FOREIGN INVESTMENT AND LABOUR-INTENSIVE INDUSTRIES

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I

Basically one can distinguish three kinds of foreign private direct investment, namely natural resource-oriented investment, market-oriented investment, and labour-oriented investment. Natural resource-oriented investment is undertaken with a view towards exploiting the natural resources of the host country, while market-oriented investment is carried out primarily with the aim of capturing the domestic market of the host country. On the other hand, labour-oriented investment is mainly motivated by the availability of abundant and cheap labour in the host country. However, the distinction between these three kinds of foreign investment is not watertight, since labour-oriented investment might also be stimulated by the lure of a potentially big market in the host country.

This paper intends to discuss some of the ways in which foreign investment, particularly of the labour-oriented variety, might assist in solving the unemployment problem in Indonesia. To that end, some recent developments in the world economy favorable to the establishment of labour-intensive industries in Indonesia will be reviewed as well as some of the policies Indonesia might adopt in order to lure such industries to Indonesia.

II

The one development favoring a rise in labour-oriented investment in Southeast Asia, including Indonesia, has been the labour shortage

problem which the Japanese economy has been confronted with to an increasing degree since the early sixties. As labour has grown increasingly scarce in the booming Japanese economy, wages of the Japanese workers have steadily risen over the past few years, thus rapidly narrowing the still existing wage differential with the industrialized countries in the West. With no reasonable prospect of the labour shortage problem being alleviated in the near future, it is expected that by 1980 the Japanese worker will enjoy a 35-hour, five day working week, and wages about four times as high as their present level[1].

Faced with rapidly rising wage levels Japanese industries particularly the labour-intensive industries, are steadily losing their comparative advantage in their own country, and thus have a strong incentive to relocate the sites of production to developing labour-abundant countries where lower wage levels prevail, such as Indonesia. Having accumulated huge foreign exchange reserves since 1968, Japan does not have only the motive but also the capacity to undertake foreign investment on a large scale in developed and developing countries alike.

With an increasingly serious unemployment problem on its hands, Indonesia would do well to take advantage of this situation and attract labour-oriented investment to its shores. By giving priority to labour-intensive industries, a growth pattern could ensue which would be more in line with Indonesia's factor endowments, i.e. labour abundance (notably in Java) and capital scarcity. By providing employment opportunities in these labour-intensive industries, Indonesia might have both higher growth (in GNP) *and* higher employment. Insofar as Indonesia's poverty problem is also to a large extent attributable to unemployment and underemployment, providing employment in labour-intensive lines of production would therefore mean a step in the right direction of a more equal distribution of income. Taiwan's experience shows that with judicious policies a developing country might achieve all the three desirable goals of more output, higher employment, and a more equal distribution of income. Moreover, many of these labour-intensive industries also turn out products geared to the domestic mass market rather than only to the high-income groups. So in this way

1 Kiyoshi Kojima: "Reorganization of North-South Trade: Japanese Foreign Economic Policy for the 1970s", *Hitotsubashi Journal of Economics*, Vol. 13, No. 2, February 1973, p. 4.

too a growth path would be taken which would really benefit the masses and not only the small privileged high-income groups.

In addition, preference should be given to labour-intensive industries which would have a real or potential comparative advantage in export markets abroad. In that way these industries would not only contribute to raising output and providing employment, but would also through exports be earning valuable foreign exchange. In fact, in addition to the magnitude of output, redistribution, and employment effects, the possibility of earning foreign exchange through exports of its products would have to be one of the prime criteria in assessing whether a specific foreign investment venture would have to be accepted or not. In short, we agree with Kojima that in general foreign investment would have to be *'trade-oriented'* in the sense that the establishment of these foreign ventures would have to stimulate increased trade flows between the investing and host countries in line with the development of new envolving comparative advantages in both the investing as well as host countries[1].

III

As mentioned earlier, Japan has for some time been experiencing a labour shortage problem which she, unlike the Western European countries, is unwilling to solve by importing cheap labour from abroad. In view of this popular resistance against importing foreign labour, the other possible alternative for Japan would be to contract her increasingly less competitive labour-intensive industries and transfer them to neighbouring labour-surplus and low-wage countries in Southeast Asia, such as Indonesia. This Japan has already been doing for some time and will increasingly do so, as is evident from a projection of Japan's overseas investments by the Japan Economic Research Center. For instance, in 1969 Japanese labour- and market-oriented investment overseas amounted to US$ 620 million, while for the year 1980 this amount is expected to rise to US$ 7.148 million[2]. These figures indicate that within a

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1 Kiyoshi Kojima, "A Macroeconomic Approach to Foreign Direct Investment", *Hitotsubashi Journal of Economics*, Vol. 14, No. 1, June 1973, pp. 2—8.

2 Kojima, op. ci., p. 3.

period of a little more than one decade, Japanese labour and market-oriented investment overseas would rise by almost 1.000 procent !

