

## **Export-Enclave Economies, International Corporations, and Development**

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The allure of export-oriented industrialization may yet prove irresistible to small underdeveloped nations (UDNs). The apparent success of the "Gang of Four"—Taiwan, Singapore, Hong Kong, and South Korea—in following such a strategy suggests to many a development model with more generally applicable implications. The reduction of tariffs under the successive rounds of the General Agreement on Tariffs and Trade and the Generalized System of Preferences seem to validate this approach through the widening of markets for exports. Additionally, for those eligible countries, the Caribbean Basin Initiative passed by the U.S. Congress in 1983, with its twelve-year free access to the U.S. market (with some important exceptions), only seems to further confirm the wisdom of small, poor UDNs with low wages exploiting whatever export advantage they may have vis-à-vis other producers.

### ***Small Economies and Export-Oriented Development***

When international corporations (ICs) began to produce manufactured goods on an expanded scale in the larger underdeveloped countries

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in Latin America during the 1950s, this often was the result of a calculated step by their national governments to further the process of import substitution industrialization (ISI) begun in the 1930s. Such ISI, it was believed, would permit UDNs to skip their own industrial revolutions; foreign ICs, on the other hand, would be attracted by the promise of protected internal markets and high profits. Nations with relatively small markets, however, were generally outside this process. Except for those countries with mineral deposits, what now attracts ICs to small UDNs are not markets, but a relatively cheap and docile labor force, complemented by attractive tax and export incentives and other fiscal subsidies that reduce the cost of capital. The potential gains from such foreign investment—access to technology, labor and management training, new markets—are real. But what are the dangers of this strategy in which small nations promote foreign IC investment directed toward export production?

*The Structure of the Vertically Integrated IC.* Sanjaya Lall has identified four bases upon which export-oriented ICs have emerged.<sup>1</sup> Of these, the two bases upon which an IC is most likely to locate in small UDNs result in production processes that are *location nonspecific*, with the main IC motive for locating a subsidiary being low per unit labor costs. The national goal justifying the pursuit of such an export-oriented strategy is not only to provide employment and income but to forge an environment in which local supplying and other spin-off industries will be able to link with the foreign ICs and among themselves. Export ICs are to be the “starter” for the growth of an indigenous manufacturing sector with even greater employment and income effects. For this to occur, however, the export-oriented ICs must be *structurally* open to the linkages this strategy envisions. If they are not, then the export platform will begin as and remain an enclave disarticulated from the other economic sectors of the local economy. What the local economy provides is cheap labor power and an attractive investment climate, both of which contribute to higher levels of profitability for the IC without substantially improving the probability that a locally directed growth process will be initiated in the UDN.

The vertically integrated ICs that small economies are able to attract maintain established and risk-reducing worldwide sourcing and distribution networks involving transfers and sales of inputs, semi-processed goods, and final products among far-flung subsidiaries of the IC itself. These networks are quite difficult to penetrate, particularly by new firms and entrepreneurs with limited experience in dealing with the immense corporate structures characteristic of the IC. Even when there is sufficient knowhow, the IC is not always ready to admit linkages with its subsidi-

aries, particularly when doing so increases the exposure of the IC to local instability or, more likely, because in small economies the difficulty of attaining scale economies may raise the cost of inputs above that of own-supply, not to mention that such linkages would be equivalent to abetting the creation of competition for one's own intermediate products.<sup>2</sup> Only in special circumstances will an IC assent to such linkages as will interfere with its meta-national profit interests. As a consequence, the dynamic GNP multiplier from such IC investment can be expected to be quite small. To the extent that export-platform promotion is an important component of a country's overall development strategy, even wages paid will have a reduced multiplier effect, being lower the more successful the promotion of exporting industries, especially when this results in the need for greater imports of consumption goods because of the decline of agriculture likely to accompany such a strategy.

