor of 4 only. The 'quantity of money' required in Keynes industrial circulation has probably increased broadly in line with the money value of the quantity of goods and services produced, with the money value of production being determined by the level of money wages and the size of the profit rate.

The quantity of money in the financial sphere has thus increased tremendously compared the quantity of money required for the transaction in the industrial or production sphere. While it is true that the financial and the real sector may lead a parallel and largely separate life for some time, there are, nevertheless fundamentally important interactions between the two sectors. Keynes has grasped most profoundly the connections between the financial and the real sphere of a monetary production economy. On this Skidelsky states: "[In Keynes's view] depressions arise […] when money is shifted from the 'industrial circulation' into the 'financial circulation" (Skidelsky 1992, p. xxiv). And Schumpeter gives a dramatic picture of the essence of the Keynesian revolution: "[The Keynesian doctrine] can easily be made to say both that 'who tries to save destroys real capital' and that, via saving, 'the unequal distribution of income

is the ultimate cause of unemployment.' This is what the Keynesian Revolution amounts to" (Schumpeter 1946, p. 517).

In the light of what has been said above and of the presentation of the classical-Keynesian system, these statements may now be interpreted; to start with, the Keynesian notions of speculation and enterprise must be distinguished: "the term speculation [stands] for the activity of forecasting the psychology of the market, and the term enterprise for the activity of forecasting the prospective yield of an asset over the whole life [...]. Even outside the field of finance, Americans are apt to be unduly interested in discovering what average opinion believes average opinion to be; and this national weakness finds its nemesis in the stock market. [...] It is rare, one is told, for an American to invest, as many Englishmen still do, 'for income' [...] when he purchases an investment, the American is attaching his hopes, not so much to its prospective yield, as to a favourable change in the conventional basis of valuation[;] he is, in the above sense, a speculator. Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirl-pool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done" (Keynes 1936, pp. 158-59).

While speculation has kept its original meaning, the idea of enterprise has gradually evolved since the Second World War. In fact, Keynes speaks of ‚enterprise in the financial sector' in a straightforward way: buying shares of sound enterprises, having a high prospective yield, and stick to these shares, also when yields decline temporarily. The attitude of ‚financial entrepreneurs' was thus purely passive, in that they did not attempt to influence the enterprises of the real economy. It is precisely here where a decisive change occurred. Finance has become concentrated within funds and banks (private banking). Financial groups, sometimes led by aggressive managers, now initiate takeovers of firms, friendly and unfriendly, with the aim of increasing their profitability. Asset stripping is just variant of these profit-making activities. These activities lead on to a rise of profits and manager's salaries. And this happens on a background of speculation which drives up assets prices, that ist he prices of shares, land, houses, old masters and so on. The result is that income distribution has become markedly more unequal since the 1980s, a fact confirmed by eminent international organisations (the International Labour Office, for example) and researchers (Joseph Stiglitz and James K. Galbraith for instance). It is indeed well-known by now that two thirds of humanity live in misery that is with less than two dollars per day and per person. From the presentation of the classical-Keynesian system in general and of the supermultiplier relation (4.37) above in

particular we know that a more unequal income distribution is, in a monetary production economy, associated with higher levels of unemployment. It is an empirical fact that unemployment has increased markedly since the middle 1970s; again the International Labour Office estimates that, at present, one third of the potentially active population worldwide is unemployed or underemployed.

The terrain for relating our long argument to foreign direct investment is now prepared. The starting point ist the fact that globalisation has resulted in a tremendous rise of uncertainty. The various facets of uncertainty pictured above have all been greatly magnified, above all since globalisation has intensified since the early 1990s. Now finance capital dislikes risk and uncertainty and is looking for areas of risk less near-certainty. Investment is now essentially about the acquisition of existing enterprises; if new investments are made they are associated with the extension of well-established, mostly large, enterprises. Small and medium-sized enterprises have great difficulties to obtain credits. These developments also shaped the structure of FDI. As has been suggested in the empirical chapter II mergers and acquisitions (M&As) became ever more important since the 1990s, that is after the breakdown of the socialist systems which seemed to hail to definite triumph of neo-liberal capitalism. This reinforces the tendency towards more inequality in income distribition through higher profits, leading to an increase in involuntary unemployment. This result emerges from the analysis carried out above: the presentation of the classical-Keynesian system, specifically the supermultiplier relation (4.37), and from figures 4, 5, and 6 above where the profit line is shifted upward, resulting in less investment, output and employment in the long run. Now, as the Schumpeter quote set forth above suggests, a more unequal income distribution leads to an increase in the average saving/income ratio. As a consequence, output and employment recede (once again, see the supermultiplier relation (4.37)), and so does investment. Less financial means are required to finance investment; even more money moves out of the industrial circulation in the direction of the financial circuit seeking association with profitable objects in the real sector, to shares of well established and highly profitable enterprises in the main. A cumulative process process comes into being which is reinforced through FDI in the form of M&As. In many developing countries, investment objects largely devoid of any risk, and as such ideal for finance capital associated with M&As, are of course to be found in the primary goods sector (agriculture, mining, and, above all, oil and gas).

4.6 Multinationals, Transnationals and FDI

It makes a great difference to a developing country whether FDI takes place through multinational enterprises or corporations (MNCs) or transnational ones (TNCs). MNCs are associated with international specialisation and international trade. In fact, if FDI is made through a MNC, a subsidiary is built up in the recipient country. This subsidiary enterprise produces one or several goods or services in its entirety. As such the MNC subsidiary not only contributes to building up real capital, but also contributes to improving the human capital of the recipient country, which is associated with new or improved know-how. Indeed, the production of some good or service requires various types of qualified, even highly qualified workers and employees whom may be formed in the process of building up a MNC subsidiary. Wage levels may be raised and work conditions improved in this process. Hence the contribution of FDI through MNCs may be potentially positive as far as human resources and real capital resources are concerned. We do not deal here with other aspects of FDI that have been pictured above, for instance whether FDI adds to domestic investment or not.

Transnational enterprises are, however, based upon international, even worldwide division of labour and specialisation on the level of the process of production. This may imply that only small parts of some good may be produced in some country. As a rule, production takes place in low wage countries, frequently countries with a developing or an underdeveloped economy; work conditions are bad, work itself is, mostly, boring and degrading. No significant contribution is thus made to developing human resources, which, in a classical-Keynesian view are absolutely crucial; this most clearly emerges from the vertically integrated model of production, value and distribution set forth above. Exports may be promoted somewhat through the transfer of the product part fabricated in the country considered to the country where the various product parts are assembled and exported. Frequently assembling is done in the home country of the TNC, which keeps and controls all the known. This means that import dependence increases for the countries producing product part; in fact, dependence in general increases for these countries, particularly regarding know-how, and one could add, research and development. In these spheres, the home country of the TNC will remain in entire control. A crucial feature of ‘development’ shaped by TNCs certainly is the world wide worsening of the distribution of incomes with its negative effects upon employment. Once again this conclusion is based upon the classical-Keynesian system set forth above, specifically equation (4.37) exhibiting the supermultiplier relation.

Chapter 5:
Conclusion

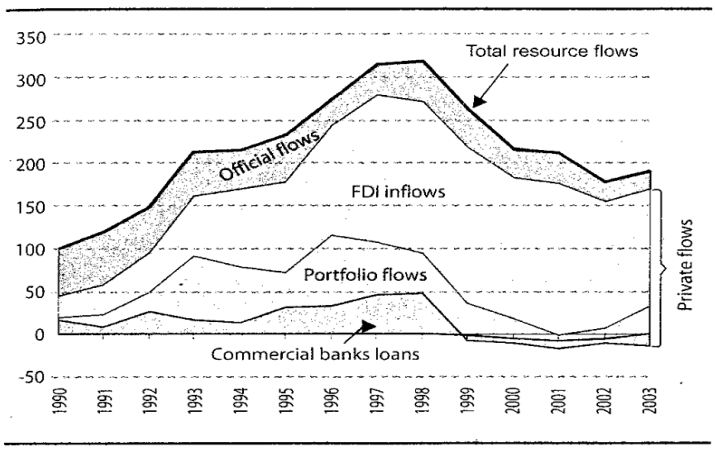
I arrive at this belief primarily from a reading of economic and political history, which suggest that pure laissez-faire is socially and even economically unsustainable. (Kuttner 1999, p.6)

5.1 Summing up; Neo-mercantilist Reality and Neoclassical Theory in Relation to the Impact of Foreign Direct Investment on Employment and Distribution

The different dimensions of investigations in the treatment of capital, capital accumulation, and capital management, have, historically speaking, had specific and varying positions in the theoretical and practical discussions on economic development. In the perspective of the dominating neoclassical theoretical background an inflow of foreign resources has emerged as the most important, the simplest and the most accessible way to compensate capital scarcity, given the lack of domestic saving and chronic disequilibria in the foreign balance, especially in countries with a developing economy. Given this, foreign direct investment (FDI), being one possible option to transfer resources, has had the most significant role in filling the capital scarcity in developing countries during the second half of the past century.

Since the 1970s, with the exception of some years after 1999, the resource flows have been growing (see, Table 2.1). Foreign direct investment has been growing steadily, though at a gradually slower pace. Figure 5.1 pictures the recent trends of the resource flows from the 1990s onwards. This empirical-historical flash reflects neo-liberal theory and policy. In chapters 1 and 2 theoretical aspects concerning foreign directs investments have been discussed. In chapter 3, the theoretical tools have subsequently been used to interpret empirical aspects of FDI.

Figure 5.1: Total resource flows to developing countries, 1990-2003



Source: World Investment Report 2004: Figure 1.3.

The theoretical discussion is related to the historical evolution of the subject. This discussion goes back to the mercantilist investment-trade mechanism that can be regarded as the theoretical starting point of today's dominating neoclassical market theory. This is largely true in spite of the fact that the economic theory implied in the mercantilist doctrine differs from the neoclassical theory that gradually emerged in the last third of the 19th century. Practically, however, the successful economic experiences of the now developed countries, in the years before 1914 and even implicitly after that, are largely due to the mercantilist system. In a first stage, the mercantilist economic system was based on the extent of attraction and accumulation of financial capital, leading on to the growth of the real capital stock. The latter in turn depended on a declining rate of interest, which was the basis to encourage investment and national production, with protectionism being implied. Moreover, protectionism was associated to a positive balance of trade, to be achieved through favourable terms of trade, minimizing imports and wages, and maximizing exports and, in the final instance, enhancing the amount of saving.

However, in the course of the 19th century Mercantilism fundamentally changed its nature, first in Great Britain and subsequently in other European countries. In this period money became more and more fiat money representing the value of goods and services; the export surplus now implied a transfer of resources abroad, eventually financed by the export of financial capital. This is contrary to the old Mercantilist regime where a surplus of export over imports was accompanied by an inflow of precious metals, this being broadly equivalent to an inflow of financial capital. Moreover, the real effect of the export surplus, that is the effect on output and employment, was replaced by the external employment mechanism. This mechanism worked in favour of the now rapidly industrialising Western countries, specifically Britain and, later, Germany, who increasingly exported high quality industrial goods for primary goods – raw materials, energy resources and standard industrial products.

