Foreign Direct Investment (FDI) Opportunities in Developing Countries:

What Do New Growth-Development Theories Have to Tell Us?

ABSTRACT

Importance given to internal features of developing countries has propitiated the emergence of a literature that is very relevant to entrepreneurial decisions to invest abroad, in terms of mapping the risks involved in such a venture. The country risk literature in the international business field is precise in pointing to key-variables related to multinationals' decisions to invest, upon constraints tied to domestic weaknesses of less-developed countries. Despite the relevance of that literature, a link connecting its empirical record with key-variables specified by new growth-development theories is still missing. In the country risk empirics, flows of FDI are shown to be negative and significantly correlated to political instability, high levels of corruption and ethnic tensions, as well as institutional weaknesses related to unimplemented or delayed reforms, all of which the new growth-development theories have elected as important variables to study underdevelopment in poor countries. As its main contribution, this article aims to bridge the two sides by summarizing part of the new growth-development literature and connecting it to the international business country risk empirical record.

Key-Words:

FDI in Developing Countries; New Growth-Development Theories; Country Risk Literature; Political Economy of Growth-Development; Institutions in Less-Developed Countries.

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Introduction

The new political economy of growth-development literature that has been elaborated since the late seventies brings important contributions from several distinct branches with a novelty: the incorporation of socio-institutional variables into its models' construction.

According to Krugman (1995), old development theories have been facing problems, mainly for not considering underdeveloped countries features linked to social, political and institutional arrangements. This has been so because the prospects of the high development theorizing period (1940s and 1950s), e.g., Rosenstein-Rodan (1943), Nurkse (1952; 1953), Myrdal (1957) and Hirschman (1958), as well as the neo-Marxist third world center-periphery dependency theoretical advances of the 1950s, 1960s and 1970s, e.g., Prebisch (1951), Lewis (1955; 1956), Flanders (1964), Cardoso (1977), and Cardoso and Falleto (1979) were unable to deal appropriately with the problems facing developing countries in the second half of the 20^{th} century.

Also, the old and new growth models, e.g., Domar (1946), Solow (1956; 1957), Swan (1956), Romer (1986), Lucas (1988), Grossman and Helpman (1990; 1991), and Romer (1996), that have basically focused on output growth due to accumulation of physical and/or human capital and technological advances, either exogenous or endogenously generated through a wide set of sources, have shown to be inappropriate to allow for institutions and consider the variety of socio-political and cultural features present in developing and underdeveloped countries.

By the late seventies, eighties and along the nineties, however, development theories reappear with a new design, incorporating a wide variety of institutional aspects linked to the developing world. Among the contributions of the new development trend, the multiple equilibria model of Akerlof (1976), based on a specific institutional arrangement, is an important piece. This author develops a model of castes, with labor immobility over social classes, whose different equilibria are possible under institutional arrangement incentives.

Another front in the recent trend of the new development literature is the so-called grassroots approach (also named locally oriented research). This theoretical branch focuses on a wide variety of aspects related to many distinct features and the diverse nature of the developing world. A summary of the grassroots approach, based on Escobar (1992), will be presented in order to highlight the important socio-institutional and cultural features of less-developed societies.

The main tenets of these two new development approaches can easily be linked to FDI decisions by multinationals in regard of social-cultural constraints as sources of country risk assessments, as advanced by Leavy (1984), and thus, they can be used as venues for analyses related to foreign investment opportunities in the developing world.

If these new development theories are sound tools to better highlight important aspects of developing countries, the main tenets of the so-called new political economy of growth literature are also of crucial relevance and must be considered in any attempt to tackle growth-development obstacles in undeveloped countries, as well as to guide multinationals' decision-making on doing investments in the developing world. Owing to this, three different aspects linked to internal socio-institutional features of developing countries are considered in four models of the new literature on economic growth.

Each of these new models addresses a different way polarization within a society can pose strong constraints on domestic growth realization, and, as a sided link, on decisions made by multinationals regarding FDI allocation in developing countries.

The first piece is due to Alesina and Rodrik (1994) who view polarization as originating from income inequality, a negative by-product of certain socio-economical arrangements. The second, due to Fernandez and Rodrik (1991) and Alesina and Drazen (1991), treats polarization as originating from diversity of interests in competing economic groups, which may prompt the occurrence of conflicts. Finally, as in Easterly and Levine (1997), polarization is seen as a consequence of ethnic diversity in the developing world, a socio-ethnical feature present in various African's countries.