While a growing part of Japanese investment abroad is thus motivated by the attraction of low wages in the developing countries of East and Southeast Asia, a similar kind of labour-oriented investment on the scale of the Japanese cannot be expected from the Americans and West Europeans. For one thing, the U.S. generally speaking does not have a labour shortage problem. On the contrary, unemployment in the country is still relatively serious. For that reason, a large-scale transfer of America's labour-intensive industries, which consist largely of declining, less competitive industries, would raise a storm of protest and meet with considerable opposition from the powerful American trade unions.

Although there are a few striking instances of West European labour-oriented investment in Southeast Asia, such as the successful Rollei venture in Singapore, the West Europeans in general do not have the same strong motivation of relocating their labour-intensive industries abroad. As indicated earlier, the rapidly growing economies of Western Europe, such as West Germany, France, and the Low Countries, have tried to overcome their labour shortage problem by importing foreign workers in large numbers from the economically depressed, labour surplus areas of Southern Europe, and Northern Africa.

For the time being, the only substantial labour-oriented investment Indonesia can expect can only come from Japan. So far a large part of this kind of Japanese investment has taken place in the smaller, rapidly growing countries of East and Southeast Asia, such as South Korea, Taiwan, Hongkong, and Singapore. However, as standards of living rapidly rise in these countries, labour becomes increasingly expensive as well as hard to come by. As a result, Indonesia with its large and cheap labour resources would look increasingly attractive to this kind of labour-oriented investment from Japan. Given the right incentives and a substantial improvement in infrastructure as well as in the efficiency of the government apparatus, Indonesia could hardly fail to attract an important part of Japanese labour-oriented foreign investment.

Care should be taken, however, that certain government policies do not promote the adoption of more capital-intensive techniques by the foreign investors. In certain industries more capital-intensive

techniques might, for instance, be adopted if wage costs are raised excessively because of the requirement of paying wages and salaries which considerably exceed worker productivity. More capital-intensive techniques might also be encouraged if the costs of capital equipment are lowered artificially because of special credit arrangements, favorable tariff concessions (on the import of capital equipment), fiscal concessions, and favorable provisions concerning accelerated depreciation of capital epuipment. On the other hand, however, one should also not overestimate the importance of these measures. Although in certain manufacturing industries substitution of labour for capital is quite feasible, in other industries substitutability of these two factors of production is rather limited.

IV

The experience of developing countries, such as Taiwan, South Korea, and Hongkong, has shown that it is possible to develop a strong comparative advantage in labour-intensive industries which combine low wage costs with sophisticated technology and management[1]. These ventures have generally been established through foreign investment, and include industries such as textile and garment manufacturing, shipbuilding, electronics, and machine tool and engineering component production. Foreign investment in these industries has been 'trade-oriented' in the sense that they have been mainly motivated by the desire to establish an export-base, rather than by the desire to capture the domestic market of the host country. Through investment in these labour-intensive industries, a new international division of labour has been envisaged in which the labour-surplus, low-wage developing countries would concentrate on the development of labour-intensive industries, while the labour-scarce, capital-abundant, and technologically advanced countries would concentrate on the development of technology- and knowledge-intensive industries. By exporting the production of these labour-intensive industries to the rich markets of the investing and other advanced countries, these industries could be assured of greater

1 Helen Hughes, "Assessment of Policies towards Direct Foreign Investment in the Asian-Pacific Area", *"Direct Foreign Investment in Asia and the Pacific"* (Peter Drysdale, editor), Australian National University Press, 1972, p. 330.

growth possibilities than if they had only relied on the domestic market of the developing country.

As Kojima has correctly pointed out, however, such trade-oriented and labour-oriented investment can only succeed if the developing host country is assured of restriction-free access to the markets of the rich countries, particularly the investing country itself. However, the experience of successful exporting countries, such as Taiwan, South Korea, and Hongkong, has shown that trade liberalization on the part of the rich countries, particularly in regard to the granting of trade preferences for manufactured goods from developing countries still has a long way to go, pious declarations of the rich countries notwithstanding. In order to really assist the developing host countries to develop, the rich countries should not only invest in the developing countries, but, equally important, should also open up their markets to the manufactured products of the developing countries.

Recent events in the U.S. have shown, however, that rapidly rising imports of labour-intensive products, such as textiles, apparel, shoes, etc., in which the developing countries have a strong comparative advantage, are likely to meet with stiff opposition from industries hurt by this foreign competition. Although most of these industries from the standpoint of the national economy are no longer economically efficient, they nevertheless have considerable political clout and can bring much political pressure to bear on the American government to introduce protective measures against foreign imports, as was witnessed by the introduction of the protectionist Burtke-Hartke Bill. To withstand domestic political pressures in favor of protectionist measures against imports of manufactures from developing countries, the rich countries should therefore design comprehensive and effective measures of domestic structural adjustment assistance schemes in order to ease and facilitate the shift of their declining, traditional, mostly labour-intensive industries to new growth industries in which the rich countries have a strong comparative advantage, such as the knowledge- and technology-intensive industries. Only by easing the pains and burdens of adjustment for the management and workers of the declining industries to the new economic conditions would it be politically feasible for the rich countries to liberalize their trade with developing countries.