This is what the Mercantilist mechanism is *really* about. In theory, however, this mechanism is based on the rate of interest, which in turn, depends upon the size of the capital stock. In Old Mercantilism, in the time before Adam Smith, capital accumulation was driven by an export surplus which had a double positive effect. First, a direct cumulative effect on consumption, which, in Keynesian terms, was associated to an export surplus multiplier: the surplus of exports over imports represents autonomous demand associated to new production and incomes of which a large part is consumed, setting thus into motion a cumulative process of derived consumption demand along Keynesian multiplier lines. Second, there is an indirect

cumulative effect on consumption due to an investment multiplier: the export surplus is associated with an inflow of precious metals which is equivalent to an increase in the quantity of money; as a consequence of the latter the rate of interest declines, investment is enhanced, representing indirect autonomous demand; as such, investment also sets into motion a cumulative process of consumption demand. Of course, with Old Mercantilism saving determined investment. Saving increased in spite of falling profits, because the exports surplus led on to an increase of profits income.

In this way a one way, unilateral flow of capital came into being. As has been suggested above, with Old Mercantilism the export surplus led on to an increase of foreign financial means, enhancing thus domestic investment. According to Keynes: "In conditions in which the quantity of aggregate investment is determined by the profit motive alone, the opportunities for home investment will be governed, in the long run, by the domestic rate of interest; whilst the volume of foreign investment is necessarily determined by the size of the favourable balance of trade. Thus, in a society where there is no question of direct investment under the aegis of public authority, the economic objects, with which it is reasonable for the government to be preoccupied, are the domestic rate of interest and the balance of foreign trade" (Keynes 1936, p. 335).

We have already mentioned that Keynes statement is *not* valid for the Old Mercantilism where foreign investment occurred in the country enjoying the export surplus in the form of an inflow of precious metals that is with money having an intrinsic value. However, with fiat money representing values and having no intrinsic value, Keynes's statement is valid. As such the above statement applies to New and Modern Mercantilism.

However, this New Mercantilism has been given a neoclassical cover, a neoclassical mask so to speak. The size of capital stock determines the rate of interest, and this in turn determines level and size of production and employment, and shapes the distribution of income and finally enhances wealth, welfare and economic prosperity. Thus, the rate of interest manages the national and international political position of a country and it expands its economic supremacy. This is a brief picture of the neoclassically disguised economic mechanism of Mercantilism, as a protector of capital and as an advocate of the free trade mechanism. Obviously this has been a basic part of the – fictional - economic theory and policy that has been very beneficial to the presently highly developed economies. In reality it is the external employment mechanism associated to a specific division of labour that benefited the Western economies. Within the framework of this division of labour England, and

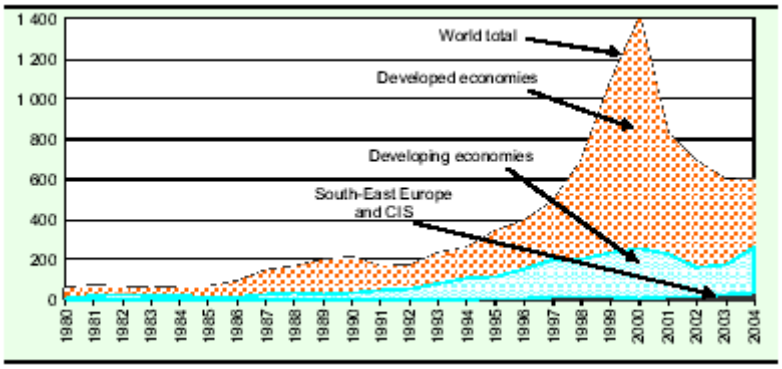
subsequently, the West produced the industrial goods and services embodying advanced technologies, the rest of the world was relegated to the production of primary goods (raw materials and energy resources) and of standard industrial products at times. This state of affairs was justified by comparative costs: The Western countries had comparative cost advantages for advanced technology industrial goods and services, the 'developing countries' could produce primary goods relatively cheaper. As a consequence, given the rate of interest in the developing countries, foreign capital – FDI - would flow into those sectors where the internal rate of return, the rate of profit is highest. On account of the comparative cost condition, FDI will, in developing economies, flow into the primary good sectors, eventually into sectors producing standard industrial products. Foreign direct investment will only flow into high-technology sectors to mainly produce for exports if a 'developing' country's economic policy is fully along free market and globalisation lines. 'Subversive' countries like Cuba or Iran will not only get no FDIs, but will even have boycott's imposed on them. This is a strong reminder that economics belongs to the social and political science, implying that in this thesis we are in the domain of political economy, not only economics.

As a result, paradoxically, within the theoretical discussion, the mercantilist model is realized in the modern neoclassic free-market theories, though just under the surface of appearances. This is especially true when, practically, the neoclassical free-market system is transformed and turned into a protective economic system, whereby protectionism is likely to be informal and hidden in most cases. For example, the highest developed economies with a very good rate of terms of trade, because of progresses in specialization and division of labour, have attracted the highest size of inflow FDI, and simultaneously had the lowest domestic rates of interest. The differences between the size of FDI inflows to groups of economies (Figure 5.2.) is clearly in benefit of the developed economies, contrary to theoretical expectation. In fact, the real average rate of long-term interest in developed countries is lower than the average rate of interest in developing countries (International Monetary Fund, 2003, pp.60-72). This also emerges from considering the changes in the World Financial System set up in Bretton Woods at the end of World War II: "The Bretton Woods system, after the Second World War, rested on the foundation of closed capital accounts markets and fixed exchange rates. Thus, in contrast to trade and FDI where gradual liberalization had been initiated, financial globalization was not even on the policy agenda at the time: The world lived with a system of separate national financial markets. This began to change in 1973 with the breakdown of the Bretton Woods system. But there was no immediate rush to capital account liberalization. This began in

the industrialized countries only in the early 1980s, with a subsequent increase in capital flows among them" (ILO 2004a, p.27).

Once again, the theoretical neoclassical framework greatly differs from what has gone on in the real world, as has been claimed in this study. Given this, urgent thinking will be required to replace neoclassical theories and policies by more appropriate theoretical and policy conceptions to come to grips with the existing socio-economic situation worldwide.

Figure 5.2: FDI inflows, World and groups of economies, 1980-2004 (billions of dollars)



Source: World Investment Report 2005: Figure I.1., p3
UNCTAD, FDI/TNC data base (www.unctad.org/fdistatistics)

This figure is self-explanatory. Hence, attraction of foreign capital in the mercantilist's system is seen as a historical and practical example of the extreme tendency of protocapitalist and capitalist systems to attract foreign resources. This should be classified as "external mechanism" of capital accumulation as is in line with the neoclassical endeavours to attract foreign capital. The neo-mercantilist-colonial system, in turn, attempts to benefit from advantages of favourable terms of trade to increase domestic well-being, for example the export of goods with high value added is advocated, while industrial imports are not encouraged as are, however, cheap raw materials and goods imported from colonies and dependent areas under unequal trade conditions (Hobson 2004, p. 263-264). This is almost exactly what is at present re-implemented by the neo-liberal system of the Washington economic school (Duncan K. Foley, 2006, p 36), which is, in fact, a neo-mercantilist system, and the economic relations between developed and less developed regions. Neo-mercantilism also influenced the discussions on economic development in countries with a developing economy. Here they are classified as the "external mechanism" system.

At this stage, some points have to be put to the fore. First, the successful implementation

of the 'external behaviour' mechanism, and the economic prosperity resulting from it, depends on the capacity and the ability to attract and accumulate capital from abroad through the control of the internal economic and social system, to determine the level and the size of trade and also the ability to regulate the domestic rate of interest. The successful countries were able to bring about a favourable structure of trade – in principle, exporting high-quality industrial goods and services and importing primaries – and, sometimes a favourable trade balance; all this enhanced productivity and efficiency in developed economies; however, to achieve these aims, interventions in the economic activities of colonies and, later, of dependent countries, were intimately connected to the external mechanism; favourable foreign conditions, for example, the opening of new markets abroad, have even be brought about by military intervention. Second, obviously the neo-mercantilist economic system was, in practice, not contributing to solving social problems, above not in countries with a developing economy; specifically, income distribution of income was largely ignored, while high employment and output levels and growth rates were implicit neo-mercantilist policy aims. This, however, was in the interest of capitalists; larger production meant higher amounts of profit and high growth rates associated to large investment volumes led on to higher rates of profit. Yet, in spite of protective measures, these aims were not realised in a substantial manner in developing countries. Protectionism without regulation of income distribution to enhance the purchasing power of the population and without expanding government expenditures to build up the basic infrastructure is bound to fail, because effective demand will stagnate, and so will output and employment.

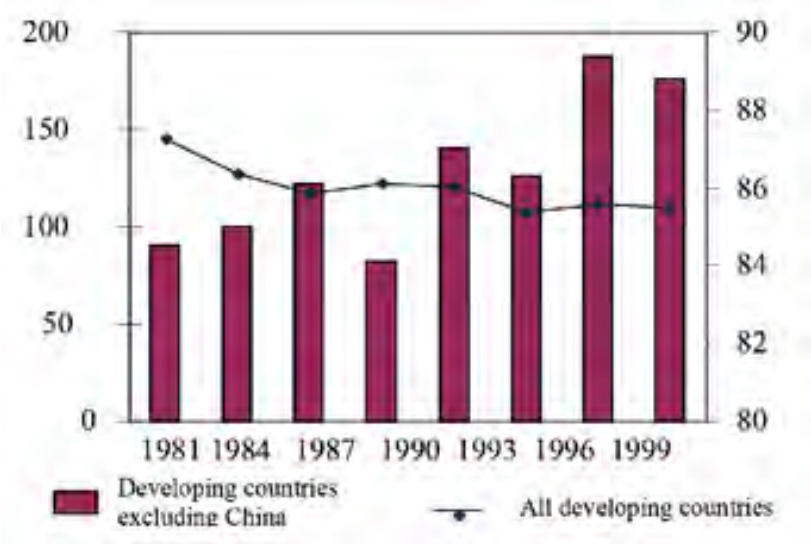
Therefore, the neo-mercantilist investment-trade mechanism associated to protection did not contribute to solve the social problems such as distribution of income or even something to improve the labour condition. The condition of labour continues to be extremely precarious in the majority of developing regions. There are unrecorded numbers of men and women without any hope, unable to find a job and living in misery. These people live on low wages and they work in unproductive and unprofitable sectors, mainly in the traditional sectors of developing economies. This is reflected in some dramatic figures. Indeed, although the number of people living on less than $1 a day has decreased worldwide, the number of people living on less then $1 and $2 a day in total has increased.

"New estimates of poverty rates, based on re-examination of household survey data back to 1981, [1,451 Million persons] show that global trends in poverty reduction have been dominated by rapid growth in China and the East Asia and Pacific region. GDP per capita more

than tripled while the proportion of people in extreme poverty fell from 56 percent to 16 percent. In 1990, 1,219 million people, 28 percent of the population of low- and middle-income countries, lived on less than $1 a day. . . and by 2001 the poverty rate had fallen to 21 percent" (World Development Indicators Report, 2004, p. 2).