All those contributions appropriately conceive economic, socio-political, cultural and institutional features of a poor country, and they are considered as key to better evaluate a poor country's potential to grow and develop. Also, using the international business country risk literature, e.g., Di Gregorio (2005), Levy and Yoon (2000), Desbordes (2007), Oetzel (2005), we can relate them to foreign investment opportunities in less-developed countries.

To handle this, the country risk empirical literature is referred, right after presenting each of the new growth-development theories, to show that the important variables selected as key to explain multinationals' FDI flows into developing countries are also the main ones depicted by those new theories, all of which consider the specific internal characteristics of less-developed countries as key to understand and analyze inherent obstacles towards economic growth and development.

Thus, as a major contribution of this paper, the main prospects of the new economic growth-development models investigated will be connected to the main tenets of the international business country risk literature, regarding host developing countries as places for multinational's FDI realization. Also, based on the two interrelated branches of literature analyzed, I will offer a general outline listing several aspects related to economic, socio-political-institutional features said to be crucial when decisions to invest in developing countries are considered.

1. Institutional arrangements and the Akerlof model of caste codes

Akerlof's (1976) model of castes offers a simple and interesting illustration of how institutional arrangements can lead to multiple equilibria in an undeveloped country. The model starts by depicting a system in which three types of jobs co-exist: skilled (s), unskilled (u) and scavenging (c). The domestic firms produce n goods using these three types of labor. Each product i has a linear production function of the type:

$$(1) \qquad q_i = \theta_s L_{si} + \theta_u L_{ui} + \theta_c L_{ci}, \qquad \text{with} \quad i = 1, 2, \dots, n,$$

where θ_j is the productivity of labor type j (j = s, u, c) and L_{ji} is the amount of labor type j used in the production of good i. It is assumed that all workers have the same ability, but their productivity may differ if they are assigned to different jobs. Also, we have $\theta_s > \theta_u > \theta_c$.

The Leontief utility function for all workers is the same and given by:

$$(2) \qquad U = \sum_i \max\,[x_i, \alpha], \qquad i = 1, 2, \dots, n.$$

where x_i is the consumption of good i and α is a positive parameter. For this utility function, if $x_i > \alpha$, then $U_j = \sum_i x_i$. If $\alpha > x_i$, then $U_j = \sum_i \alpha = n\alpha$. Each worker in the system can work on the production of only one product. Entry of firms into the market is free (even coming from abroad) and each firm specializes in the production of one product. Assume that the price of good i is 1 ($p_i = 1$) and that a worker in a skilled job, having productivity θ_s, is not sufficiently productive to reach the maximum utility limit $n\alpha$, i.e., $\theta_s < n\alpha$.

Suppose that there are two types of workers that are differentiated by birth (caste), although the difference in their appearance has no consequences for their abilities. The first type of worker belongs to a dominant caste represented by d, and the second to other non-dominant caste denoted by n. Both types of workers may become member of a third caste denoted v (scavengers) if they do not follow (obey) the institutional rules of the society. These rules are called caste codes. They dictate that the members of caste d, n and v may only work in skilled, unskilled and scavenging jobs, respectively. Firms also have to obey these rules. In addition, any of the two types of workers who purchase from firms that violate the employment caste codes will be outcasted (quitting castes d and n and entering caste v).

Regarding rewards, if everyone believes that the caste codes are effective and there are no outcasted workers at the beginning of a given period, i.e., no workers buy from firms that violate the rules, then the wage rates of the three types of workers are determined by their respective productivities. Thus, $w_d = \theta_s$, $w_n = \theta_u$ and $w_v = \theta_c$. Moreover, the prices of all goods will be 1, which implies that the wage rates represent the utility levels of the workers, since an individual expenditure is $w = \sum_i p_i x_i$ and $w = U_j = \sum_i x_i$, for $p_i = 1$. For this outcome to be equilibrium, a violating firm hiring workers of caste n to fill skilled positions should not be able to attract customers and make a profit.

To prove the existence of this equilibrium, suppose that a violating firm offers a wage $w_v < \theta_s = w_d$. Note that profits for this firm is at most $[p\theta_s - w_v]$ and is non-negative if and only if $p \geq w_v/\theta_s$. Only outcasted workers who are working for the violating firm purchase from it, since they find this firm's products cheap $[w_v = \sum_i p_i x_i < \theta_s]$ and buy from it all they can (i.e., α), spending the rest of their income w_v on other goods, which gives them $[w_v - \alpha p]$ units of those goods. As a result, their utility will be the following:

(3) $$[w_v - \alpha p + \alpha] \leq [w_v - \alpha w_v/\theta_s + \alpha], \text{ since } p \geq w_v/\theta_s.$$

