

# Multinationals and the Globalization of Production

*FDI and the host country II*

*Competing for FDI*

Penn State // Fall 2017

## Administrative things

- ▶ Sign in to Arkaive.com (course code: 84ST)
  - ▶ If not working, sign in up front
- ▶ Problem set #4
  - ▶ Due end of class, Thursday 11/2
  - ▶ Available on course website
- ▶ Exam #2
  - ▶ Thursday, 11/9
  - ▶ Covers material from 10/10–11/7
  - ▶ Same format as exam #1

## Roadmap

- ▶ Past: Motives for firms to produce abroad
  - ▶ Horizontal reasons (market access)
  - ▶ Vertical reasons (factor cost differences)
  - ▶ Some mixture of the two
  - ▶ Focused on the firm
  
- ▶ Currently: The impact of FDI on the host country
  - ▶ Host country productivity effects of MNEs ✓
  - ▶ Factor market effects
  - ▶ Competition effects
  - ▶ Should governments encourage inward FDI?

## Factor market effects and FDI

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- ▶ How will MNEs affect factor market prices?
- ▶ Factor markets: labor markets, capital markets, natural resource markets, utilities
- ▶ Key issue: factor demand by MNEs vs. factor supply in the country

## Negative factor market effects

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- ▶ If MNEs need factors that are inelastically supplied
  - ▶ Likely to raise factor prices
- ▶ Example
  - ▶ Energy-intensive MNE...
  - ▶ ...in a country with limited electrical capacity
  - ▶ MNE demand for electricity increases price of electricity
  - ▶ Higher electricity prices hurt other firms and consumers

## Neutral factor market effects

- ▶ If MNEs need factors that are elastically supplied
  - ▶ Small impact on factor prices
- ▶ Example
  - ▶ Unskilled-labor intensive MNE...
  - ▶ ...in a country with lots of unskilled labor
  - ▶ MNE demand for unskilled labor changes unskilled wage little
  - ▶ Other firms that use unskilled labor unharmed
- ▶ If MNE investment is large enough, can eventually matter
  - ▶ Rising Chinese wages → MNEs look to Vietnam

## Factor market effects and FDI

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- ▶ How will MNEs affect factor market prices?
- ▶ Factor markets: labor markets, capital markets, natural resource markets, utilities
- ▶ Key issue: factor demand by MNEs vs. factor supply in the country
  - ▶ If MNEs need inelastic factors → likely negative effects
  - ▶ If MNEs need elastic factors → likely small effects

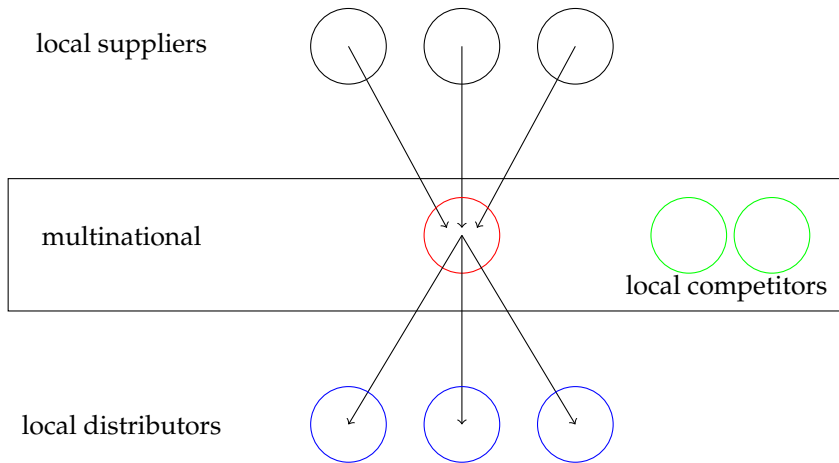
## Competition effects of FDI

- ▶ Will the MNE improve competition?
- ▶ Is there an established local industry?
  - ▶ How competitive is the local industry?



## MNE interactions with other firms: flow of goods

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## Competition effects of FDI

- ▶ If local firms have market power
  - ▶ MNE provides competition
  - ▶ Decreases markups, lowers prices
  - ▶ Good for consumers, downstream firms
  
- ▶ Can it go too far?
  - ▶ If MNE drives local firms out of business
  - ▶ Potentially less competition in the market
  - ▶ Higher markups and prices
  - ▶ Bad for consumers, downstream firms

## Summary: The impact of FDI on the host country

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- ▶ A framework for evaluating foreign investment projects
  - ▶ Host country productivity effects of MNEs ✓
    - ▶ Compositional effects
    - ▶ Spillovers (backwards and forwards)
  - ▶ Factor market effects ✓
  - ▶ Competition effects ✓
  - ▶ Others...
- ▶ Used by governments to evaluate potential FDI

## Evaluating potential FDI

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- ▶ Policy makers faced with potential FDI projects
- ▶ Who are the winners and the losers?
- ▶ A framework of questions
  1. Is the investment likely to raise production costs for local firms?
  2. Are there local firms that compete directly with the MNE?
  3. Are there local firms that will likely benefit from the MNE?
- ▶ Often this a local (region/state/city) analysis
- ▶ Depends on how “big” markets are

## **Is the investment likely to raise production costs for local firms?**

- ▶ Factor market competition
- ▶ What factors do the MNE need?
- ▶ How abundant are those factors?

## **Are there local firms that compete directly with the MNE?**

- ▶ Competition effects: Are there other firms in the MNE's market?
- ▶ How competitive are the markets?