As a result, the extent of poverty in countries with developing economy, *excluding* China, a unique phenomenon, not only was not reduced, but in some cases even increased (Figure 5.3. and table 5.1).

Figure 5.3: People living on less than $ 1 a day
Person (Millions) 1981-2001



Source: World Development Indicators Report, 2004, p.3

The number of people living on less than $1 a day was 1,451 millions, that is 39.5 percent of the total population in 1981, and this was reduced to 1101 millions persons in 2001, corresponding to 16.3 percent of the people living in the world which shows an improvement. While the total, excluding China, was, raised from 845 millions in 1981 to 888 millions in 2002 which shows an increasing rate of poverty if unexpected rate of China's economic growth is regarded exceptional. In addition the number of people living in less than $2 per a day was 2.419 millions in 1981, which increased to 2.732 millions in 2001. That indicates inequality growth in the world during the time while Inward FDI flows as a percentage of world Gross Fixed Capital Formation was grew from 2.23 percent in 1980 to 9.45 percent in 2002. in addition, as an important key indicator, the distribution of income did not show up in a significant improvement in the sense of more equality in this era of neoclassical policies, in

spite of the huge amount of capital in form of FDI that has been transferred to developing countries; indeed FDI has increased enormously, in fact from 5.1billion in 1980 to 181.7 in 1999 (Chapter 2, Table 2.1).

Table 5.1: People living on less than $ 1 a day (millions) developing economic countries, 1981-2001

Region	1981	1984	1987	1990	1993	1996	1999	2001
East Asia & Pacific	767	558	424	472	416	287	282	284
China	606	421	308	377	336	212	224	212
Eastern Europe &Central Asia	1	1	2	2	17	20	30	18
Latin American & Caribbean	36	46	45	49	52	52	54	50
Middle East & North Africa	9	8	7	6	4	5	8	7
South Asia	475	460	473	462	476	441	453	428
Sub –Saharan Africa	164	198	219	227	241	269	292	314
All developing countries	1451	1272	1169	1219	1206	1075	1117	1101
Excluding China	845	850	861	841	870	863	894	888

Source: World Development Indicators Report, (2004, p. 3)

However, according to neoclassical economic theory, this trend of stationary or even increasing poverty should be affected by the rate of growth and the distribution of income: "Continued progress in poverty reduction depends on economic growth and the distribution of income. Growth without poverty reduction is at least a theoretical possibility, and in regions such as Latin America, where the distribution of income is less equitable, the poverty reducing effects of growth are weaker" (World Development Indicators Report 2004, p. 2). Hence, as a result, growth oriented neoclassical theory did not succeed to lower poverty rates in developing economies mainly because the developing countries were on the losing side of the mercantilist mechanism, which is equivalent to the external development mechanism set out previously.

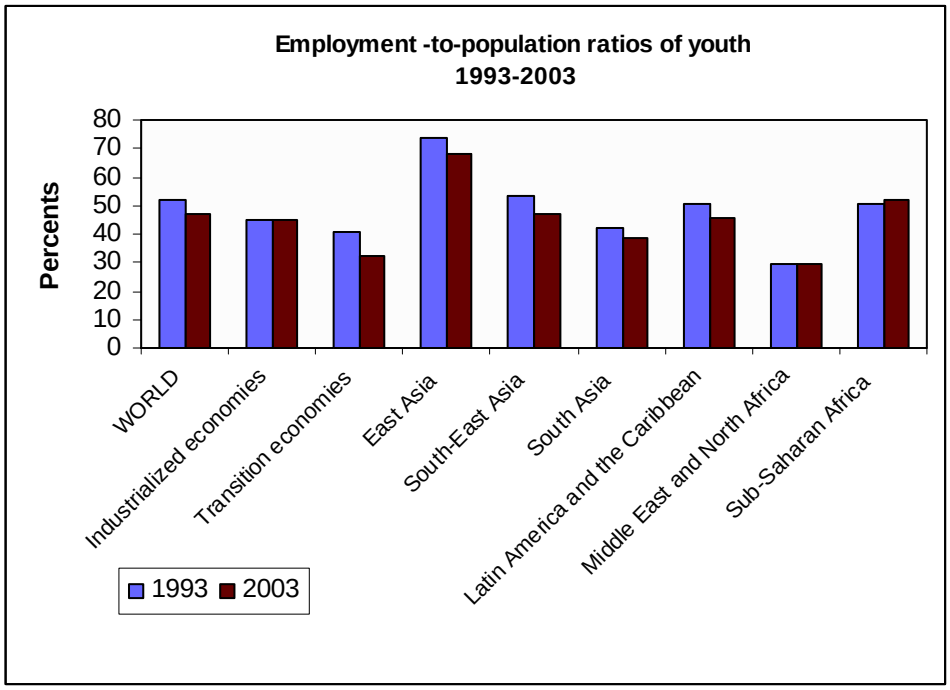
Moreover, in a classical-Keynesian view, a high rate of growth should not be single-handedly put to use as an indicator to evaluate economic success, especially in countries with a developing economy. For example, the presently high rate of growth of the Chinese economy might not be sustained indefinitely, due to a lack of world effective demand to absorb Chinese industrial and service exports and, eventually, to increasing formal or informal protectionism. Consequently reducing the rate of poverty by means of the rate of growth might result in a deep crisis, mainly because of an increasingly unequal distribution of income which, on account of a lack of purchasing power could bring about high rates of unemployment; this is incidentally, one of the main features of the classical-Keynesian system set out in chapter 4. In addition, other social indicators besides poverty in terms of income should be taken into account, for example, access to education or to health care.

It is also important to mention, that many of those who are worried about the growing inequalities in the distribution of income in China as well in the world as a whole, overlook the fact, this precisely results from applying neoclassical theory to the real world economies where neo-mercantilism, that is the classical-Keynesian external employment mechanism is at work. This amounts to applying an economic theory postulating self-regulation to a world economic system, which in fact, is not self-regulating. The results of doing so are shattering. Indeed, according to the *World Development Indicators Report* (2004, Table 1f, p. 3), the people living on less than $ 2 a day have increased from 2419 million (excluding China, 1,561 millions) in 1981 to 2733 millions in 2001 (excluding China 2137 millions). Hence, China excepted, there has been no progress at all in poverty reduction. This stands in strange contrast to the dominating position of neoclassical economics and the free trade policies based upon it.

Moreover, the politically unproductive, even counterproductive neoclassical system has not produced satisfactory results regarding employment. Indeed, from a classical-Keynesian perspective, the neo-mercantilist external employment mechanism produces cumulative processes, as has been argued in the previous chapter: to remain competitive wages must be kept low relative to labour productivity; on the other hand, profits must rise, frequently because of the requirements of shareholders; income distribution thus becomes more unequal, reducing thus purchasing power and effective demand. Moreover, countries and regions attempting to attract try to keep tax rates on a low level; to prevent large state deficits government expenditures stagnate or even decline, reducing thus effective demand. Given the reduction of effective demand unemployment is bound to increase enhancing thus the endeavour of governments to carry neo-liberal reforms to make the economy even more competitive. A cumulative process of increasing income inequality and growing unemployment thus comes into being. This classical-Keynesian perspective of looking at the neo-mercantilist world economy, hidden below a neoclassical theoretical veil has been a crucial feature of the present work.

The employment issue as results from this cumulative process may be illustrated here through youth employment and unemployment that forms an important part of unemployment problem. The data suggest that youth employment has not evolved very satisfactorily on a world level. In fact, the percentage rate of the Youth Employment to Population-ratio as an index has decreased except in developed economies that are facing a low rate of population growth or even a declining population.

Figure 5.4: Employment -to-population ratios of youth, 1993 and 2003



Source: Global Employment Trends for Youth 2004, International Labour Office, Geneva Table 3, p.7

In fact, the 2004 International Labour Office (ILO) Report states: "The share of youth who are employed in the youth population (the youth employment-to population-ratio) decreased from 51.6 to 47.3 over the ten years (1993-2003). The only region where the youth employment-to-population ratio increased was the Middle East and North Africa, which is noteworthy given the tremendous growth of the youth population there of over 30 per cent during this period that the labour market has had to accommodate. At the same time, the region still has the lowest youth employment-to-population ratio with 29.6 – only every third young person has a job. …All other regions also witnessed decreases, with the exception of the Developed Economies and European Union where it stayed more or less stable over the decade. When interpreting employment-to-population ratios, it has to be keep in mind that they most likely mean something different in the developing world where many of the jobs are in the informal economy with low wages and high levels of insecurity compared to the developed world where being employed more often means to have a good job with a decent salary and some form of social protection. Given that, in addition, people in the very poor regions have to work to survive, meaning that they have to take any work available, it becomes clear that a high youth employment-to population ratio, as in sub-Saharan Africa

(53.7 in 2005) could be associated with a high incidence of working poverty" (ILO 2004a, p. 16).

This unsatisfactory picture is confirmed through the analysis of the data presented in (Table 5. 2.) below, which, again, are taken from an ILO Report: "The overall youth population grew by 10.5 per cent over the past ten years while youth employment grew by only 0.2 per cent…. The picture was even more remarkable for some regions. In the transition economies the youth population grew by 10.1 per cent, whereas youth employment dropped by 11.7 per cent. In East Asia the youth population fell by 11.3 per cent but at the same time youth employment fell by 18 per cent. South-East Asia witnessed growth in the total number of young people of 13.1 per cent but employment grew by only 0.3 per cent. In South Asia, the youth population grew by 21.9 per cent whereas employment only grew by 11.6 per cent. Finally in Latin America and the Caribbean there were 13.1 per cent more young people in 2003 than in 1993 but only 2.8 per cent more young people working. Only the Middle East and North Africa and sub-Saharan Africa saw a relative balance between youth population growth and youth employment growth. At the same time the Middle East and North Africa still had by far the lowest youth employment-to-population ratio, with only every third young person working in 2003" (2004, table 3, p.7).

These data suggest that there is a deep contraction between the expectations based upon neoclassical theory and the real results produced by the underlying neo-mercantilist system. In fact, the worse youth employment situation came into being in a time period in which the free market practice gained a tremendous momentum just after the breakdown of the Socialist systems. Moreover, in this time period FDI flows were at very high levels. As the data and figures presented previously attest a conflict between theoretical expectation and the real results of the neoclassic systems and some of its instruments such as free market and FDI in practice. Both, the extension of free markets and increasing FDI flows should, in line with neoclassical theory, have improved the employment situation, including youth unemployment.