The level of utility in equation (3) will not induce any worker in caste n or d to purchase from the violating firm if:

(4) $$w_u = \theta_u > [w_v - \alpha w_v/\theta_s + \alpha] \quad \text{or} \quad \alpha < [(\theta_u - \theta_c)/(1 - \theta_c/\theta_s)].$$

Since the right-hand side of the first expression in equation (4) is increasing in w_v, this condition is most likely to hold when $w_v = \theta_c$, which is the lowest wage the violating firm can pay to an outcasted worker. Therefore, an equilibrium exists if $\alpha < [(\theta_u - \theta_c)/(1 - \theta_c/\theta_s)]$. That is, if the amount of goods that workers of a violating firm can buy from it is sufficiently small, then no caste member would want to become an outcaste and thus would avoid buying from firms that violates the caste code. In this situation, no firm would offer a wage higher than θ_c to outcastes because even with $w_v = \theta_c$ $[w_v/\theta_c = 1 = p]$ the break even price is too high to attract caste members $[p = 1 = w_v/\theta_c < w_v/\theta_s]$. Thus, an equilibrium exists where a violating firm hiring workers of caste n to fill skilled positions should not be able to attract customers and make a profit.

If there are some outcastes at the beginning of a given period, i.e., there are outcasted workers purchasing from their own violating employers, then these violating firms, hiring these workers and selling them products, can make a profit when $w_v = \theta_c$ $[w_v/\theta_c = 1 = p]$. As a result, the firms will bid up the wages of outcastes until $w_v = \theta_s$ and the price of the product reaches $p = 1$, beyond which the firm could not attract any customers, since violating firms' products will not be cheap. However, even before the outcastes wage rate reaches such a level all members of caste n would want to drop out of the caste system. This is another equilibrium, where some workers disobey the caste codes and work according to their real productivities, not those imposed by birth, and thus there are wage incentives in the system.

Recalling the first equilibrium where there are no outcastes at the beginning, still a coalition of firms could break the caste equilibrium. Suppose k firms producing k different products decide to jointly violate the caste code. Then, a outcasted worker buying from them expects a utility $[\theta_c - \alpha pk - \alpha k]$, which may exceed θ_u if $\alpha k > [(\theta_u - \theta_c)/(1 - \theta_c/\theta_s)]$. The caste equilibrium is sub-optimal because the system can in principle employ everyone (from any class) in skilled positions. Thus, the model has another equilibrium where everyone is employed in this way, i.e., the Pareto optimal equilibrium. The problem is that this optimal equilibrium may not be attainable due to the constraints imposed by the institutional arrangements of caste codes. If this is the case, the model implies that the first castes code equilibrium prevails and no one gains from the caste system, since there are no incentives for high productive workers from non-dominant classes to ascend socially.

Akerlof (1976) believes that while it is possible for a deviant to get a positive return, wage rewards seem to favor those who follow the institutional codes embodied in the social custom. This may give good reasons why such social customs may last over long periods of time and negatively affect economic growth-development paths.

2. Socio-Institutional arrangements and the grassroots approach

The so-called grassroots approach, included here as a new branch of the development literature elaborated since late seventies, is summarized by Escobar (1992, pp. 421-422) in the following way:

> Although it would be impossible to summarize even a few of these movements here, it is important to identify *grosso modo* some of their general features … (1) They are essentially local movements, responses given by a group of people to particular problems or direct instances of power … They concern the day-to-day experience of people … In sum, they are non-party political formations which may

> or may not form horizontal networks or regional movements … They are pluralistic struggles … They tend to bypass established Development organizations, local elites and parties … But they are by no means apolitical; instead of a depoliticized Development, they politicize the rights of the poor…Even if they are frequently motivated by economic reasons, … local culture, artistic aspects and communal aspirations are often equally important concerns … They do not accept at face value the knowledge of the 'expert' and of government agents … They rely on their own knowledge or, at any rate, their knowledge occupies an increasingly important role in their decision-making processes.

From the above citation, it is clear that the grassroots approach deals with day-to-day experiences of the third world people in a wide range of social-political-institutional matters. Despite the difficulty to generalize and condense the approach in a single theoretical model, it can be conciliated, at least in one aspect, with the multiple equilibria development model of section 1.

The impossibility of firms' coalition formation to block the bad institutional arrangement of castes code in Akerlof (1976) may be seen as counterfactual support to reason and guide FDI decision-making towards safe opportunities in the developing world. Also here, the interplay of institutional property rights and local cultural specificities, under the diversity of local people's cultural background, may pose constraints to handle local labor force and society as a whole, with possible negative effects on multinationals' FDI realization in undeveloped countries.