The structure of the international production process of the export-oriented IC locating in a small UDN can be shown by the circuit of capital in Figure 1.<sup>3</sup>

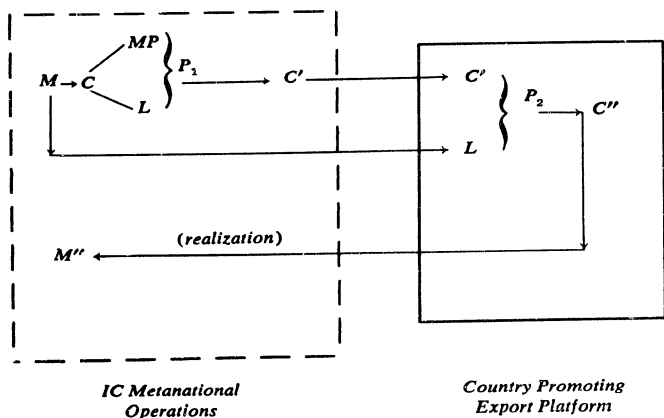


Figure 1.

*Circuit of Capital: Vertically Integrated, Export-Enclave Production.*

The production process is initiated outside the country in which the export subsidiary of the IC is located. Money capital ( $M$ ) is used to purchase produced means of production and raw materials ( $MP$ ) and labor ( $L$ ), for the first stage of the production ( $P_1$ ). From this comes a partially transformed output or new means of production ( $C'$ ) with a value (as yet unrealized) greater than the initial outlay,  $M$ . With the completion of the first stage of production,  $C'$  is shipped by the IC to its export subsidiary in the small, export-platform economy. There the semi-processed product is combined in the local production process ( $P_2$ ) with cheap labor power. The subsidiary of the IC produces final (or partially assembled) commodities,  $C''$ , which then are reexported, their value to be realized and their profit accumulated not in the export-oriented economy but within the meta-national structure of the IC. Production ( $P = P_1 + P_2$ ) and realization are completed and terminated only on an international scale in which many individual subsidiaries in widely scattered locations ultimately may participate.  $C'' > C' > C$  and  $M'' > M$ , where the difference,  $M'' - M = S$ , is the gross level of profits.

Structurally articulated *internally* with its own subsidiaries, and already linked to established sourcing and distribution networks, the export-oriented IC subsidiary in a small UDN is sectorally and structurally disarticulated with the local economic structure. The local economy is but a production point—and then for only a fragment ( $P_2$ ) of the complete production process—and a source of cheap labor to the IC. The manufacturing export-platform economy provides but a convenient physical location, albeit one that is frequently quite profitable to the IC. It is this *nonspecific locational bias* of the manufacturing export IC, as opposed to the *location specific* nature of mining ICs, for example, which results in local governments having little leverage when attempting to pressure an IC to create or permit backward linkages when they do not emerge spontaneously.

Further, export-platform strategies may create only the *appearance* of industrialization and development, without the substance. The location of the  $P_2$  phase of production by ICs in a UDN will almost always contribute to a higher GDP, though the *net* contribution of such production will be less than the gross addition to GDP to the degree that local industry and agriculture are adversely affected. The contribution of the IC to GNP will be less than its contribution to GDP by the level of repatriated profits, interest, and dividends, and more properly can be measured by the net impact on labor's share of GNP. Yet even the best, adjusted macro measures of the contribution of manufacturing-export IC production to

GNP will overstate its impact on the local economy: since the  $P_2$  process of the IC subsidiary is not location-specific, it can be transferred to another more hospitable country relatively easily by these "footloose" ICs, though obviously not without cost.<sup>4</sup> The transitory nature of such production will never be revealed in national income accounts, and the much too common acceptance of gross financial revenues as measuring real structural change is a profound and disturbing error. Nor is such enclave development likely to contribute to the breakdown of stultifying and regressive class structures or to the greater capitalization of production that is so much in need if workers and entrepreneurs are ever to escape from the low productivity informal sector and agriculture. Enclave ICs cannot contribute to the expansion of the "industrial arts" in small UDNs in a dynamic process of creative destruction that breaks down restraining internal barriers to progress, at least partly because it is in the interest of the ICs to maintain the low-wage sector.<sup>5</sup> Consumption, it is true, may rise but only as an industrial welfare economy is created based on wage expenditures internal to the IC.