Table 5.2: Employment and employment-to-population ratios of youth, 1993 and 2003

World, Region and countries	Youth employment (000)			Youth Employment to-population rate (%)	
Years	1993	2003	(%change)	1993	2003
WORLD	525'142	526'060	0.2	51.9	47.0
Industrialized economies	57'484	55'675	-3.1	44.9	44.6
Transition economies	25'037	22'112	-11.7	40.5	32.4
East Asia	183'575	150'530	-18.0	73.6	68.0
South-East Asia	50'846	50'990	0.3	53.3	47.3
South Asia	94'428	105'384	11.6	41.8	38.3
Latin America and the Caribbean	46'241	47'513	2.8	50.2	45.6
Middle East and North Africa	17'264	23'810	37.9	29.2	29.6
Sub-Saharan Africa	50'268	70'046	39.3	50.3	51.6

Source: ILO Report: Global Employment Trends for Youth, (2004), Geneva, Table 3, p.7

The gap between neoclassical theory and neo-mercantilist reality is confirmed by further ILO findings regarding youth unemployment: "The number of young unemployed people increased by 14.8 per cent over the last ten years to the current high of 85 million in 2005. A closer look at the different regions shows an increase of 85.5 per cent in South East Asia and the Pacific, 34.2 per cent in sub-Saharan Africa, 23.0 per cent in Latin America and the Caribbean, 18.2 per cent in the Middle East and North Africa, 16.1 per cent in South Asia, slight decreases in Central and Eastern Europe (non-EU) and CIS and East Asia and a considerable decrease of 17.5 per cent in the Developed Economies and European Union. Between 2004 and 2005 the only decrease was observed in the Developed Economies and European Union. All other regions saw increases between 0.4 per cent (South East Asia and the Pacific) and 3.1 per cent (Central and Eastern Europe (non-EU) and CIS). The total number of unemployed youth has increased again over the last two years and stood at 85.3 million in 2005" (2006, p.16, See also table 5.3 and figure 5.5.).

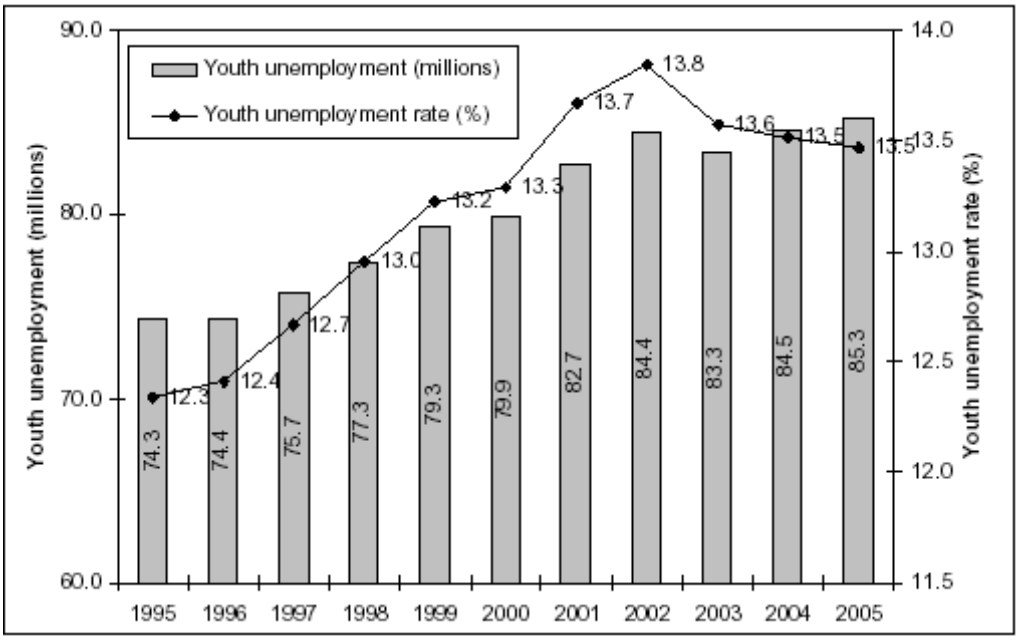
Table 5.3: Total youth unemployment, 1995, 2004 and 2005

World, Region and countries	Youth unemployment ('000s)			
Years	1995	2004	2005	Change %
World	74'302	84'546	85'278	14.8
Developed Economies and European Union	10'281	8'997	8'481	-17.5
Central and Eastern Europe (non-EU) and CIS	5'962	5'724	5'900	-1.0
East Asia	13'149	11'840	12'076	-8.2
South East Asia and the Pacific	5'242	9'687	9'727	85.5
South Asia	11'765	13'561	13'662	16.1
Latin America and the Caribbean	7'722	9'263	9'495	23.0
Middle East and North Africa	7'209	8'380	8'525	18.2
Sub-Saharan Africa	12'972	17'095	17'414	34.2

Source: ILO Report, Geneva (2006), Global Employment Trends for Youth, Table 2.5, p16

It is well known that unemployment and underemployment are the basic causes of poverty which, as has been insisted upon in this thesis, have reached dramatically high levels. This connection is conformed the International Labour Organisation: "Usually, long-term unemployment leads to poverty and social exclusion, and this tends to further undermine future chances to find new work" (ILO report (2006, p.16).

Figure 5.5: Global youth unemployment and youth unemployment rates, 1995-2005



Source: ILO, Global Employment Trends (GET) Model, 2006. P.17 Figure 2.3,

The situation is most dramatic, particularly given the rise of youth unemployment rate over the last ten years, the time-period of particularly high FDI flows worldwide. According to an ILO Report "[the] youth unemployment rate stood at 13.5 per cent in 2005 (compared to 6.4 per cent for the total unemployment rate and 4.5 per cent for the adult unemployment rate). The rate remained unchanged from 2004, but represented an increase of almost 10 per cent above the global youth unemployment rate in 1995. The highest regional youth unemployment rate can be observed in the Middle East and North Africa at 25.7 per cent. Central and Eastern Europe (non-EU) and CIS had the second highest rate in the world with 19.9 per cent. Sub-Saharan Africa's rate was 18.1 per cent, followed by Latin America and the Caribbean (16.6 per cent), South East Asia and the Pacific (15.8 per cent), the Developed Economies and European Union (13.1per cent), South Asia (10 per cent) and East Asia (7.8 per cent)" (ILO Report 2006, p.18).

The evolution of employment and unemployment deepens the wealth gap between highly

developed and less developed countries, confirming thus the cumulative processes at work suggested by classical-Keynesian political economy. This is reflected in a particularly dramatic way in the real purchasing power gaps between groups of countries. There are, in fact, almost unbelievable gaps between average of purchasing power parity of incomes (international dollars) in high income countries with $ 27770 and low income countries group with $ 1980 while the World average rate is $ 7410. This means High income countries group per head have 14 times more then the low income countries group and 4 times more then average World Purchasing power parity.

Table 5.4: Purchasing power parity year 2000, international $ dollars

World	7,410
Low income	1,980
Middle income	5,680
Lower middle income	4,600
Upper middle income	9,210
Low & middle income	3,910
East Asia & Pacific	4,130
Europe & Central Asia	6,670
Latin America & Caribbean	7,080
Middle East & North Africa	5,270
South Asia	2,240
Sub-Saharan Africa	1,600
High income	27,770
European Monetary Union	23,600

Source: World Development Indicators database, World Bank, April 2002, p. 4

These impressive figures confirm the classical-Keynesian suggestion that powerful cumulative processes are at work deepening the real income's gap between developed and developing economies. Moreover, in order to protect capitalist's benefits in a broad sense, including high salaries, the system maximizes profits by minimizing the cost of production, through a pressure on wages in the main; interest rate are, as a rule, also low, also on account of very high share prices. Low interest associated to high share prices enhances capital accumulation and attracts foreign resources, real and even more financial, on a very large scale. To attract foreign resources an effective free-trade as managed by the World Trade Organisation is required. The huge amount of attracted and accumulated foreign capital by developed countries through their trade capacities is good evidence of identifying the neo-mercantilist system as the real counterpart of neoclassic economic theory which, as has been suggested, covers the underlying real system.

In modern monetary production economies where the law of increasing returns (or declining costs) dominates, a free-trade system render cumulative processes, leading on to an

increase in the world social and economic gap as is implied in Figure 5.2. (FDI inflows, World and group of Countries, 1980-2004.) This processes of FDI flows and free trade also lead on to ever increasing concentration in the world economy; an important reason for concentration is that financial capital is looking more and more for secure real investment.

Indeed, according to *World Investment Report* (2004, p. 21) "[the] composition of the largest TNCs among the top 50 did not change much during this period [1995 and 2002] and the ten largest accounted for almost two-thirds of foreign assets, almost the same as between 1995 and 2002. However, they now come from fewer economies (11) than in 1995 (14)." Also according to "The largest TNCs remain geographically concentrated in a few home countries. The United States dominated the list with 25 entries" (World Investment Report 2005 p. 15).

"[And, despite] the growing number of small and medium-sized enterprises with investments abroad, a good part of FDI continues to be concentrated in the hands of a small number of companies. The largest 100 TNCs, ranked on the basis of the size of foreign assets, own $1.7 trillion assets in their Foreign affiliates, controlling an estimated one-fifth of global foreign assets. In the United States, 25 TNCs are responsible for half of that country's outward stock, a share that has remained almost unchanged during the past four decades. For six out of nine developed countries for which such data are available, 25 TNCs account for more than a half of their respective countries' outward stocks" (World Investment Report 2004, Overview, p. XVI).

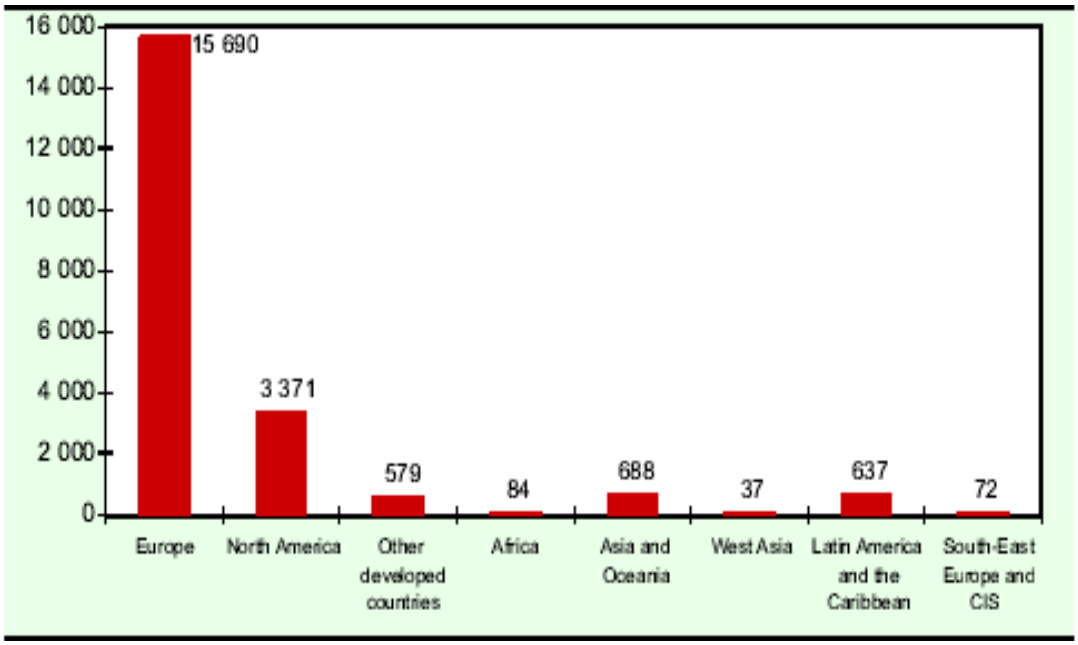
Moreover, "TNCs from five countries (France, Germany, Japan, the United Kingdom and the United States) dominate the list, accounting for 70% of all companies in the top 50 and 74% of their total assets" (World Investment Report, 2005, p. 20). Indeed, the dominating power of TNCs leads countries with a developing economy to criticise the neo-mercantilist world economic system based upon the external employment mechanism. Indeed, as a result of the competitive circumstances there is a contradiction between theoretical and practical aspects of neoclassical system. In fact, competition brings about monopoly in practice which is in contradiction with the neoclassical theoretical system which is based on competition. Finally, the picture will be complete with a look at the distribution of foreign affiliates of the TNCs:

"The Internationalization Index shows that, on average, 46% of the affiliates of the top 50 financial TNCs are located abroad. The index is highest for financial groups from Switzerland that face domestic growth constraints due to the small size of the domestic market, and have built up strong competitive advantages over a long period of time. The top 50 financial TNCs have, on average, affiliates in 25 countries. The largest share of affiliates is in Europe. . .