Below we consider the main implications of the two new development theoretical approaches to FDI opportunities in the developing world, focusing on the empirical literature on country risk.

3. The caste codes model, the grassroots approach and the country risk empirics: implications to FDI opportunities in developing countries

More important than the social castes code features embodied in the first development model with multiple equilibria by Akerlof (1976), is its adequacy to analyze international investment allocation decisions towards undeveloped countries with specific institutional arrangements.

The castes code multiple equilibria model showed that the existence of a bad and a good equilibrium is a consequence of local firms and workers acting under an institutional arrangement of incentives. If it is not possible, due to the social caste rules, to move from the inferior, where everybody obeys the caste codes, to the superior equilibrium, where more productive workers can find better positions in different outcasted jobs, then entrepreneurial business decisions would be at odds. If the possibility to move to the superior equilibrium, where more skilled workers driven by productivity (not by birth) have wage incentives to be more productive and deviant firms to make higher profits, is blocked, then it would be hard to conceive FDI moving into a developing country facing such institutional arrangements.

Implications of the labor class immobility model to FDI opportunities in the developing world can be analyzed through the specific relations of multinational operations and local labor force institutional arrangements. If a multinational firm enters the castes code system in an Asian country such as India, and have to follow the social rules applied to local companies, i.e., hiring workers in the local labor market according to castes code, then the only way to aim reaching the superior equilibrium, getting high productive workers and making higher profits, would be to form a coalition with other local or multinational firms to block the bad institutional arrangement, which may not be feasible due to the country's cultural patterns.

Despite the caste codes model gives emphasis to institutional arrangements specific of certain countries in Asia (India and Nepal, for example), it sheds light to other institutional mechanisms more common in other poor countries worldwide, with scope to analyze issues of international investments decision-making.

One possibility is the coexistence of power and corruption in a given country. Suppose that an inferior equilibrium exists in which a powerful politician (a Governor or even a President) misallocates money by spending it in personal expenditures and not, for example, in key-infrastructure investments to boom private businesses. In this equilibrium the corruption machine could be established in a way that any violating person (a participant official who eventually would denounce the corrupt politician) would be strongly retaliated for his/her decision to denounce the fraudulent scheme.

Also, public scrutiny is ruled out because the powerful politician has close relation with the media (e.g., TV network, newspaper, etc, are proprieties of the Governor's family members). If this type of corruption is widespread, such an institutional environment eliminates the feasibility of reaching a superior equilibrium due to the impossibility to block the corruption scheme. In such cases, it is unlikely that foreign investment realization occurs in an undeveloped country with such features.

Thus, corruption multiple equilibria models are counterfactual to augmenting FDI opportunities in developing countries facing such bad institutional schemes, as advanced by Straub (2008).

Cuervo-Cazurra (2008) unambiguously affirms that corruption, as a bad institutional arrangement, has a negative effect on FDI flows into transition countries. He differentiates corruption into two types – pervasive corruption (widely present) and arbitrary corruption (uncertain), the former having a stronger deterring influence on FDI. Considering these two types of corruption and their effects on FDI flows into transition economies, Cuervo-Cazurra

(2008, p. 24) poses the main empirical findings:

> The empirical analysis reveals that corruption, pervasive corruption, and arbitrary corruption have a negative influence on FDI. However, when I explore how these relationships differ in transition economies, I find that corruption results in less of a negative influence on FDI in transition economies. This finding is further refined when I separate corruption into different subtypes and find that pervasive corruption has a larger negative influence on FDI in transition economies, while arbitrary corruption has a lower negative influence on FDI there. These findings point to the importance of exploring in more detail the different types of corruption and also analyzing how corruption may vary in its influence on FDI depending on the host country.

On the other hand, Leavy (1984) states the importance of taking into account institutional and socio-cultural differences between domestic and foreign environments, as assessing developing countries' risk on FDI decision-making. Treviño and Mixon Jr (2004) also point that institutional robustness are key for 7 Latin American countries as attractors of multinationals' investment flows. As referring to important empirical findings, Treviño and Mixon Jr (2004, p. 241) state:

> Institutional reforms introduced in Latin American countries in the early 1990s were swift and decisive and the MNE strategic response was predictable. … To assist in this understanding, managers of MNEs could develop and/or apply separate statistical indices comprising macroeconomic and institutional information for proposed host countries. Empirical results presented here suggest that managers should take particular care to examine host country institutional environments (reforms), and a longitudinal data base (of indices for

> individual countries) could be useful to managers in formulating FDI strategies. … This refocusing of effort would likely exhibit a higher marginal productivity given the greater scope for political/public influence on a country's institutional framework rather than its macroeconomic environment.