V.

A widely held view regarding the possibility of choice of techniques in manufacturing industries is that technological coefficients of production are generally fixed, that is to say that in most manufacturing industries capital and labour can only be employed in fixed proportions to each other. This would mean that there is actually little room for substitution of labour for capital and for the adaptation of foreign productive techniques to local factor endowments. If this observation is true, the outlook for Indonesia to induce foreign as well as domestic investors to adopt more labour-intensive techniques in manufacturing industries would seem pretty bleak.

Although it is undoubtedly true that in many modern capital-intensive industries capital and labour can only be employed in relatively rigid proportions, the historical experience of Meiji Japan and the recent experience of such rapidly growing economies as Taiwan and South Korea have shown that the alleged rigidity of technological coefficients of production is not always true. Entrepreneurs in these countries showed themselves to be quite imaginative in introducing innovations which involved adaptations of foreign techniques to local conditions[1]. Most of these were *'capital-stretching innovations'* in which more units of labour were combined with one unit of capital than was customarily the case in the countries in which the technology originated.

In the case of Meiji Japan one example of a successful capital-stretching innovation was an innovation which was introduced into the production process in textile industries. In these industries machinery imported from the U.S. and England was used much more heavily and faster than in the originating countries the introduction of more work shifts per day and the use of more workers per machine. Instead of working the machines during one shift per day, more workers could be employed by the introduction of more work shifts per day. In addition, during one shift more workers were employed by putting more workers at work at each machine which, as a result, could be run at higher speeds[2]. Recent experiences in

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1. Gustav Ranis, "Industrial Sector Labour Absorption", *Economic Development and Cultural Change*, Vol. 21, No. 3, April 1973, pp. 397—408.
2. Ranis, *op. cit.*, pp. 398—399.

Taiwan and South Korea have indicated that in various industries similar capital-stretching innovations have been successfully introduced, thus enabling these countries to enjoy higher output and employment. Considering these successes there is no reason why manufacturing industries in Indonesia could not also introduce capital-stretching innovations into their production processes, thus playing an important role in helping to alleviate unemployment and underemployment in Indonesia.

Another recent development of significance to developing labour-surplus countries such as Indonesia has been the development of specialized labour-intensive *processes* and *activities* within vertically integrated multinational companies[1]. This development is characterized by the internationalization of production and marketing activities of the large multinational companies in which certain labour-intensive processes in the chain of the whole production process of a certain manufactured product are located in developing labour-surplus countries to take advantage of low wages there. By adopting this kind of internationalization of production processes, the developing labour surplus countries have another channel for exporting their manufactured products to the rich countries, specifically the exports of manufactured *intermediate* goods, such as component parts to be further used in the production of manufactured final products in the rich countries themselves.

From the viewpoint of earning foreign exchange, this kind of farming out of labour-intensive processes and activities to low-wage developing countries looks promising too, since it offers the developing countries another channel to export manufactured products to the rich countries, notably the U.S. Under the provisions of items 806.30 and 807.00 of the U.S. Tariff Schedules, for instance, import duties are levied only on the value added abroad, provided the inputs of the manufacturing process (producing that particular value added) originated in the U.S.[2]. Obviously, these provisions in the U.S. Tariff Schedules have been made with a view to the interests of U.S.-based multinational companies who wanted to move the labour-intensive parts or activities of the production process of their industries to developing countries in order to take advantage

1 G.K. Helleiner, "Manufactured Exports from Less Developed Countries and Multinational Firms", *The Economic Journal*, March 1973, pp. 28—31.

2 Helleiner; *op. cit.*, pp. 29—30.

of low wages there. Nevertheless, these provisions have afforded developing countries another way of getting into the rich U.S. market where other channels are less promising, specifically the export of final manufactured products, the inputs of which do not originate in the U.S. However, the disadvantage for Indonesia of this development of labour-intensive processes within vertically integrated multinational companies would be that it would increasingly tie Indonesia within the international network of multinational companies which could limit her independence of action and therefore ultimately be harmful to her national interest.

VI

In the above pages a few ways have been sketched in which foreign ventures in Indonesia could provide increased employment opportunities. Important though it is that foreign investment should provide ample employment opportunities to Indonesian nationals, increased employment for Indonesians is not the sole criteria by which Indonesia should measure the usefulness of foreign investment. No matter how large the material, technological, and other benefits which foreign investment could provide in the short run, in the end Indonesia, like other developing countries accepting foreign investment as an engine of growth, cannot avoid making the difficult decision assessing and striking a proper balance between tangible economic benefits on the one hand and the maintenance of economic and political independence on the other hand.