[figure 5.6]. There is a strong correlation between the size of a company and its transnationalization: the top 10 companies on the list have, on average, 58% of their affiliates located abroad in 44 countries, while the average for the whole group of affiliates is 43% in 25 host countries" (World Investment Report, 2005, p. 20).

All this suggests that neoclassical theory does reflect adequately the realities of the world economy dominated by the largest TNCs in finance and production, whereby, presumably, finance dominates production to a large extent.

Figure 5.6: Distribution of foreign affiliates of the 50 largest financial TNCs, 2003



Source: World investment Report, 2005, p. 20 Figure I.9

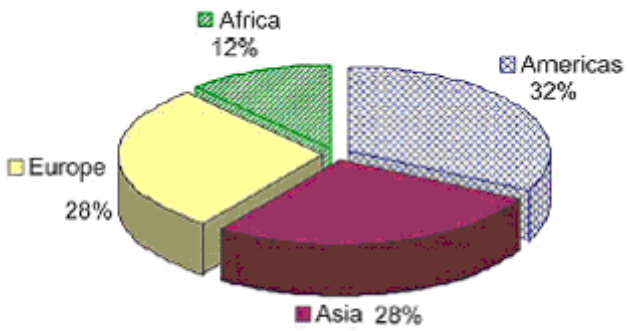
This figure also confirms the very unequal distribution of foreign affiliates of the 50 largest financial TNCs, between regions in 2003. In addition, Economic Integration Investment Agreements" (EIIAs) and «Bilateral Investment Treaties" (BITs) have been increasingly implemented as parts of bilateral, regional and interregional investment and trade. These accelerated the worsening of the competitive situation and produced unexpected results for the developing countries. These countries, in fact, hoped for strong positive effects on their economies based upon the neoclassical vision of a self-regulating economy. From what has been suggested above this was evidently not the case.

Consequently, a new type of criticism arose, focusing on the severe lack of competition brought about in practice by the supposedly self-regulating neoclassical system, following up the disappointing results produced by EIIAs and BITs.

According to UNCTAD "[the] number of EIIAs has been growing steadily since the early 1990s, reaching 218 by June 2005. In 2004 and early 2005 alone, at least 32 EIIAs were concluded, and 66 others were under negotiation or consultation, thus promising further expansion. Recent EIIAs tend to address an expansive set of investment issues in provisions that are increasingly elaborate." (UNCTAD 2006b, p.8). These developments reflect the globalization policies based upon neoclassical theory which are pursued by more and more countries in response to the increasing global competition – struggle would perhaps be more appropriate - for more primary resources and new markets for final goods. This process became more specific through a number of factors that affected some partner country's economic preferences and policies to make decisions. For example, each country when entering the free trade world has some preferences of its own, like the temporary protection of some branches of industry, temporary limitations of take-overs of specific firms, and others. These preferences differ within and between regions in response to a variety of economic and political motivations and situations, depending also on the numerous characteristics of the countries involved, which do not necessarily correspond to the characteristics required by neoclassical economics, for example protection of agriculture. A recent UNCTAD Report states on these issues: "The dramatic growth in the number of EIIAs since the early 1990s parallels the increase in the number of countries that are party to such agreements. Today, more than 99% of all countries and economies are members of at least one EIIA, and the majority of countries are members of several such treaties. At the same time, the increase in membership of certain regional integration schemes has reduced the number of existing EIIAs. For example, the recent accession of 15 European countries to the EC has rendered obsolete a number of previous agreements between the EC and these countries" (UNCTAD Report, 2006, p. 33).

"[Moreover, in] terms of the distribution of EIIAs among geographical regions, the American countries have concluded the largest number of EIIAs with 95 agreements, experiencing a sharp increase in the mid-1990s after the conclusion of NAFTA. European countries were the first to conclude an EIIA after the adoption of the GATT. They have since concluded the second largest number of EIIAs, reaching a total of 83 (excluding EIIAs that were terminated after the EC accession of additional European countries). They are followed closely by Asian countries with 81 agreements, although these countries had a late start. On the other hand, African countries were the first among developing countries to conclude EIIAs but have since concluded fewer agreements than the other developing regions. The African countries are parties to 34 agreements" (UNCTAD Report, 2006, pp.32-33).

Figure 5.7: Total EIIAs concluded by region, June 2005



Source: UNCTAD. 2006, Figure III.3 p. 33

Finally, as a result, the limitative theoretical neoclassic condition is realized, as unproductive in practice too. For example, according to an UNCTAD Report, "[the] EIIAs often include provisions intended to regulate investment. The most common provision of this kind is one intended to limit practices that restrict or distort competition. Provisions regulating restrictive business practices appear in most types of EIIAs signed by the European Community and EFTA countries with third countries, as well as in the recent bilateral free trade agreements that expand and elaborate on the NAFTA model. The breadth and depth of these provisions vary considerably between different types of EIIA. … In any case, it is easy to conclude that this provision, despite being structured as a restriction on investment, is intended principally to protect foreign investment against natural or State-created advantages enjoyed by domestic investors. Thus, the competition provisions may be seen as investment protection provisions in that they protect foreign investment against the conduct of private parties. In that sense, they are similar to the intellectual property provisions that have been common in EIIAs. Competition provisions may also be regarded as investment liberalization provisions in that they are intended to remove potential barriers to the entry of foreign investment. They differ from other investment liberalization provisions, however, in that the barriers being removed may be created by private competitors rather than the host country itself. In any event, to the extent that the host country wishes to allow a particular domestic firm to enjoy a monopoly position as part of its development policy, it will need to exclude, or negotiate an exception to, this provision" (UNCTAD Report, 2006, pp.125-127).

These are clearly unexpected contradictory situations as have been experienced during the second half of the last century, especially by countries with a developing economy where neoclassical free market theories have been taught at the universities and policy makers had to

deal with concrete situations shaped by mercantilist practices.

Keynes' critical views also were an offspring of unexpected results produced by the conflict between the tenets of neoclassical theory and mercantilist reality (Wood 1982, vol. 6, no. 2, pp. 555-61). Although Keynes was sympathetic to some aspects of Mercantilism, mainly the importance of the balance of trade surplus to promote economic development through increased effective demand and lower interest rates, he was aware that they neglected internal demand, mainly related to the relationship between effective demand and income distribution; in fact, a more equal distribution would enhance purchasing power and lead on to higher levels of output and employment. Moreover, in Keynes's view, the Mercantilists were not clear about the relationship between investment and saving; in fact, the very unequal distribution of incomes lead to an accumulation of financial means that could not be invested due to a lack of effective demand (Keynes, 1936, pp. 333-351 and pp. 372-73). Moreover, he also criticized the protectionist economic system: "If there is one thing that protection cannot do, it is to cure unemployment" (Keynes 1936, p. 334). Indeed, protectionism does not lead anywhere if internal demand is not stimulated. This already points to the importance of the internal employment mechanism set forth in the previous chapter.

In a historical perspective, it becomes clear that the mercantilist theories provided an inappropriate policy foundation to properly manage the financial capital available through the inflow of foreign financial resources in the form of precious metals. Similarly, there are, at present, reasons to believe that neoclassical economic theory has not been able to deliver appropriate policy conceptions in order to manage foreign resources, especially FDI, in a way beneficial to developing economies. This emerges from the overall argument set forth in this thesis, including the empirical evidence. This is a rather shattering conclusion concerning the real effects worldwide of economic policies based upon the still dominating neoclassical theory.

Now, we present a somewhat more detailed analysis of the failures of mercantilism and neo-mercantilism, the latter being superseded theoretically by neoclassical economic theory.

First, the accumulation of unproductive capital was the main cause of the Mercantilist's problems. Unproductive capital simply consists of financial means, precious metals at the time, which could not be invested because of a lack of investment opportunities due to a lack of effective demand. Similarly, at present, in the neo-mercantilist monetary production economies, there are huge amounts of unproductive money circulating in the financial sector along money circulating in the industrial (real) sphere. In the previous chapter we have already mentioned

this basic distinction between "industrial circulation" and "financial circulation" Keynes set forth in chapter 15 of the first volume of his *Treatise on Money* (Keynes 1971/1930, pp. 217-230). Again, these financial resources cannot be used to finance *new* investments because of a lack of effective demand. Therefore, money circulating in the financial sector seeks investment opportunities within already existing assets: shares, bonds, including treasury bonds, land, real estate, houses, old masters, precious metals, and others. When transactions are taking place within the financial sector the money stays, as a rule, in this sector and the prices of existing assets may go up indefinitely. It is only for fear of falling prices of existing assets – share prices in particular – which induces the owners of financial means to hold these in the form of money that is purely liquid means. Hence as has been argued in the previous chapter FDI will only add to domestic *new* investment if there is sufficient effective demand. Otherwise, FDI will simply move as unproductive capital to the financial sector and remain idle there. However, according to neoclassical theory, all accumulated savings would, on account of Say's Law, finally get invested in *new* capital goods. New financial capital, including financial FDI, would lead to falling interest rates rendering thus profitable all investment projects the internal rate of return of which exceeds the rate of interest. Since in developing economies capital is scarce internal rates of return are high. This is the main rationale for claiming that FDI is the main engine of economic development. Once again there is a deep cleavage between neoclassical theory, implying a self-regulating economy, and neo-mercantilist reality where effective demand governs economic activity.

Second, in a macroeconomic perspective, the old mercantilists did not keep the magical balance relation between investment and saving. This lead to oversaving which resulted in stocking up unproductive financial capital instead of investing it to keep the rate of interest low; however, one may suppose that investment was not possible due to a lack of effective demand. Neoclassical theory, too, overlooks the fact that within the banking system money may be created and that, given this, invisible resources tend to exceed more and more investment. This has adverse effect on the economies, mainly through worsening distribution of incomes leading on to more unemployment due to declining purchasing power. These adverse effects of the financial capital inflows have, probably, offset at least partly, the positive effects brought about by the export surplus, which constitutes autonomous demand capable of setting into motion a cumulative process of increased consumption and investment. In Keynesian terms, the inflow of financial capital resulting in a more unequal distribution, increased the saving ratio and reduced the size of the multiplier effect, annihilating thus, partly at least, the

positive effect on output and employment brought about by the export surplus.