Hefeker and Busse (2007) find that bad internal institutional arrangements are important deterrents of FDI flows into 83 developing countries. The main empirical findings stated by Hefeker and Busse (2007, p. 399) are:

> Covering a time span of 20 years in our analysis, we find that only few indicators for political risk and institutions are closely associated with FDI. These are government stability, law and order, and quality of the bureaucracy. Employing a panel setting with two different econometric specifications, we establish instead a statistically significant link with a much larger number of indicators. In addition to the three mentioned indicators, we find that investment profile, internal and external conflict, ethnic tensions and democratic accountability are important determinants of FDI flows. Across different econometric models, the relative magnitude of the coefficients for these political indicators are largest for government stability and law and order, indicating that changes in these components of political risk and institutions are highly relevant for investment decisions of multinationals.

As long as FDI opportunities in the developing world are concerned, if society, incumbent government, interest groups, etc, may not visualize ways to eliminate bad institutional arrangements, via any mechanism that can start a process to block or break them, the possibility for a poor country attracting foreign investments in the form of multinationals' investments is unlikely to materialize. Both governmental and non-governmental organizations may be seen as important entities to help in coalition formation aimed to eliminate bad institutional arrangements.

Considering the grassroots approach we should say that socio-political-institutional transformations that countries in the developing world could experience have close ties to FDI flows toward places in this part of the planet. The main reasons for the emergence of such socio-political movements are related to the failures toward development as well as the inability of governments in poor countries to respond to persistent crises, whose perverse effects on people's lives calls for immediate actions.

In terms of improvements in foreign investments opportunities, one possibility for the demands coming from such social-political movements would be for representative groups or organizations having voice and access, direct or indirect, to political power. If this is not the case, an alternative possibility is to convince in power politicians to conduct social policy changes in favor of the most prominent needs that social movements demand, which may or may not include formation of local demands for attracting FDI from abroad.

Despite the fact that new social-political movements in the developing world are diverse and constructed upon different supports, the most vivid feature of such movements relates to day-to-day people's life improvements. If it is right to conceive such an emergence of social movements in the developing world as formation of coalitions, and if such coalitions are powerful enough to bring their demands to the attention of public authorities, social policy changes may be seen as urgent and actions accordingly taken.

In general, there is no incompatibility for undeveloped countries local governments and policy makers to advocate social changes based on social movements' demands, mainly if there is a consensus that actions are really needed. Referring to the former Brazilian First Lady Ruth Cardoso (*in memorium*), Escobar (1992, p. 427) points out:

> There is no doubt that we are confronted with new actors engaged in direct and confrontational dialogue with the State; to decipher this dialogue, however, new ways of understanding are required. If, on one hand, the contemporary society rediscovers certain forms of participation, the State, on the other, widened and diversified the field of its actions.

Therefore, the State and the new social movements' representatives may not be seen as opposite parties. Contrarily, they may find out a way to conciliate interests. In other words, social demands coming form society manifestations can and must be taken into account in governmental policy-related programs in the developing world.

On the other hand, in some instances, social coalition formation may be dangerous in terms of creating incentives to attract foreign investments. One example is the case of the landless movement in Brazil, where rural workers get together to invade rural private proprieties in the country side. If FDI opportunities are to be taken into account by undeveloped countries, blocking such a bad arrangement is to be done in first place, since private property rights is an important feature to base business in a free society.

4. The new literature on the political economy of growth

The growing importance economic growth-development theorists have given to internal features of developing countries, in terms of their social-economic-political-institutional environments, has propitiated the emergence of an important body of literature closely related to reform in the developing world.

The implications coming from Dollar and Svensson (1998) are key in any consideration of growth-development issues in the developing world. They claim that the probability of success of foreign-supported structural adjustment programs, sponsored by International Financial Institutions such as the International Monetary Fund (IMF) and/or the World Bank, is completely determined by internal characteristics inherent to a specific developing country. No matter what the World Bank staff, for example, does in terms of perfecting, supervising or improving the overall programs-related activities, if internal vulnerabilities are known to exist in poor countries, adjustment programs' ineffectiveness is an almost sure result.

Evidence on the effectiveness/ineffectiveness of these adjustment programs is abundant, e.g., Connors (1979), Conway (1991), Corbo and Rojas (1992), Bagci and Perraudin (1997) and Bordo and Schwartz (1998). If effectiveness is shown to be closely related to internal institutional robustness, then the same is to be expected regarding improving FDI opportunities in the developing world.

