Free capital mobility and sustainable community development: A theoretical framework

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ABSTRACT

Although most economists defend the role of foreign investment in global development as positive, a number of tourism geography studies present divergent views on the impact of foreign investment on host communities. To examine this issue, this study develops a simple model to show that liberal economic doctrines tend to shape policies in host communities, thus generating a higher degree of openness to foreign factors of production than is optimal. It treats the openness of a host community to foreign investment as a practical dimension, examining how foreign investors and host communities can negotiate and share the benefits of capital flows from projects with foreign investment. Foreign investors have the first-mover advantage in bargaining with host communities for full openness. However, the impatience of foreign investors can cause them to act against their own interests when faced with the reluctance of host communities to open further because of weak physical, economic, and institutional infrastructures those areas.

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Introduction

Liberal economic doctrine argues that inflows of foreign capital engender a variety of benefits, stimulating economic growth (Bonefeld, 2013; Sheng, 2010b, 2012a), intensifying inter-firm competition (Chin, 2012; Sheng, 2011a; Xafa, 2008), generating advanced technology and management skills (De Meester, 2012; Delimatsis, 2012; Kessler, 2012; Sheng, 2011a), cultivating policy transparency and market discipline (Gu & Sheng, 2010; Manoli, 2013; Sheng, 2010a), and enhancing efficiency in financial markets (Erforth, 2012; Jackson, 2012; Lopez-Mejia, 1999; Vrasti, 2013). Based on the assumption that inter-destination competition is escalating, liberal tourism economists encourage emerging tourism destinations to create market conditions that attract foreign investors to ensure the survival and prosperity of host communities.

Although much of the tourism economics literature argues that foreign investment is desirable, several tourism geography studies highlight the serious side effects for host communities that accompany an overgrown tourism industry driven by substantial inflows of foreign capital. Economic side effects — including leakage, increased cost of living, and asset bubbles — are documented in Briassoulis (2002), Brohman (1996), Copeland (1991), Göymen (2000), Sheng (2011b), and Sheng and Tsui (2009b). Environmental side effects, such as air pollution, noise pollution, and the overuse of natural resources, are analyzed in Balaban (2012), Ogbazi (2013), Qian, Feng and Zhu (2012), Sheng (2011d), and Sheng and Tsui (2009a). Social side effects, such as increased crime, social polarization, and cultural alienation, are illustrated in Butz and Zuberi (2012), Sheng (2011c), Vaz, Cabral, Caetano, Nijkamp, and Painhp (2012), Walpole and Goodwin (2000), and Yıldırım and Turan (2012).

This paper emphasizes the deep concerns of host communities with weak physical, economic, and institutional infrastructures regarding the side effects of massive inflows of foreign capital. Host communities understand that foreign factors of production provide them with opportunities for economic growth but that these opportunities are coupled with the risk of economic, social, environmental, and political side effects. The simple model developed in this paper shows that host communities that manage their openness to foreign factors of production may have better and more sustainable local performance and development that balances growth and side effects. By contrast, imprudent openness is likely to end in failure because of volatile growth and significant side effects. Theoretically, a division of capital mobility benefits can be achieved through formal negotiations between foreign investors and host communities concerning the host community's openness.

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This issue is addressed with a sequential bargaining model based on differences in the degree of impatience of the two sides.

A critical review of literature

Ritchie and Crouch (1993, 1999, 2000) observe that tourism destinations increasingly compete to create market conditions that will attract inflows of foreign capital to exploit their competitive advantage, although Hall (2007) considers an approach that treats firm competitiveness as an invalid metric for analyzing destination competitiveness. In fact, whether tourism destinations should aggressively attract foreign investment depends on the overall impact on host communities. Unfortunately, the limited existing literature related to this issue offers largely split views. Jarvis and Kallas (2008) find that inflows of foreign capital have significantly contributed to increasing Estonia's tourism infrastructure and to attracting massive inflows of inbound tourists, which, in turn, has resulted in considerable tourism revenue. Tang, Selvanathan, and Selvanathan (2007) identify various positive effects of inflows of foreign capital on China's tourism infrastructure and economic growth; in particular, this study finds that preferential treatment for foreign investors results in greater tourism activity and more rapid economic growth in poor regions. Forsyth and Dwyer (2003) argue that the benefits of foreign investment in the Australian tourism sector outweigh its costs. The increase in welfare is reflected in positive changes in tourist expenditures, the balance of payments, and the structure of the industry. They conclude that foreign investment in tourism should be neither restricted nor discouraged.