Hence, the third point is that the mercantilists did not pay any attention to distribution. Present-day neoclassicals join Adam Smith in saying that an unequal distribution of incomes is required to bring about higher volumes of saving and investment, and, consequently, higher growth rates. To be sure, there were exceptions like Daniel Defoe among the mercantilists who argued that wages ought to be high to enhance the motivation of the working population and their purchasing power. Crucially, the old mercantilists and the modern neoclassicals do not understand the relation between the level of output and employment and income distribution set forth by Keynes and subsequently elaborated by the classical-Keynesians. In fact, at the outset of the final chapter of his *General Theory* Keynes states: "[Up] to the point where full employment prevails, the growth of capital depends not at all on a low propensity to consume but is, on the contrary, held back by it; [consequently] measures for the redistribution of incomes in a way likely to raise the propensity to consume may prove positively favourable to the growth of capital" (Keynes 1973/1936, pp. 272-73). This point stands at the centre of classical-Keynesian political economy set forth in the previous chapter: a more equal distribution of incomes is, in principle, associated with higher levels of output and employment (Bortis 1997, 2004).

Fourth, "the mercantilist economists intuitively understood that the emerging monetary economies were not self-regulating" (Keynes, 1936, p.341). State intervention was therefore necessary. Specifically, the internal employment mechanism set forth in the previous chapter has to be put to use. In principle, this implies that state expenditures must be sufficiently high and income distribution equal enough to, ideally, bring about full employment. Fifth, it is also important to note that the mercantilists paid due attention to the world economic system as a one-way flow, in fact, as a unilateral trade system. The surplus of export over import, including some real foreign investment, is indeed equivalent to a unilateral flow as is the consequent inflow of precious metals. Modern neo-mercantilism, too, channels direct investment abroad, through MNCs and TNCs in the main. Huge profits are subsequently returned to the home countries in the form of financial capital (Fujita, 2005). Presently, reinvested earning is one of the major foreign capital flows to the countries with a developing economy (World Investment Report, 2005, Table 1.2, p.12). As we have suggested, these processes are disguised by neoclassical efficient allocation considerations: real and financial capital, including reinvested earnings, flows most intensely to countries where real capital is most scarce.

As a final point, modern (neo-liberal) neoclassical theory has changed the conventional

role of capital. In fact, in traditional neoclassical theory capital could not move that is it could not leave the home country. This enabled the principle of comparative costs to work properly, since only relative prices were relevant. Now, with globalisation absolute costs and prices have moved to the fore. According to individual self-interest capital will move to countries and region where the cost of production, wage-costs in the last instance is lowest. This means that industrial locations are no longer stable, but, move around, capital is invested where the highest profits can be reaped. Since the self-regulating does not work in reality (Foley 2006, pp.36-38) this amounts to a neo-mercantilist struggle for workplaces. This struggle has become one of the main features of the modern world. A gradual shift of workplaces from highly developed to emerging economies is a probable consequence.

On the other hand, an alternative to the mercantilist and neo-mercantilist external employment mechanism has gradually come into being. Fundamentally, this approach is based upon internal elements, with public and private consumption being fundamental for determining output and employment. There is no self-regulation of markets, which implies that the price mechanism cannot bring about any tendency towards full employment. The state, through his expenditures, and eventually through an incomes policy has therefore a crucial role to play in solving the great socio-economic problems, employment and distribution in the main. François Quesnay's with his fundamental and simplified tableau économique may be considered the founder of the internal approach to tackle the great economic problems. His approach was taken up by Ricardo, Marx and List, and, later by Sraffa and Keynes. The work of Keynes and Sraffa has been carried on by the Post-Keynesians, including the neo-Ricardians. Finally, these developments have led up to the Classical-Keynesian Political Economy synthesis.

Hence François Quesnay, David Ricardo and Maynard Keynes have provided the conceptual tools for looking in an alternative way at the problems of production, distribution, employment, investment and growth. The alternative was in fact to Adam Smith and the neoclassical equilibrium theory, which culminated in the presently dominating neo-liberal free-market theory. Specifically, François Quesnay, like David Ricardo, considered distribution as the fundamental and most important problem of political economy. In this political economy view, economic activities appear as socio-economic relation, which is the economic interaction between the social groups, as alternative of neoclassic individualism economic theory (Pasinetti 1977, p. 5). This interactive relation between economic sectors was taken up later by Leontief and Sraffa. While Leontief's analysis deals with quantities, the Sraffa's model deals with the

problem of value and distribution within the social process of production. All these models exhibit the nature aspect of the social process of production as is set forth in Pasinetti (1977): Primary products – raw materials, energy resources and agricultural products (food) – circulate between industries to enable the production of intermediate and final products. These horizontal production models put to the fore the crucial importance of the basic goods taken from nature (Bortis 2003, pp. 433-436). Fundamentally new concepts are put to use in economic science for the first time, such as net product, social surplus and distribution of income as a social process (Pasinetti 1977, p. 5).

Social production, relative prices and quantities, and distribution of income (income shares and wage structures, for example) appear as the fundamental proportions elements of the socio- economic system (Bortis, 1997. p. 286). In addition, François Quesnay took up for the first time, the problem of the scale of economic activity – the level of output and employment with structures given – which is shown to result from a multiplier relationship linking autonomous expenditures – the spending of land rents – to output and, implicitly, employment (Bortis 1997, p.153). This theme was taken up by Marx, Keynes, the post Keynesians, and, finally, by classical-Keynesian political economy which has been extensively dealt with in the previous chapter. For our theme, FDI, it is highly relevant that the pioneers of the alternative approach, especially François Quesnay and Maynard Keynes, clearly recognized the danger of over saving which would lead to a flow of financial resources into the financial circuit where it would remain sterile.

In fact, Quesnay worried that landlords might not spend the whole of their rent income because this would negatively affect the scale of economic activity, that is output and employment. Hence, Quesnay already considered, implicitly though, the problem of effective demand, before it was taken up systematically by Keynes in the 1930s. Keynes, and particularly the classical-Keynesians, have related effective demand as governing output and employment directly to income distribution. A more equal income distribution enhances the purchasing power of the population, which is reflected in a higher propensity to consume. Increased demand for consumption goods leads on to higher levels of output and employment. This connection between income distribution and employment has been extensively dealt with in the previous chapter. The distribution – employment relationship is also of crucial importance to assess the impact of FDI upon the economy of the recipient country. To this issue we now turn.

5.2. The Impact of Foreign Direct Investment from the Classical - Keynesian Point of View

In the first place it had to be justified why the classical-Keynesian approach has been selected, and not neoclassical theory, to deal with the impact of FDI upon a developing countries in general, and Iran in particular. The reasons are theoretical and empirical and have been put to the fore in the preceding chapters. The theoretical reasons start from the fact that, in neoclassical theory, the rate of interest plays a central role. In the neoclassical exchange approach the market for new capital goods transforms saving into investment with the rate of interest establishing equilibrium on this market. Since in developing countries capital is scarce and the rate of interest relatively high foreign capital is attracted; in the neoclassical view, foreign resources always add to domestic investment, enhancing thus growth and development. In any case, as has been most clearly perceived by Keynes, the rate of interest plays a crucial role not in mercantilist theory, but even more in neoclassical theory where it is basic in the bringing about of a full employment equilibrium: the rate of interest brings about an equilibrium between saving and investment such that full employment prevails. The neoclassical theory is thus grounded upon a well-behaved association between rates of interest and quantities of capital, in general between factor prices and factor quantities. This implies that the price mechanism can bring about a tendency towards a full employment equilibrium if sufficient competition prevails.

However, Keynesian, Post-Keynesian, and Neo-Ricardian critiques of neoclassical theory have plausibly argued that, in market economies, the price mechanism cannot bring about a tendency towards a full employment equilibrium, even if conditions were ideal, that is, if perfect competition prevailed. Specifically, there is no well-behaved association between factor prices and factor quantities: lower interest rates are not necessarily associated with higher capital stocks, and declining wages will not lead to higher employment levels. Moreover, there may be interaction between markets which prevent economies from moving towards a full employment equilibrium; for example, if wages decrease because of unemployment, the demand for consumption goods may decline, leading on to even more unemployment. The reason is that, as a rule, wages are largely consumed, whilst profits are saved in order to accumulate wealth in real or in money form. Finally, in a monetary production economy, effective demand governs output and employment in a monetary production economy. In this context, contradictions between the rationality of individuals and the rationality of the system

may come into being, Keynes's paradox of thrift perhaps being most significant here. It may be rational for all individuals to save more; however, in a monetary economy this will contradict the rationality of the system. In this context we have already mentioned Schumpeter who wrote that, "[the Keynesian doctrine] can easily be made to say both that 'who tries to save destroys real capital' and that, via saving, 'the unequal distribution of income is the ultimate cause of unemployment' [because of reduced purchasing power]. *This* is what the Keynesian Revolution amounts to" (Schumpeter, 1946, p. 517). This may lead on to cumulative processes characterised by a mutual interaction between unequal distribution and unemployment. Such processes may be reinforced by the interaction between the financial and the real sector: "Depressions arise, Keynes wrote in his *Treatise on Money* (1930), when money is shifted from the ‚industrial circulation' into the 'financial circulation' (Skidelsky, 1992 p. xxiv). Indeed, the banking system has the capacity to create money. Financial resources tend to exceed *new* investments more and more and flow into financial circulation, seeking profitable investment opportunities among existing assets (shares, land, real estate, e.g.). In this thesis the financial resources circulating in the financial sector have been called unproductive capital, which come into being through oversaving and money creation through the banking systems. As a consequence, share prices rise, and enterprises are forced to realise higher profits to prevent takeovers. Income distribution becomes more unequal, saving increases and so does unemployment on account of diminishing purchasing power. Moreover, asset management oriented banking tends to avoid risky investments. This favours the expansion of large and well-established enterprises, and leads to the elimination of small and medium enterprises. This concentration process also leads on to a more unequal distribution of incomes and thus rising involuntary unemployment. Hence, in a monetary production economy, powerful cumulative processes come into being: an growingly unequal income distribution and more unemployment interact.

This is confirmed by historical examples, most strikingly through the great depressions of the last quarter of the 19th century and of the 1930s. It has already been mentioned that, according to eminent international organisations, the ILO for example, about one third of three billion people able to work are unemployed or underemployed; moreover, about two thirds of humanity live in misery with less than two dollars per person and per day.

Finally, in this thesis it has been argued that mercantilism and neo-mercantilism was underlying the economic policies of the successful developed countries, of the West in the main. In this view, neoclassical free-market theory was merely an ideological veil covering up

underlying reality. This view is, in fact, implied in Ha-Joon Chang's *Kicking Away the Ladder – Development Strategy in Historical Perspective* (Chang 2002). These theoretical and empirical-historical reasons have led us to adopt the social liberal classical-Keynesian approach to deal realistically with economic development and the role of foreign direct investment played in the development process. In chapter four above the differentiated conclusions on the effects of FDIs have been reached.