If this is a meaningful way in dealing with conditions for foreign investments in the developing world, the main tenets of the so-called new political economy of growth is of crucial relevance and must be considered as a core branch upon which any attempt connected to evaluating current foreign investment opportunities in developing countries must rely on. Owing to this, three aspects linked to internal features of developing countries are considered next in four models of the new literature on the political economy of growth. Each model addresses a different way polarization within a society can pose strong constraints on domestic and/or external investment realization.

The first piece is due to Alesina and Rodrik (1994) who view polarization as originating from income inequality. The second, in two versions by Fernandez and Rodrik (1991) and Alesina and Drazen (1991), treats polarization as originating from diversity of interests in different competing groups. Finally, Easterly and Levine (1997) treat polarization as a consequence of ethnic diversity in the developing world.

4.1. A model of polarization with income inequality

Income inequality in a country is an important aspect to be focused on when business issues are at center. Alesina and Rodrik (1994) explicitly model the perverse effects a society can experience (in terms of low economic growth) when two classes (capitalists and workers) stand to push the government to tax and redistribute income. The model they develop to show the inverse relation between economic growth and income inequality is as follows.

The aggregate increasing returns production function is:

$$y = Ak^{\alpha}g^{1-\alpha}l^{1-\alpha}, \qquad 0 < \alpha < 1, \tag{5}$$

where k and l are the aggregate stocks of capital (physical and human) and labor (raw), respectively, g is the aggregate provision of public services supplied by the government and used in private production, and A is a technological index. Clearly, the production function presents increasing returns to scale because of the presence of the government as a supplier of basic services (e.g., law and order).

Also, it is assumed that the government finances its expenditures on public services from taxing capital, i.e., $g = \tau k$, where τ is the tax rate. There is no tax on labor. Net capital and labor incomes are, respectively:

$$y_k = [r(\tau) - \tau]k \qquad \text{and} \qquad y_l = w(\tau)k. \tag{6}$$

Note that both interest rate r and wage w are (positively) affected by the tax τ – for a given level of k, higher taxes will translate in more public productive services for everybody in the economy. Since an individual can earn income from both capital and labor, we have:

$$(7) \qquad y_i = w(\tau)kl_i + [r(\tau) - \tau]k_i = w(\tau)k_i\sigma_i + [r(\tau) - \tau]k_i,$$

where $\sigma_i = l_i/[k_i/k]$, $\sigma_i \ \varepsilon\ [0, \infty)$, is the ownership share of individual i in the economy's aggregate stocks of capital and labor and $\sigma_i \neq \sigma_j$ for all individuals i, j. Here it is assumed that labor supply is inelastic, such that $l = 1$. In an equalitarian society, $\sigma_i = 1$.

Consumption is modeled by a logarithmic utility function with all nice properties for a dynamic maximization problem:

$$(8) \qquad \text{Max } U_i = \int [\log c_i]e^{-\rho t}dt$$

$$\text{Subject to } \dot{k}_i = w(\tau)k_i\sigma_i + [r(\tau) - \tau]k_i - c_i,$$

where c_i is consumption of individual i and ρ is the discount rate.

Using the standard solution method for a dynamic maximization problem, the capital and consumption growth rates are:

$$(9) \qquad \dot{k}_i/k_i = \dot{c}_i/c_i = [r(\tau) - \tau] - \rho \equiv \lambda(\tau).$$

From equation (9) we see that all individuals accumulate at the same rate and thus there is a growth rate for the economy $\lambda(\tau)$ that is independent of the initial distribution of factor endowments σ_i. Moreover, growth is positive as long as the difference between the after-tax return to capital is greater than the discount rate. The higher this difference, the greater the economy's long-run growth rate. But, the size of the tax rate plays an important role. Large magnitudes for τ is bad for growth, i.e., the size of the government intervention is inversely related to growth. This is the same result as in the *growth-cum-government* model of

Barro (1990), where for small tax rates the productivity-augmenting effect of public expenditure dominates and growth results. Here, the after-tax capital revenues increase with τ, as far as the tax rate is small. But, when τ is raised further, the after-tax return to capital starts to decrease.

The important issue government faces relates to what tax level population will support. Since both capitalists and workers earn income from capital and labor and since taxation affects capital only, the government may face pressure to raise τ in the case of a society where the majority of the population earns relatively more income from the labor source.