*Export Promotion, Industrial Linkages, and Foreign Exchange.* While there are those who argue against foreign investment in general,<sup>6</sup> the actual record of benefits and costs from ICs is mixed. This does not mean, however, that the impact of the IC is a random event; there are lessons to be drawn. The previous section suggested, and empirical analysis generally verifies, that though backward linkages in nonlocation-specific IC subsidiaries are less probable,<sup>7</sup> this does not mean such linkages never occur or that they will not be tolerated by ICs. It is clear, though, that *market-determined linkages* are substantially less likely to be created than *institutionally determined linkages*. This refers not only to the oft-forgotten fact that Albert Hirschman's original description of selecting industries with the greatest linkage possibilities never implied that linkages automatically would appear, but more fundamentally that those intersectoral linkages that *are* forged will be dependent upon a complex of institutions and institutionally determined factors particular to each country, from the level of education, skills, and unionization of the labor force, to the degree of financial articulation and intermediation, to state policy on income redistribution, to the nature of fiscal incentives provided to ICs, to the overall degree and sophistication of state planning, to the strength of external forces. Few, if any, of these factors are strictly technological in nature or are they likely to be revealed in an input-output table showing linkage effects.<sup>8</sup>

A recent study of Singapore, for example, which purports to show that

market-determined (or better, IC-determined) linkages can emerge spontaneously, actually demonstrates that foreign ICs permitted vertical linkages because of particular institutional conditions which, Ayres might argue, were not in conflict with industrial advance: a well-developed infrastructure; long-term political and economic stability; a well-trained and scarce, not redundant, labor force, which has reduced tensions created by unemployment and poverty elsewhere.<sup>9</sup> But these surely are not the conditions characteristic of small UDNs in general. Experience in other countries such as Brazil suggests that backward linkages have been determined by conscious public policy that creates the institutionally determined conditions for their emergence and have been weakest, as in Argentina, when the market was left to itself.<sup>10</sup> The prognosis, then, for backward linkages emerging spontaneously to any degree as a result of market forces or IC initiative or permissiveness seems singularly slim for most small UDNs. The exceptions, such as Singapore, should not be paraded as the rule.<sup>11</sup>

Another consideration important to a small UDN is the impact on foreign exchange reserves of an export-oriented IC drive. Such a strategy may not be a net foreign exchange earner when intermediate good requirements and all *sectoral substitution effects* are taken into account. The need for foreign exchange for imports of intermediate goods to the ICs is unambiguous and obvious. However, it also is likely that ICs paying higher than average wages will attract workers from other sectors, particularly agriculture, reducing local output and requiring larger imports of food, thus drawing-down foreign exchange reserves. In addition, state promotion of the foreign export sector probably will result in a shift of public investment away from agriculture, further contributing to the decline of output and employment and creating push forces that reinforce the pull forces of expected higher wages in the export sector (which together will expand the informal urban sector and worker marginalization).

Further, if ICs are successful, profits, interest, service contract payments, royalties, and other disguised forms of profit-taking will contribute to a stream of repatriated returns from the UDN to be recorded on the books of the parent IC (or elsewhere within the meta-national structure of the IC), further reducing the gains from the export strategy. Thus though the promoted export sector certainly will generate foreign exchange for the UDN, it is not at all certain that there will be a net gain when profit repatriation, the import requirements of the IC, and sectoral substitution and other external effects are taken fully into consideration.

If the state must borrow externally to finance its IC promotional activities or to provide the necessary infrastructure, the foreign exchange gains will be even less, or the loss greater, and the expansion of this debt also should be reckoned as a cost of the export strategy.