In fact, FDI has positive effects in various situations. First, if long-period effective demand brought about by sufficiently high government expenditures is such that the realised profit rate exceeds the target or satisfactory profit rate generally, that is in all sectors of the economy, FDI is beneficial to the recipient economy. It will add to domestic investment and, as such, enable a developing economy to reach a higher output and employment trend as is pictured by the supermultiplier, in fact through the internal employment mechanism based on internally created effective demand. In this situation it is true that investing today – with investment consisting of domestic and foreign investment – enables to harvest tomorrow. However, and this is very important, the soil has to be prepared. Effective demand has to be created through additional government expenditures or eventually through incomes policies aiming at reducing excessive income inequalities in order to enhance the purchasing power of the population. At the same time the balance on current account has to be managed in a way as to preserve equilibrium between exports and imports, not in every short-term time period, but broadly in the long-term average.

Second, foreign direct investment is beneficial to the recipient country if the output is exported or if import substitution takes place. This conclusion directly follows the external employment mechanism set forth in chapter 4. It is evident, however, that only a few developing countries enjoy the privilege of obtaining export-oriented foreign direct investment. The countries in question must have very good political relations with the advanced industrialised economies and must accept the rules of the game prescribed by the World Trade Organisation and eventually by the Washington Consensus. For obvious reasons Iran does not enjoy this privileged situation. For political reasons, national and international, Iran is in a very difficult situation economically, particularly regarding foreign economic relations, including FDI. In a way, Iran has, at present, to carry out balancing acts between East and West, with both trying to gain economic, political and, even military, advantages from this strategically very important country. This is why the theoretical analysis of the impact of foreign resources carried out in this thesis is to some extent normative. Indeed, the present analysis refers to a

normal situation in which developing countries find themselves. This normal situation of developing countries is by no means an easy one, but in the case of Iran difficulties are huge which means that there is a very large deviation from the normal situation prevailing in most developing countries.

Third, foreign direct investment may be beneficial to the recipient economy if bottlenecks are removed. This case has also been dealt with in chapter 4. Bottlenecks show up when in some basic industry, the steel industry for example, the realised rate of profits r_i exceeds the normal profit rate r*. Production in this industry therefore falls short of the normal level, restricting thus production in other sectors. The shortage of steel may limit the production of industrial equipment and therefore may prevent extending the productive capacities in sectors where the realised profit rate exceeds the target rate of profits. In normal circumstances the rate of growth of investment in the sectors in question should be above average in order to expand capacities quickly. This may not be possible because of a lack of required domestic resources of the specific type. Foreign direct investment may therefore be highly beneficial to the recipient country if bottlenecks may be relieved.

Fourth, it has been argued in chapter 4 that foreign direct investment may dampen the business cycle. The reason is that there is no income effect in case of foreign direct investment because the investment goods are produced outside the recipient country. Given this, only the capacity effect is relevant in relation with FDI inflows. Output increases in the cyclical upswing are speeded up exerting thus a pressure on prices and profits. This reduces the speed of expansion of investment in the upswing, and less excess capacities are built up, dampening thus the cyclical movement. However, if during the downturn of the cycle, foreign investment continues to flow into the country considered, domestic investment may be displaced.

However, besides the – potential - positive impact of foreign direct investment there are also negative effects. These harmful effects of FDI have all been sketched in chapter 4. In fact, four circumstances may cause FDI to have a damaging impact on the recipient economy. First, consider a developing country which within the ongoing process of globalisation opens its economy along the neo-liberal free-market doctrine. To attract foreign direct investment the country in question will eventually lower tax rates and, consequently, government expenditure. The latter is, as a rule, required to prevent a budget deficit, which might lead on to inflation. In fact, a stable internal value of money is a precondition for a stable external value of money which is also an essential element to attract foreign investors. The preservation of a stable value of money is frequently associated with a pressure on money wages, increasing inequality of

income distribution and rising unemployment; in fact, some unemployment is required to prevent money wages from rising. In supermultiplier terms set forth in chapter 4 above, this is reflected in a downward movement of the long-period trend since more inequality of income is, in long-period classical-Keynesian political economy, associated with reduced effective demand and declining output and employment levels. This tendency is enhanced through the reductions in government expenditures required to attract FDI. If, given these circumstances, FDI flows into the country considered and if production out of FDI is for the domestic market, then domestic investment will inevitably be squeezed out of the markets because of a lack of investment opportunities, due, in turn, to a low level of effective demand. as has been suggested in the previous chapter.

However, problems also arise, even if the output produced by FDI is exported. In fact, in a dual economy, with a traditional and several types of the advanced sectors, FDI may lead on to the formation of enclave economies. With the output emerging from FDI exported and higher than average wages paid, most of the incomes created through FDI may be spent abroad, largely isolating thus the FDI sector from the rest of the economy.

This leads to a second issue. Foreign direct investment may bring about an increased dependence from the outside world, technically and culturally. Increasing technical dependency from abroad will raise the import coefficient for necessary goods, indispensable in the social process of production. Moreover, 'cultural' dependence from abroad may increase because FDI and the associated enclave economies may lead to an increase of Western type consumption goods. This means that the coefficient for non-necessary goods, associated to consumption out of the surplus, also increases. From the supermultiplier relation presented in chapter 4 it immediately follows that higher import coefficient lead to lower employment levels.

In the third place there is the important problem of – sterile – finance capital circulating in the financial circulation which is associated with mergers and acquisitions (M&A). In chapter 4 we have argued that due to the capacity of the banking system to create money a continuous tendency of financial resources to exceed investment comes into being in a monetary production economy; this tendency is reinforced through a large saving ratio due to an unequal distribution of incomes. The excess of financial resources over *new* investments flows out of the industrial circulation into the financial circulation. In this context it should be noted that the equality of saving and investment (S = I) represents a macroeconomic equilibrium condition on the goods markets: saving liberates the real resources, that is direct and indirect labour and real capital (past labour) to produce the investment goods (the issue of

direct and indirect labour, as well as past labour has been dealt with in chapter 4 where the classical aspects of the classical-Keynesian model have been set forth). Now, the amount of new investments is, in the long run, limited by effective demand governed through the supermultiplier relation set out in chapter 4 (in the short- and medium term investment is autonomous and fluctuates around supermultiplier trend investment which is decisive in the long run). This amount of new investments governs together with other macroeconomic variables – government expenditures and private consumption – the amount of money circulating in Keynes's Industrial Circulation. The excess of newly created financial resources over saving – a flow – joins the stock of money circulating in the financial circulation.

Now, money circulating in the industrial circulation is always associated with a value – new or newly production public and private consumption and investment – goods. This is not so with money circulating in the financial circulation which is divorced from values, but constantly seeks to get associated with value, possibly values being able to produce a surplus value, that is, concretely speaking, profits. This is the case with mergers and acquisitions (M&As), which have also been dealt with in chapter 4 above. Hence financial capital flowing into some recipient country acquires existing values, existing enterprises (acquisitions), which may be reorganised through mergers. This implies, as a rule, that share prices rise whereby speculation adds as an important cause for the increasing value of stock. This fact may be interpreted in two ways, the neoclassical and the classical-Keynesian way. The neoclassical economist would argue high share prices are equivalent to low interest rates and should induce enterprises to carry out additional *new* investment. In this view foreign financial capital would also be beneficial to the recipient country. Keynesian, particularly classical-Keynesian political economists would argue, however, that a rising value of stock ultimately results in a more unequal income distribution. To get an acceptable rate of interest on the financial resources in shares dividends must increase if share prices rise. This, in turn, requires rising profits, implying that a continuous pressure on wages and costs must be exercised. In a way, production gets subdued to finance (normally finance should stand in the service of production). With distribution getting more unequal, effective demand increases and unemployment increases, a fact that follows directly from the supermultiplier relation set forth in chapter 4. However, a long-period decline of output and employment will be associated with less investment opportunities; according to the supermultiplier, the institutionally determined long-period investment level declines. Given this, eventually incoming real FDI is now more likely to drive out domestic investment than would have the case without an inflow of financial

foreign capital.

In this context, still another aspect, also mentioned in chapter 4, of the relation between the financial and the real sector has to be mentioned. In fact, the financial sector, above those parts of the banking system associated with asset management, tends to avoid risky investments, including the financing of risky new investments. Given this, only large and well-established enterprises tend to get credits for new investments. This leads on to a concentration process, and, as a rule, to a more unequal income distribution. The same conclusions as just mentioned follow on the basis of the supermultiplier relation: In a long-run view, output and employment, and investment opportunities decline, with real FDI probably squeezing out domestic investment in the recipient economy.

This conclusion holds also in a fourth case, that for FDI associated with Transnational Corporations (TNCs) in developing economies, a case also mentioned in chapter 4. TNCs produce only part of some product in the recipient country of FDI; eventually, assembling also takes place there. The important point is that technology remains in control of the home country, an advanced industrialised country as a rule. This is evidently of a great disadvantage since TNCs do not contribute to contribute to economic development in the technical domain. Moreover, in a situation of intense competition on the world markets, TNCs naturally tend to exert a pressure on wages; simultaneously, high profits must be realised to maintain high share prices and to prevent takeovers. Income distribution is thus likely to worsen, with the negative consequences on aggregate output and employment suggested above. Most importantly, perhaps, TNCs do not contribute to the development of human capital. Most of the work places are of low quality and work is badly paid; the danger of workers being exploited, especially women, is very great, since in developing countries getting a workplace, even a bad one, is just a matter of survival. This is the main reason why many developing countries are not eager to get FDI through TNCs.

To conclude this section, it may be said that classical-Keynesian political economy allows for a balanced assessment of the positive and negative effects of FDI in countries with a developing economy. This stands in contrast to the clear cut principles that arise from neoclassical free-market theory. In the next section some policy implications emerging from classical-Keynesian political economy are presented, with a specific emphasis on development policies in countries producing primary products, of which Iran as an oil-producing country is a prominent example.

5.3 Long-period Policy Implications along Classical - Keynesian Lines

An underlying theme of this thesis is that neither Liberalism, realised through capitalism, nor planning-cum-protectionism are appropriate doctrines to promote even economic development. More specifically it has been argued that both doctrines are not able to deal appropriately with foreign direct investment either. On the positive side it has been suggested that classical-Keynesian political economy, the political economy of Social Liberalism, can deal in a refined and balanced way with the positive and negative effects of foreign direct investment. However, classical-Keynesian political economy can also provide some sound and basic principles on the process of economic development at large.

The starting point is the specific Western way of growth and development. This way was essentially neo-mercantilist. No longer the export surplus played the crucial role as in mercantilist times, but the structure of foreign trade now moved to the fore. This was associated with a specific structure of division of labour on the world level. England, and subsequently the West, becomes the "factory of the world" producing and exporting technologically ever more advanced manufactured products, and importing primary goods (agricultural products, raw materials and energy resources) and standard manufactured products. This division of labour was brought about at a time when the West dominated Asia, Africa, and Latin America; in this circumstance, Western industrial growth was relatively easy going because the World was still little industrialised with favourable proportions between the primary sector and the industrial sector prevailing. This specific world division of labour went along with a growing gap, productivity gap between economically developed and underdeveloped countries due to a technical gap and to economies of scale. This productivity was accompanied by a growing wealth gap: still in 1750 England and India were, as far as wealth was concerned, approximately on the same level; at present immense wealth differences between the economically most advanced countries and the least developed countries have come into being. And very importantly, investment opportunities in the industrial and service sectors are now limited at a world level through effective demand. There are no free markets to be conquered as was possible in the 19th century through conquering a now colony or creating another dependent territory to which, in fact, Iran belonged. World markets are saturated at present. This implies that competition is not sound competition as is implied in neoclassical theory, but competition is now, more intensely than in the 19th century, about survival, which, in turn, means that the rise of one region or country, China or India for example, may imply the decline

of other hitherto industrialised regions, including highly industrialised countries.