Using the median-voter theorem, the main result coming from the Alesina and Rodrik model is that the higher the difference between the median voter share ($\sigma_i = \sigma_m$) and the equalitarian share ($\sigma_i = 1$) in the stocks of capital and labor of the economy, the lower is the growth rate of this economy. In other words, the larger $[\sigma_m - 1]$, the more unequal is the society in terms of income distribution, and thus, the lower is the long-run growth rate. When the majority voting population receives relatively more income from labor activities, i.e., a high σ_m occurs, the pressure from this fraction of the population on the government to raise τ and then redistribute it among the less fortunate, may cause perverse consequences for economic growth. As Alesina and Rodrik (1994, pp. 477-478) state:

> For growth to be as high as possible, we need the median voter to own as much capital as possible, and to have as high an income (relative to the average) as possible. When a large segment of the electorate is cut off from the expanding and income-generating assets of the economy, it is more likely to be willing to tax income from these assets and to undercut growth.

As far as inequality in a society is due to earning income differences between two segments, such as the ones visualized by Alesina and Rodrik (1994), and majority voting rules are present, an unequalitarian society may experience retarding investments opportunities due to this type of polarization.

4.2. Two models of polarization with interest groups

In the Fernandez and Rodrik (1991) model, polarization originating from economic interest groups is the major cause preventing policy reforms. The main argument is that uncertainty about who, in a specific group, is going to face the onus of the policy change makes such change unlike to occur. For example, if a society is formed by two economic interest groups (exporters and domestic producers) and nobody knows for sure who, within the exporter group, will gain from a trade reform, then the majority can block the reform ex-ante, even if the whole society will stand to benefit ex-post. In other words, uncertainty regarding the distribution of gains and losses from policy reforms prevents governments from improving upon economic policy. The greater the uncertainty, the more acute polarization is and the smaller the government capacity to promote growth enhancing policies, and thus, business opportunities will be reduced.

Using a model to highlight the main aspects of trade policy reform in a society formed by two different types of interest groups, the relevant conclusions coming from the Fernandez and Rodrik (1991, p. 1154) model are as follows:

> … uncertainty regarding the identities of gainers and losers can prevent an efficiency-enhancing reform from being adopted, even in cases in which reform would prove quite popular after the fact… there is a bias towards the status quo… in countries like Korea, Chile, and

> Turkey, radical trade reforms introduced by autocratic regimes have not collapsed (and indeed have turned out to be popular), even though they had little support prior to reform.

Alesina and Drazen (1991), on the other hand, address the role of economic interest groups differently. They conceive conflict of interest among individuals of different groups as the cause for delaying, not preventing, reform towards better economic environment. According to them, the group who concedes first must bear the onus of the reform. If this is known in advance, each interest group tries to outwait the other, delaying policy reform, and then negatively affecting growth opportunities.

These authors model a situation where a country facing a large budget deficit needs to implement a restrictive fiscal policy under a stabilization program. Although everybody agrees that the reform is necessary, no interest group individual knows exactly how the onus of the policy reform is to be shared. As posed by Alesina and Drazen (1991, pp. 1170-1171):

> … even though it is agreed that stabilization requires a change in fiscal policy to eliminate budget deficits, there may be disagreement about how the burden of the policy change is to be shared. When socioeconomic groups perceive the possibility of shifting this burden elsewhere, each group may attempt to wait the others out. This war of attrition ends, and a stabilization is enacted, when certain groups "concede" and allow their political opponents to decide on the allocation of the burden of the fiscal adjustment. Concession may occur via legislative agreement, electoral outcomes, or ceding power of decree to policy-makers… if it is the poor who suffer most in the prestabilization period, they bear the largest share of the costs of stabilization.

In the above two models, polarization is accessed via war of attrition among interest groups with the resultant policy reform delay, and/or uncertainty about gainers and losers from policy changes may prevent policy reform. In both cases, it is of crucial importance to understand the internal struggles among different groups or classes a society faces. Looking at these features is important to understand growth collapses in poor countries, and thus, poor conditions regarding FDI opportunities in these countries.

4.3. A model of polarization with ethnic diversity: Africa’s tragedy

Another possibility to address societal polarization is via ethnic diversity. Easterly and Levine (1997) evidence a strong positive correlation between ethnic fragmentation and poor-growth policy implementation. They claim that the existence of ethnic divisions in a country adversely affect economic activities through poor choices and display Africa’s tragedy in three decades (1960s, 1970s and 1980s) as empirical evidence supporting the arguments linked to ethno-linguistic diversity.

Despite their empirical exercise focuses on Africa, the overall prospects can be generally conceived. The main findings are twofold. First, ethnic fragmentation encourages the adoption of poor-growth policies. Second, ethnic divisions prevent the emergence of consensus for growth-enhancing public goods provision. These two perverse consequences of ethnic diversity on provision of infrastructure in a given country are stronger than the direct impact of ethnic fragmentation on growth itself. Both adversely affect the opportunities for FDI realization in the developing world.