However, Walpole and Goodwin (2000) observe serious leakage during the tourism boom in Indonesia in the 1990s. Outflows of capital as a result of foreign ownership, foreign dominance in the transportation sector, substantial inflows of foreign labor — particularly managerial and professional staff — and the isolation of tourists from the local economy caused the loss of 80% of the revenues generated from tourism. In an analytical framework with general equilibrium, Copeland (1991) shows several adverse socio-economic effects of foreign investment in tourism. In particular, he identifies a "Dutch Disease" phenomenon in which the tourism sector expands at the expense of other sectors, particularly the manufacturing sector, and leads to de-industrialization and an economic structure dominated by tourism. Göymen (2000) finds that foreign investment in tourism often results in real estate bubbles because significant inflows of foreign capital stimulate rising land values and building costs; moreover, foreign investment fosters speculative activities that often lead to financial crises. Sheng (2012b) argues that small local businesses that do not own real property face high labor costs and rental costs as a result of foreign investment in tourism. In Macao, such businesses cannot compete with multinational enterprises which has caused significant bankruptcies.

Briassoulis (2002) believes that a tourism boom driven by foreign investment causes excessive inflows of tourists, stresses destinations' environments and pressures local public sectors. More vehicles produce more noise, air pollutants, and traffic congestion, and more visitors produce more waste. Brohman (1996) finds that a number of tourism destinations are facing increasing poverty and inequality after having developed booming tourism industries with foreign investment; the study suggests that this phenomenon was caused by the postcolonial economic dominance of powerful multinational enterprises. Sheng (2012b) reports that competition for labor, resources, and markets in Macao has caused serious conflicts between local and foreign economic powers in addition to creating problems among foreign competitors, which has destabilized Macao's political environment since its gaming sector was liberalized to allow multinational enterprises. Hall (2007) finds that developed and developing/emerging economies have significantly different opinions regarding free capital mobility in tourism services. Whereas the former try to reduce barriers to foreign tourism investment, the latter are concerned about the power wielded by multinational enterprises in host communities.

From this critical review of the literature, it can be observed that the effects of foreign tourism investment largely diverge across destinations. In large, developed countries, the negative effects are generally not perceived to have a substantial impact, whereas small and developing/emerging tourism economies that have small land areas, small populations, limited resources, and limited carrying capacity often suffer severe negative effects. This paper will study the effects of foreign tourism investment on small tourism economies because tourism is generally more important to small and developing/emerging economies than it is to large, developed economies and because there are a number of small tourism economies across the developing world. The relative paucity of theoretical models in the literature was another factor that motivated us to pursue a purely conceptual analysis based on a self-developed theoretical framework.

Tradeoffs between side effects and economic growth

This section illustrates how an emerging tourism destination negotiates the tradeoff between economic growth and the accompanying side effects through its policy preferences regarding risky growth opportunities presented by foreign capital inflows. Based on its specific natural tourism resources and socio-economic resources, each destination may have a different attitude toward side effects, offer different opportunities for foreign capital, and allow a different degree of openness to foreign factors of production. The differences between destinations also have particular implications for policy tradeoffs and socio-economic development. The riskiness of these opportunities is related to the risk of economic, social, environmental, and political side effects caused by interactions between international capital movement and domestic physical environments, socio-economic systems, political institutions, and culture.

Let a be a value between 0 and 1, where $a = 0$ and $a = 1$ indicate complete closure and full openness to foreign factors of production, respectively, and where $1 - a$ is understood as the intensity of a destination's control over inflows of foreign capital. Let b be a vulnerability index where a lower b represents a destination with substantial land area, a well-developed infrastructure, and a mature economic and financial structure that is able to promote economic growth by effectively utilizing inflows of foreign capital while containing their inherent side effects. Obviously, the average level σ of side effects for a destination will increase with vulnerability b. Thus, the risk of side effects is a function of a destination's openness to foreign factors of production and its vulnerability, i.e., $\sigma = \sigma(a, b)$, where $\partial\sigma/\partial(a, b) > 0$. Suppose that $\sigma = \sigma(a, b)$ is concave so that a typical iso-side effects curve is decreasing and convex. Because it is reasonable to treat b as an underlying parameter when taking a as a choice variable, we can rewrite $\sigma = \sigma(a, b)$ as $a = a_\sigma(b)$ to define the degree of openness (a) based on local vulnerability (b), for a particular level of side effects, (σ).

Assume that a destination's expected output growth g initially rises with greater inflows of foreign capital under wider openness (larger a), reaches a maximum at an intermediate level a_m, and finally declines. The marginal growth benefit diminishes as more foreign capital flows in for $a < a_m$ and may become negative for $a > a_m$. The relationship $g = G(a)$ between economic growth and openness can be changed to $g = g_b(\sigma)$ (between growth and side effects) because openness is positively related to side effects. Rewriting $\sigma = \sigma(a, b)$ as $a = a_b(\sigma)$ and substituting it into $g = G(a)$ yields the opportunity curve $g = G(a_b(\sigma)) = g_b(\sigma)$.