Given this, the developing countries cannot develop along neo-mercantilist lines as the Western countries did until the beginning of the First World War (1914), except very large countries that have a very large internal market, China and India being the prime examples. Thus, the external employment mechanism is not possible for the small and medium-sized developing countries. As a consequence, the internal employment mechanism, associated to some management of foreign trade relations is only way out. In fact, the now developing countries have, in a way, to counterbalance the unfavourable situation they have been put into through the neo-mercantilist policies pursued by the now developed countries.

The internal employment mechanism is closely associated with the classical-Keynesian theory of economic development and with the social liberal theory of the state, which necessarily plays a crucial role in economic development. Indeed, in the view of social liberal classical-Keynesian political economy, there is no self-regulation at all in a modern economy. This means that the state, in collaboration with society, must intervene to set up an orderly functioning economy. The most important features of such an economy would be full employment and a 'fair' distribution of incomes. The level of employment and output depends, in the main, upon government expenditures and upon the purchasing power of the population which, in turn, is higher if income distribution is more equal.

Hence the role of the state in Social Liberalism is a very important one: creating as much social harmony as possible and reduce system-caused alienation – involuntary unemployment and highly unequal distribution of income - as far as is humanly achievable. This does not imply an authoritarian state, however. In fact, the citizens should hardly be aware that there is a state. Indeed, government activity, must, in the first place, be directed towards organising the social system, i.e. towards setting up, or favouring the coming into being, of appropriate institutions. This can only be done properly if there is a very solid economic theory from which appropriate policy conceptions may be derived and, much more important, underlying theory, there must be vision of the society to be aimed at, and a vision implies values. Ideally, with alienation (mainly involuntary unemployment and the social problems resulting there-from) reduced to a minimum, the state would be almost imperceptible. (Contrariwise, with heavy alienation - unemployment and social unrest, in the main - the state would have to be a law and order state, interfering heavily with the behaviour of individuals, reducing thus the scope of liberty.) The social liberal vision of the state in fact implies that, on account of the Principle of Subsidiarity, the scope of freedom for the social individuals and collectives should be as large

as possible. The problem is to organise the socio-economic and political system appropriately and to minimise interference with the behaviour of individuals through legal prescriptions, giving ethics a much larger place. Such a situation would enable the social individuals to prosper, that is to unfold their potentials and to broaden their capacities.

These aims are very difficult to reach, however. Greek and old Persian political theory in fact holds governing is the most difficult of all the arts, the central problem being to bring about social justice, distributive justice in the main (to which the full employment aim would add at present). And the difficulty of governing has dramatically increased since the coming into being of modern monetary production economies with very extended division of labour and the crucial role taken by money and finance. Without understanding how monetary production economies function and how they are related to society and the state, appropriate political action is not possible. Political economy had become and has remained *the key social science* of the modern era. Indeed, on the basis of a well organised economy, the socially appropriate use of the social surplus may now be tackled. This means setting up an institutional superstructure in view of permanently aiming at social values in the fields of law and justice, internal and external security, education and learning and culture. To set up a socially appropriate set of institutions requires governing on the basis of a vision of the good society to be realised as closely as is humanly possible.

These theoretical considerations are of fundamental importance for conceiving of an alternative world order. Indeed, given the extreme complexity of governing, states should not be too large to be governable. In fact, the small and medium sized states as have emerged in Western and Central Europe are most appropriate, this would also hold for Iran. This means that large polities like Brazil, China, India, Russia, and the United States will have to decentralise substantially. And very importantly, each country should have its own money to be able to pursue economic and social policies, and international transactions should be effected through supranational world money, Keynes's Bancor, to be managed by the World Bank. This new monetary order would greatly facilitate the achieving of equilibrium of the foreign balance of each country. Foreign trade, as is governed by natural resource endowments and historically grown specialisation, links together, directly or indirectly, all polities of the globe. However, for environmental reasons, the volume of international trade should eventually be minimised. Each country would export only to an extent such as to be able to buy abroad the necessary and non-necessary goods not available domestically. Keynes's vision represents an intellectual revolution, having fundamentally important policy consequences. Indeed, if, in normal

circumstances, orderly economic, social and political conditions can only be created in small and medium-sized states or regions of large states, the politically appropriate world order emerges as a family of nations. This world order would render possible to realise, worldwide, fundamentally important values for the social individuals: Full employment, fair distribution, the economy as the material basis for a well-organised society, within which the social individuals may prosper, mutually enrich each other in all domains of life, social and cultural most importantly, not only on the national, but also on the international level, that is between the culturally diverse world family of nation states, with full world-wide mobility for individuals which would be associated with mutual spiritual, intellectual and material enrichment.

In this – Aristotelian - view, the fundamental policy issue consists in the setting up of the good society, as far as is in line with human possibilities. In modern terms, this means bringing about a well-organised economy, ideally, with full employment and a fair distribution of incomes prevailing. The economy forms the material basis, so to speak, of a society, which produces the social surplus. The *use* of the social surplus, ideally, provides the *material basis* for all the persons active in the non-profit sector in the widest sense, including the state, to pursue and to realise *political, social, legal and cultural* values through the actions of individuals and collectives within the institutions established in the institutional superstructure. *These values cannot, in principle, be measured in money terms*. Highly unequal distributions of the surplus and the ensuing inappropriate use of the social surplus are, as a rule, associated with alienated social states of affairs.

In the social liberal view, to realise the good society as far as is humanly possible, requires a very solid theory, classical-Keynesian political economy to wit. And very importantly, the social liberal political philosophy implies that each political community may build up an institutional superstructure corresponding to her values. Moreover, cultural diversity appears no longer as a source of conflict, but enriches the social individuals through increasing the social potential of a society so to speak. Indeed, a well-organised economy provides the basis for an orderly living together of the social individuals and of social, ethnic and religious entities, and cultural diversity brings about their mutual intellectual and spiritual enrichment.

These considerations imply that the internal employment mechanism is not just a mechanical device to bring about growth and development. In fact, the size and the structure of state expenditures are associated with a vision of man and of society pointing to the society to

be gradually realised in the course of economic development. This is associated with the gradual transformation of a traditional society to a modern one. In this process elements of the traditional society should be preserved if the contribute to enhancing the stability of the modern society.

The mechanics of the internal employment and development mechanism have been set forth in chapter 4 above (equation 41a). The implications of this equation for growth and development emerge most clearly if it written as

$$G = (1 - c - i)\, Q = t\, Q \qquad (5.1)$$

Here c is the consumption dependent upon income distribution, i equals the gross investment-output ratio (g + d) v (relation 37 in chapter 4): g is the rate of output, employment and real capital, d represents the replacement coefficient and v is the capital-coefficient.

This very simple way of picturing the internal employment and development mechanism has some crucially important long-period implications. First, in a monetary production economy government expenditures set economic activity into motion bringing about a cumulative process of production of consumption and investment goods (relation 41b in chapter 4). Ideally, the amount of government expenditures G, its growth, and the size of the tax rate t should be such that the full employment of resources is realised. Second, government expenditures create the taxes required to finance government expenditures in real terms. In fact, government expenditures are financed in money terms through state money; taxes liberate the real resources required to produce the goods making up public consumption G, that is direct and indirect labour as well as past labour as is implied in relations 1 to 26 of classical-Keynesian system set out in chapter 4. Hence in the long run taxes must equal government expenditures if inflation is to be prevented. In this view, the tax system emerges as the backbone of any economy, developed or developing. To be efficient, the tax system should be very simple, easy to administer and psychologically appropriate in the sense that tax payers should be hardly aware that they are paying taxes. In this sense, direct taxes at source and indirect taxes in the form of wholesale taxes are most appropriate. Third, in the course of the development process, implying the transition from a traditional to a modern economy, that is realising the fundament social and political values in changing ways, the size and the structure of government expenditures varies. This will bring about changes in the interindustry structures and the – vertically integrated – sectoral structures pictured in chapter 4 (equations 1-26) that is

in the proportions of a monetary production economy expressed by relative prices and quantities.

The development process based upon the internal employment and output mechanism should go along with a broad management of international trade. This means ensuring the long-period equality of exports and imports through adjusting the import coefficient relating to non-necessary goods (b_2 in relation II) in an appropriate way; this would prevent the developing country from incurring a foreign debt. (In relation II, X are exports, π the terms of trade ($X/M = (e\ p_M/p_X)$, e being the exchange rate).

$$X = \pi\ (b_1+b_2)\ Q\ =\ \pi\ M \qquad (5.2)$$

Output Q evolves through forces associated to the internal employment and development mechanism (G and t). The growth of X exports is governed by the general competitiveness of a country on the world markets, and so are the terms of trade π. The coefficient of necessary imports, b_1, is governed by technical and physiological factors. Now, if Q grows faster than X, the coefficient b_2 has to be adjusted downwards, and vice versa. These adjusted processes would be facilitated if supranational money, Keynes's Bancor existed. For example, countries having an export surplus and accumulating Bancor balances could be induced to spend these balances through negative interest rate for example. This would enhance the exports of countries having an import surplus.

Last but not least, the specific situation of countries exporting raw materials or energy resources, oil for instance has to be considered. The problem is to prevent the Dutch disease, exporting primary good and importing industrial goods and services. The Dutch disease leads to uneven development, complete dependency from abroad and, above all, to low employment levels since primaries are land intensive and industrial goods and services are labour-intensive, directly and indirectly. The Iranian Prime Minister around 1950, Mossadeq, has proposed a very ingenious and simple solution to prevent the Dutch disease. Imagine two Irans, Iran I without oil and Iran II with oil. In principle, both, Iran I and Iran II, must develop in the same way. However, Iran II will be able to produce more goods than Iran I, because it can export oil. Iran II will, as a consequence, be richer than Iran I, enjoying higher living standards. Moreover, Iran II will be able to grow faster because part of the oil exports may be spent to import high technology capital goods. Hence, in the final analysis, Iran II will be richer than Iran I and her wealth will grow faster as in fact is normal. A country possessing natural resources should be

richer than a similar country which has none. In attempting to pursue an oil policy of this type, Mossadeqh aimed at establishing national independence, while at the same time aiming at a peaceful cooperation with other nations.

We may conclude by saying that the social liberal principles of social and political ethics and their implementation through economic and social policies are a modern expression of the way of governing in the old Persian Empire founded by Cyrus. The Persian rulers aimed ensuring the social and cultural independence of the various peoples living within the Empire, regulating income distribution, caring for the economically weak and creating work places through large public works. In fact, sound political action is, at all times, the realisation of the immutable principles of social justice in varying forms.

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