Ethnic diversity is measured by linguistic heterogeneity, defined as the fraction of a population who speaks a non-official language at home. In countries in Africa this fraction is above 90%. The conclusions from Easterly and Levine (1997, p. 1241) are as follows:

> Africa's poor growth – and resulting low income – is associated with low schooling, political instability, underdeveloped financial systems, distorted foreign exchange markets, high government deficits, and insufficient infrastructure. High ethnic diversity is closely associated with low schooling, underdeveloped financial systems, distorted foreign exchange markets, and insufficient infrastructure. While motivated by Africa, these results are not particular to Africa… The results lend support to theories that interest group polarization leads to rent-seeking behavior and reduces the consensus for public goods (and sound policy choices), creating long-run growth tragedies.

5. The new growth-development theories and implications to FDI opportunities

After having summarized several new political economy growth and development models, considering the core aspects of social-political-institutional arrangements and their implications to FDI opportunities in the developing world, we can propose a general outline.

The main purpose is not to provide a guide applicable everywhere in the developing world. It is a simpler one: to list several aspects related to political-institutional features in poor countries said to be crucial to be looked at when foreign investments opportunities are considered in the developing world. It is conjectured that any attempt aimed to evaluate these opportunities, via looking at the institutional-social-economic-political features embodied in the theoretical models analyzed, must take into account the proceeds given below.

Observation of the internal characteristics of a wide range of undeveloped countries worldwide, as advanced by the new political economy of growth and the development literature presented, is a number one priority. Based on the main tenets of the theoretical models analyzed above, and have in mind the international business country risk empirical literature, we can list the following, as of fundamental importance for evaluating FDI opportunities in the developing world:

i) Income inequality and its related consequences. Developing countries with high levels of income and wealth inequality may not be able to escape from poverty traps, and thus, FDI opportunities may be low. Redistribution may be envisioned first, even if it brings lower foreign business opportunities in the short-run;

ii) Internal attrition of interest groups in specific economic activities must be understood in advance of any attempt to decide applying foreign business resources in a given activity. If this is not the case, investments can be unrealized, or if implemented, shown unprofitable;

iii) Countries facing ethno-linguistic fragmentation must envision mechanisms to conciliate diverse demands and objectives. If public infrastructure is been poorly supplied because of ethnic diversity, governments must find a way out of the problems to allow better FDI opportunities;

iv) Corruption schemes, poor socio-institutional arrangements, all must be given special attention before any attempts to conduct investments in poor countries are tried. Coalitions formation blocking such poor institutional arrangements, may translate in an important source of improvements for business environment in the developing world.

Under this perspective, we can make use of the key tenets of these pieces of literature in order to highlight the most important variables said to be crucial in fostering economic activities that are investment augmenting in undeveloped countries.

Also, it should be said that not all of the poor arrangements present in undeveloped countries worldwide, many of which the new growth-development literature brings to our knowledge, need to be completely eliminated in order to have better investment opportunities in the developing world. If this were the case, the undeveloped world would be seen as futureless – there is no way to totally eliminate all the problems related to poverty worldwide. The conjecture here is that we must take into account the cited problems when visualizing

FDI opportunities in those countries, having as support the two branches of literature (the new growth and development theories) and their connections to the record coming from the country risk empirics.

Final considerations

The main conclusion is that the prospects of the new political economy of growth and the new development literature can be conceived as important theoretical pieces aimed to base analyses concerning FDI realization in developing countries. It was seen that several political-institutional features, closely related to the constraints advanced by the new models investigated, are of importance to evaluate investments opportunities in poor countries.

Also, a general outline is proposed with a list of features said to be of crucial importance to base decisions to conduct business in developing countries. It was shown that looking at the characteristics included in the prospects of the new growth-development theories, with care attention to the specific internal social-political-institutional record of a certain developing country, is a relevant way to understand and foster FDI flows to the developing world, a venture contemplated by the international business country risk literature.

Despite the relevance of these separated contributions, a link connecting them is still missing. In the country risk empirics, flows of FDI are shown to be negative and significantly correlated to political instability, high levels of corruption and ethnic tensions, as well as institutional weaknesses related to unimplemented or delayed reforms, all of which the new growth-development theories investigated have elected as important variables to study underdevelopment in poor countries. As its main contribution, this article aims to bridge the two sides by summarizing part of the new growth-development literature and connecting it to the international business country risk empirical record.

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