Chapter Eight

The Political Economy of Foreign Direct Investment

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Adapted by R. Helg for LIUC 2007

Political Ideology and FDI

Radical View	Pragmatic Nationalism	Free Market

The Radical View

- Marxist view: MNE's exploit less-developed host countries
  - Extract profits
  - Give nothing of value in exchange
  - Instrument of domination, not development
  - Keep less-developed countries relatively backward and dependent on capitalist nations for investment, jobs, and technology

The Radical View

- By the end of the 1980s radical view was in retreat
  - Collapse of communism
  - Bad economic performance of countries that embraced the radical view
  - Strong economic performance of countries who embraced capitalism rather than the radical view

The Free Market View

- Nations specialize in goods and services that they can produce most efficiently
- Resource transfers benefit and strengthen the host country
- Positive changes in laws and growth of bilateral agreements attest to strength of free market view
- All countries impose some restrictions on FDI

Pragmatic Nationalism

- FDI has benefits and costs
- Allow FDI if benefits outweigh costs
  - Block FDI that harms indigenous industry
  - Court FDI that is in national interest
    - Tax breaks
    - Subsidies

Summary of Political Ideology

TABLE 8.1

Political Ideology toward FDI

Ideology	Characteristics	Host-Government Policy Implications
Radical	Marxist roots Views the MNE as an instrument of imperialist domination	Prohibit FDI Nationalize subsidiaries of foreign-owned MNEs
Free market	Classical economic roots (Smith) Views the MNE as an instrument for allocating production to most efficient locations	No restrictions on FDI
Pragmatic nationalism	Views FDI as having both benefits and costs	Restrict FDI where costs outweigh benefits Bargain for greater benefits and fewer costs Aggressively court beneficial FDI by offering incentives

The Benefits of FDI to Host Countries

- Four main benefits of FDI for a host country
  - Resource-transfer effect
  - Employment effect
  - Balance-of-Payments effect
  - Effect on competition and economic growth
- In a free market view
  - Economists argue that the benefits of FDI so outweigh the costs associated with pragmatic nationalism that it is misguided
  - The best policy would be for countries to forgo all intervention in an MNE's investment decisions

Resource-Transfer Effects

- FDI can make a positive contribution to a host economy by supplying
  - Capital
  - Technology
  - Management

Employment Effects

- Brings jobs that otherwise would not be created
  - Direct: Hiring host-country citizens
  - Indirect:
    - Jobs created by local suppliers
    - Jobs created by increased spending by employees of the multi-national enterprise

Balance-of-Payments Effects

- Balance-of-Payments Accounts are divided into two main sections
  - The current account records transactions that pertain to three categories: merchandise goods, services, and investment income
  - The capital account records transactions that involve the purchase or sale of assets
- Current account deficits occur when a country imports more goods, services, and income than it exports
- Current account surpluses occur when a country exports more goods, services, and income than it imports

US Balance of Payment Accounts for 2004

TABLE 8.2

U.S. Balance of Payments Accounts for 2004 ($ millions)

Source: U.S. Department of Commerce.

Current Account	Credits	Debits
Exports of Goods, Services, and Income	$1,516,169	
Merchandise Goods	807,610	
Services	339,571	
Income Receipts on Investments	368,988	
Imports of Goods, Services, and Income		$2 1,764,256
Merchandise Goods		2 1,473,087
Services		2 291,169
Income Payments on Investments		2 344,925
Unilateral Transfers		2 72,928
Balance of Current Account		2 665,940
Capital Account		
U.S. Assets Abroad		2 817,676
Foreign Assets in U.S.	1,433,171	
Statistical Discrepancy	51,922	

Balance-of-Payments Effects

- Host country benefits from initial capital inflow when MNC establishes business
  - Host country records current account debit on repatriated earnings of MNC
- Host country benefits if FDI substitutes for imports of goods and services
- Host country benefits when MNC uses its foreign subsidiary to export to other countries

Effect on Competition and Economic Growth

- Greenfield investments increases the amount of competition, which can:
  - Drive down prices
  - Increase the economic welfare of consumers
- Increased competition tends to stimulate capital investments
- Long-term results may include
  - Increased productivity growth
  - Product and process innovations
  - Greater economic growth

Costs of FDI to Host Countries

- Adverse effects on competition: greenfield vs M&A
- Adverse effects on the balance of payments
  - After the initial capital inflow there is normally a subsequent outflow of earnings
  - Foreign subsidiaries could import a substantial number of inputs
- National sovereignty and autonomy
  - Some host governments worry that FDI is accompanied by some loss of economic independence resulting in the host country's economy being controlled by a foreign corporation

Benefits of FDI to the Home Country

- Improves balance of payments for inward flow of foreign earnings
- Creates a demand for exports.
- Export demand can create jobs
- Increased knowledge from operating in a foreign environment
- Benefits the consumer through lower prices
- Frees up employees and resources for higher value activities

Costs of FDI to the Home Country

- Can drive out local competitors or prevent their development
- Profits brought home 'hurt' (debit) a host's capital account
- Parts imported for assembly hurt trade balance
- Can affect sovereignty and national defense

Home Country Policies and FDI

- To encourage outward FDI
  - Government backed insurance programs to cover foreign investment risk
  - Capital assistance
  - Tax incentives
  - Political pressure
- Restricting Outward FDI
  - Limit capital outflows out of concern for the country's balance of payments
  - Tax incentives to invest at home
  - Prohibit national firms from investing in certain countries for political reasons

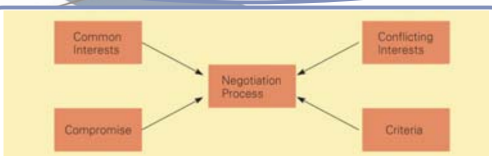
Host Country Policies and FDI

- Encouraging Inward FDI
  - Offer government incentives to foreign firms to invest
    - Tax concessions
    - Low interest loans
    - Grants/subsidies
- Restricting Inward FDI
  - Ownership restraints
    - Foreign firms are prohibited to operate in certain fields
    - Foreign ownership is allowed but a significant proportion of the equity must be owned by local investors
  - Performance requirements that control the behavior of the MNE's local subsidiary

The Nature of Negotiation

- Objective: reach an agreement that benefits both parties
- In the international context, we must
  - understand the influence of norms and value systems
  - be sensitive to how these factors influence a company's approach to negotiations

The Negotiation Process



- The negotiation process has been characterized as occurring within the context of "the four Cs"
  - Common interests
  - Conflicting interests
  - Compromise
  - Criteria

Negotiation and Bargaining Power

- The outcome of any negotiated agreement depends on the relative bargaining power of both parties
- Bargaining power depends on three factors
  - The value each side places on what the other has to offer
  - The number of comparable alternatives available to each side
  - Each party's time horizon

Bargaining Power

TABLE 8.3
Determinants of Bargaining Power

	Bargaining Power of Firm	
	High	Low
Firm's time horizon	Long	Short
Comparable alternatives open to firm	Many	Few
Value placed by host government on investment	High	Low

Looking Ahead to Chapter 9

- Regional Economic Integration
  - Levels of economic integration
  - The case for regional integration
  - The case against regional integration
  - Regional economic Integration in Europe
  - Regional economic integration in the Americas
  - Regional economic integration elsewhere
  - Managerial implications