*Export Enclave ICs and the "Open" Economy.* A further, mostly unexplored issue is the impact of vertically integrated export ICs on the effectiveness of state economic policy and, ultimately, on national sovereignty. Open economies, particularly those with underdeveloped financial institutions and incomplete market structures, function in ways considerably different from what the conventional wisdom posits. A "successful" export strategy will depend upon reduced (or no) tariffs on imported inputs and reduced tariffs (or even subsidies) on exports. Foreign borrowing may be required as a result of balance of payments problems created by import requirements and profit outflows, and to finance state expenditures. Barriers to the movement of financial and physical capital resources will need to be liberalized. The impact of this opening of the economy, however, not only increases the sensitivity of the local economy to external forces, but it also reduces the effectiveness of national economic policy.

For example, monetary policy becomes increasingly problematic in open economies with fixed exchange rates. While the money supply is always endogeneously determined, in a small open economy, external capital flows and foreign borrowing enter into the determination of the growth of the monetary base in ways very different than for closed economies or even large open economies.<sup>12</sup> In small UDNs with undeveloped, or better, informal capital markets, the ability of the monetary authorities to carry out their policies will be affected by the size of net capital inflows and by foreign borrowing by private and public bodies. Things are no better with a regime of floating exchange rates: then it is fiscal policy that becomes ineffective. And the more open an economy, the purer these effects.

The empirical evidence from countries like Chile, which moved rapidly to open its economy after 1973, does not instill much confidence in the gains to be made from greater openness coupled with underdeveloped markets and financial institutions, weak taxing systems, and other institutional barriers inimical to the spread of industrial relations and capitalist-oriented behavior. The benefits of openness are fundamentally based on the theory of comparative advantage and its extensions, which, in theory and practice, leave each country/participant as but a passive recipient of "market forces." Interference with such forces by any one

country, it is true, can result in greater gains for the "violator" than the free trade, free capital-flow outcome. But an attempt by all countries to reap such gains will result, it is claimed, in a welfare loss to all.

It is not clear what all this has to do with real-world small UDNs with a limited range of tradeable goods that encourage foreign ICs to establish production units to exploit their low-wage "comparative advantage." The traditional trade-theory view, by focusing on macro aggregates like the level of GDP and gross exports and imports, encourages the facile conclusion that more output means greater welfare and production and consumption possibilities for *individual* countries. When vertically integrated, and often closed, ICs are increasingly important to world production, it is in fact IC production possibilities that expand, not those of individual UDNs. For the small UDN serving as but a physical location for the  $P_2$  segment of the IC export production process, the productive structure of the economy actually may have deteriorated rather than expanded with the export strategy due to sectoral substitution. What exists is but a fragile, financially based export sector grounded in the internal dynamics of the meta-national structure of the IC, and not an industrially based productive structure in the UDN. Take away the supposed comparative advantage of the low-wage host, and what is left by the departing IC is worse than the hole in the ground left by an exiting mineral exporting IC. In the latter case, if the IC closes, at least the mineral resource remains to be exploited. Without doubt it is difficult for a country to mobilize its own resources to profit from such a pull-out and move forward to local production and, ideally, an integrated, articulated and linked industrial structure, but at least that becomes possible once the vertically integrated structure of the IC no longer acts as a barrier to the extension of such local industrialization.

In contrast, if an export-manufacturing IC liquidates its subsidiary it leaves behind virtually nothing, and the fewer the linkages that had appeared, the greater the vacuum. Even if physical capital were to be left behind, its usefulness without the inputs from the  $P_1$  production phase provided by the IC may be very nearly zero. The  $P_2$  production stage, once cut from its lifeline to the IC, has sufficient local articulation to supply it; it ceases to function. The growing GNP and GDP created by the insertion of the IC subsidiary into the local economy are revealed to be the transitory phenomena they always were. To the extent that other manufacturing and agriculture were neglected to pursue export promotion, the exit of a number of firms can be potentially devastating to local income and employment. The important point, however, is that this possibility was always latent in the premise of such export promotion itself.



