# Over-Reliance on Foreign Investment Leads to Negative Results

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**Abstract.** Developmental states in East Asia and Southeast Asia are accustomed to relying on foreign investment frequently for industrialization. It is crucial to understand whether foreign investment contributes to the economic stability and industrialization process of these developmental states. This study focuses on the consequences of over-reliance on foreign investment in developing countries. Through case studies such as Thailand and the definition of developmental states by Leftwich and Wade, this paper finds that excessive reliance on foreign investment will deepen the financial crisis. At the same time, foreign capital cannot provide effective help to developmental states to overcome the difficulties. From the political economy perspective, the dual role played by the state and institutional flaws makes developmental states increasingly dependent on foreign investment. The main findings of this paper show that excessive reliance on foreign investment will weaken the initial positive role of the developmental states in the economic field, resulting in improper resource allocation and corruption. To sum up, although the developmental state model initially promoted the development of industrialization, over-reliance on foreign investment made it difficult for the developmental state to adapt to post-industrialization and financialization.

**Keywords:** developmental states, foreign investment, political economy

## 1 Introduction

Countries in East Asia and Southeast Asia that focus on economic development are called developmental states. According to Leftwich (1995), developmental states need to rely on numerous foreign aids or loads. And it requires a relatively independent economic bureaucracy. Wade (2010) held the view that the state and enterprises need to be balanced and also need service-minded officials to promote the developmental state into a virtuous cycle. The thesis statement is that over-reliance on foreign investment leads to the positive role of developmental state becoming weaker.

The first part of this paper is about the process of how the advantages turn into disadvantages when the developmental state depends on foreign investment. The second part of analysis, from the point of political economy, is about the causes of excessive dependence on foreign investment. Meanwhile it has been explained why it violated


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the reasonable assumptions. This paper also explores whether good governance can meet the above assumptions [20]. Finally, a reflection was given on reliance on foreign investment.

# 2 The Changing Role of Foreign Investment

## 2.1 Economic Policies to Attract Foreign Investment

A developmental state refers to a country whose overall development direction and policy formulation revolve around the keyword "development" [11]. Export-oriented economic policy is one of the core strategies of the developmental state [5]. After World War II, East Asian countries used the development-oriented development model to create many economic development miracles [5]. Unlike Western countries, Asian countries lack sufficient capital, have obvious labor market segmentation and abundant surplus labor [19], and therefore can only rely on sufficient labor and land to attract foreign investment and develop labor-intensive manufacturing industries. According to flying geese theory [4], these countries benefit from the drawback advantages as they don't need to bear the risk of renewing technology and systems. What they only need is to create an opening investment environment, then they can receive the mature support of sharing technology and funds. Singapore is a good illustration. They have no threshold set by the government for foreign investors, but they do provide a series of non-inflation initiatives owing to few local entrepreneurs. This helps the People's Action Party realize the transition to a capital-intensive economy [5]. The Washington Consensus points out that foreign investment is an important factor in a country's economic growth, and believes that the more foreign investment there is, the more beneficial it is to economic development, especially in the case of a lack of funds like a developing country [20].

## 2.2 Disadvantages of Over-Dependence on Foreign Investment

But the foreign investment is not the more the better. Research shows that foreign direct investment has a positive impact on developed economic sectors and a negative impact on developmental states [2]. Firstly, over-reliance on foreign capital will disturb stable development in the domestic market, leading to a financial crisis. Based on Lewis's labor market dualism, Ricci (2019) argues that rising wages encourage labor to move from rural areas to urban areas. The agricultural surplus population gradually will gets into the industry field to make labor costs rise as a result. Finally, it reaches the Lewis turning point, which expands the disadvantage of relying on foreign investment. To relieve the double pressure—labor costs and production costs, corporations need to continue expanding production and increase productivity. Therefore, domestic savings were not enough as usual. The bank started to accumulate funds through international short-term loans. To maintain the fake stability of the bully market, banks have to reduce providing loans to small and medium enterprises, which makes enterprises fire the labor. People who lost their jobs realized it was not safe to put savings in the bank, so they withdrew deposits. Adding the pressure of nonperforming loans, capital has reversed. Finally, the central bank collapsed and triggered an Asian financial crisis.

Secondly, the assistance of foreign investment is not completely helpful when the enterprises face an economic crisis. Both Thailand and Indonesia used to seek help from the IMF. However, there was an unhealthy coordination between the government and the IMF, such as take austerity policies, reduce social welfare, which lead to a prolonged and deepened economic recession [4]. At the same time, developing states are more vulnerable to economic turmoil in developed regions, such as the 2008 global financial crisis that originated in the United States [15]. Foreign investment not only fails to provide help at this time, but also exacerbates the economic vulnerability of the region [15].

## 3 Root Causes of Dependence on Foreign Investment

### 3.1 Dual Government Reduces Economic Efficiency

The state is the policymaker and also the actor in economic activities [21]. The two roles of the state may cause more need for foreign assistance as enterprises will lose the ability to innovate. Connect political returns and economic management may affect the effectiveness of the system [20]. In China, the Party appoints the lead managers of the state-owned enterprises, while the government is also constrained by these enterprises [6]. In this regard, it shows that the government has always provided assistance to help enterprises use existing advantages instead of creating comparative advantages [20]. Consequently, those enterprises are unable to create unique advantages. They can only rely on the help of the state and foreign investment. On the other hand, the dual role can result in corruption. The interaction between the leaders of private enterprises and government officials will not only change the direction of policies [21], but also worsen the effect of supervision, which makes the boundaries between the state and enterprises unclear [3]. So, it will be difficult for the economic bureaucracy to become independent. This breaks Leftwich's assumption about developmental state that “the economy bureaucracy should insulate and not penetrate”.

The state’s preference for large enterprises is a significant driving factor in becoming more dependent on foreign investments. Wade (2010) indicated that the cooperation method of “state-business alliance" might form a positive development circle. However, he overlooked the importance of the domestic market vertical. The resources are concentrated by the state on those large or state-owned enterprises. Therefore, state-owned enterprises have an increasing influence on the country's overall economic support [14], which has led to these enterprises gradually occupying a monopoly position. This results in the market being flooded with more incomplete information. While small and medium-sized enterprises (SMES) increase their R&D costs [9], their competitiveness gradually declines. As overcapacity accumulates, SMES are marginalized. For example, state-owned enterprises play the leading role in China. Therefore, SMES cannot participate in the infrastructure construction industry like railroads [6]. It will be a heavy blow to enterprise vitality because of the management of limiting the production of local intermediate industries, which will also damage the whole industry's continuity in the domestic market [20]. The competition motivation and innovation ability will be affected too, causing the local enterprises to decrease. This kind of unreasonable distribution of resources will make the domestic market rely on foreign technology and funds even more.

### 3.2 Monopolies in Imperfect Systems Exacerbate Systemic Crisis

Wade (2010) argues that the systemic crisis is one of the contributing factors to economic difficulties. For instance, the case of private bankers in Thailand can affect policy-making up to their own preferences by penetrating government systems [21]. A defective institutional design breaks the assumption that "the state and the firms should be balanced." This can be illustrated briefly by the elite group in the Philippines or South Korean’s chaebols. For example, the South Korean government refused to provide assistance to bankrupt companies and instead imposed severe punishments [13]. SMES attempts to challenge the government stem from using monopolies to influence the government. Government officials will draft political decisions that don't meet the overall requirements of national development. This also breaks the assumption that “public officials should have service consciousness [20]”. In summary, government management capacity is positively correlated with economic development level [1], imperfect institutional design increases the reliance on foreign investment, thus bringing about a weaker positive role in developmental state.

### 3.3 Whether a Clean and Efficient Government can Mitigate the Crisis

The question is whether a clean and efficient government can help development state to meet the above assumptions or not. Wade (2010) offered a negative answer. He believes that the evaluation of national capacity depends on that of foreign businessmen in a great degree. And they will practise evaluation in accordance with their self- interests and preferences [20]. Multinational corporations often propose regulations that benefit themselves [10]. To make them satisfied, the officials of the state need to have a sense to serve foreign businessmen, so they cannot really consider the interests of their own country. The flexibility of foreign investors can do business well is an important criterion for evaluation [8], which forces the state to rely on foreign capital. The result is that innovation ability is consumed, which makes the country be vulnerable to the middle-income trap [20]. When a country is restricted by interest groups, problems such as waste of resources and economic inefficiency will occur [7]. The rigidity of the industrial structure will inevitably result in the imbalance between the state and the enterprise. This situation will affect the governance capacity of the government and reduce the independence of the economic bureaucracy.

## 4 Reflection

In 1997, South Korea borrowed $58 billion from the IMF, the largest loan in the history of the IMF [12]. Although South Korea has tried its best to avoid heavy reliance on foreign capital in its policy orientation [17], it still suffered huge losses due to systemic defects in its financial sector. The financial crisis showed that East Asia's model of reliance on foreign capital has inherent flaws [17], but it also reflects the problem of poor management of enterprises and banks [16]. This shows that even without excessive participation of foreign capital, Asia will still face economic crises due to imperfect financial systems and flawed national governance.

According to the latest report of the United Nations Trade and Development 2024, the amount of foreign investment flowing into ASEAN has increased significantly in the past decade [18]. This is closely related to the promotion of regional integration. This also shows that formulating clearer investment rules and regulating the domestic business environment will help foreign investment to realize its original value.

## 5 Conclusion

The focus of this paper is put on the point of excessive dependence on foreign investment in developmental states. From the view of political power, it explains why the foreign capital stimulated the economy in the early days but gradually transferred into a negative trend. It also proves this fact by questioning the assumptions about developmental state that were proposed by Leftwich and Wade.

It's undeniable that the mode of developmental state indeed can support a country to realize industrialization, from light industries to heavy industries. However, it is unable to adapt to the development of post-industrialization due to its inner conflicts of interest. Therefore, the model of developmental state will eventually turn negative.

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