Dependence on export subsidiaries of ICs for GNP and employment generation creates an economic structure without a foundation. It creates but the appearance of growth and development of the forces of production—particularly when economists do not look beyond GNP and manufacturing's share in GNP—that is not evident when the actual level of local disarticulation is properly perceived. The vertically integrated IC is not inherently conducive to local articulation. Further, the open economy/comparative advantage strategy suggests that solutions to the poverty of the UDN lie outside the country in external sources of capital and technology, thus downplaying the crucial necessity for internal social and institutional change and transition, by falsely suggesting that the power of market forces, themselves manipulated by the ICs, will break down internal barriers to progress. As Clarence Ayres stated, to believe that is to have learned nothing from history.<sup>13</sup>

#### Notes

1. Sanjaya Lall, "Transnationals, Domestic Enterprise, and Industrial Structure in Host LDCs: A Survey," *Oxford Economic Papers* 30 (July 1978): 215-48.
2. The U.S. Tariff Code (Items 806.30 and 807.00), which taxes foreign-originated production using U.S.-made components only on its value-added, also discourages local sourcing, as do free trade zones.
3. This is an extension of the work of Christian Palloix, "The Internationalization of Capital and the Circuit of Social Capital," in *International Firms and Modern Imperialism*, ed. H. Radice, pp. 63-88 (Baltimore, Md.: Penguin Books, 1975).
4. Richard E. Caves, *Multinational Enterprises and Economic Analysis* (Cambridge: Cambridge University Press, 1983), pp. 20-21, 255-57, 271; Deepak Nayyar, "Transnational Corporations and Manufactured Exports from Poor Countries," *Economic Journal* 88 (March 1978): 59-84.
5. C. E. Ayres, *The Theory of Economic Progress*, 2d ed. (New York: Schocken Books, 1962), pp. xii, 200-201.
6. José A. Mendez, "Immiserisation and the Emergence of Multinational Firms in a Less Developed Country: A General Equilibrium Analysis," *The Journal of Development Studies* 20 (October 1983): 23-33. Also see Gustav Ranis, "Challenges and Opportunities Posed by Asia's Super-exporters: Implications for Manufactured Exports in Latin America," *Quarterly Review of Economics and Business* 21 (Summer 1981): 204-26, which suggests that in Latin America the skipping of stages of economic evolution has negatively affected the labor force and technological transfer and adaptation, at least partly as a result of excessive reliance on foreign capital (pp. 215-16).
7. Lall, "Transnationals, Domestic Enterprise, and Industrial Structure";

- Linda Y. C. Lim and Pang Eng Fong, "Vertical Linkages and Multinational Enterprises in Developing Countries," *World Development* 10 (July 1982): 585-95.
8. K. N. Raj, "Linkages in Industrialization and Development Strategy: Some Basic Issues," in *Industrialization and Development: A Third World Perspective*, ed. P. K. Ghosh, pp. 65-84 (Westport, Conn.: Greenwood Press, 1984).
  9. Lim and Fong, "Vertical Linkages and Multinational Enterprises."
  10. R. Kronish and K. S. Mericle, eds., *The Political Economy of the Latin American Motor Vehicle Industry* (Cambridge, Mass.: The MIT Press, 1984).
  11. "How can institutional obstacles be weakened or removed? Not, obviously, by letting things alone! To suppose that in any given area or period technology must inevitably prevail is contrary to both the instrumental logic and to all that we know of history." Ayres, *The Theory of Economic Progress*, p. 250.
  12. See, for example, Rudiger Dornbusch, *Open Economy Macroeconomics* (New York: Basic Books, 1981) or John Williamson, *The Open Economy and the World Economy* (New York: Basic Books, 1983).
  13. The Puerto Rican experience, wholly dependent upon export-oriented development, ought to be one that small countries contemplating an export strategy examine closely; see Dietz, "Puerto Rico in the 1970s and 1980s: Crisis of the Development Model," *Journal of Economic Issues* 16 (June 1982): 497-506, and *Economic History of Puerto Rico* (Princeton: Princeton University Press, 1985), chap. 5.