## **Are there local firms that will likely benefit from the MNE?**

- ▶ Improved inputs for downstream firms
- ▶ Spillovers to upstream/downstream firms

# Competing for FDI



## Governments and FDI

- ▶ How do governments compete for FDI?
- ▶ Should governments compete for FDI?

## Competing for FDI

- ▶ Nissan Motors (Japanese MNE) in October 2016
- ▶ Announces plans to build two new cars in Sunderland, England
  - ▶ Brexit: uncertainty about market access (most cars exported)
  - ▶ Nissan postponed decision over new investment
  - ▶ Nissan chief executive: government “support and assurance”

“The promise to shield Nissan from the impact of Brexit will not be lost on rival manufacturers, both those already in the UK as well as those that might be tempted to come.”

## Competing for FDI

- ▶ Foxconn (Taiwanese MNE) in September 2017
- ▶ LCD screen manufacturing facility (8K TVs?!)
- ▶ \$10 bil. investment; 3,000–13,000 jobs
- ▶ Wisconsin to provide \$3 bil. in incentives
  - ▶ \$2.5 bil. state income tax credits
  - ▶ \$0.5 bil. sales and use tax exemption
- ▶ State pays about \$15,000 per job per year

## FDI promotion policies

- ▶ Available to most/all MNEs:
- ▶ Corporate income tax exemptions & VAT exemptions
  - ▶ Maybe complete or partial; usually temporary
- ▶ Import tariff exemption
  - ▶ Usually restricted to inputs to be used to create exports
- ▶ Usually come with string attached
  - ▶ Locate in specific places (export processing zones)
  - ▶ Do specific activities; hire a certain number of locals
  
- ▶ Not available to local firms!

**CORPORATE TAX RATES FOR G-24 AND OTHER COUNTRIES, 1990 AND 1998**

	1990		1998	
	Min. rate	Max. rate	Min. rate	Max. rate
<b>Group of 24</b>				
Congo	49.0	49.0	45.0	45.0
Egypt	34.0	42.0	34.0	42.0
Gabon	40.0	45.0	40.0	45.0
Ghana			8.0	35.0
Nigeria	20.0	40.0	20.0	30.0
India	50.0	64.8	40.0	43.0
Iran	12.0	75.0	15.0	57.0
Pakistan	45.0	66.0		
Philippines	35.0	35.0	34.0	34.0
Sri Lanka			35.0	35.0
Argentina	33.0	33.0	33.0	33.0
Brazil	6.3	41.5	15.0	25.0
Colombia	30.0	30.0	35.0	35.0
Guatemala	12.0	34.0	30.0	30.0
Mexico	36.0	36.0	17.0	34.0
Peru	35.0	35.0	30.0	30.0
Trinidad & Tobago	15.0	40.0	15.0	35.0
Venezuela	15.0	50.0		
<b>Other countries (regional averages)</b>				
Africa	36.2	46.5	25.8	35.6
East Asia	24.1	39.8	20.0	42.1
Eastern Europe	0.0	40.0	33.4	35.0
Latin America	19.2	31.7	24.5	28.5
Middle East	12.7	39.3	11.3	34.4
North America	27.5	47.3	26.6	48.3
Oceania	41.0	41.0	34.5	34.5
South East Asia	26.0	39.8	22.6	29.2
Western Europe	37.2	43.1	33.5	37.2

**Source:** Price Waterhouse (1990). Table 1: Hanson (2001) "Should countries promote FDI?"

**Note:** This table shows minimum and maximum corporate income tax rates for selected countries. See text for details. Data is more detailed for some countries than others. Approximations are made in certain cases.

**TAX CONCESSIONS FOR INWARD FDI IN G-24 COUNTRIES, 1998**

Country	(I)			(II)		(III)		(IV)	Available to domestic corporations?			
	Corporate income tax exemption	Period	Sectors	Value-added tax exemption	Items	Import duty exemption	Items	EPZ provision	(I)	(II)	(III)	(IV)
Côte d'Ivoire	X	5-8 years	All			X	All					
Egypt	X	5-20 years	All <sup>a</sup>						X			
Gabon	X	0-10 years	All						X <sup>b</sup>			
Nigeria	X	0-5 years	P, E, A, M	X	All <sup>c</sup>	X	E, R	X	X	X	X	X
Congo	X <sup>d</sup>	0-10 years	A, P, M									
Argentina (tax credit bonds)				X	E	X	E, R			X	X	
Brazil				X	E, P	X	E, P			X <sup>e</sup>		
Guatemala <sup>f</sup>	X		E			X	K, E, R	X	X		X	X
Mexico (tax credits)						X	E					
Peru	X		All <sup>g</sup>	X	All <sup>h</sup>				X	X		
India	X	5 years	All <sup>i</sup>			X	E	X			X	X
Philippines	X	3-6 years	All <sup>j</sup>	X	All <sup>k</sup>	X	All	X	X	X	X	X
Sri Lanka	X		P			X	P		X		X	

**Source:** Price Waterhouse (1998).

**Note:** \* = taxed at lower rate.      • A = agriculture.      • E = exported goods/exporting.      • K = capital.  
 • M = manufacturing.      • P = priority companies/industries.      • R = raw materials.      • X = country offered concession in indicated year.  
 • Data is more detailed for some countries than others. Approximations are made in certain cases.

- a* An investment and guarantee law effective as of 11 May 1997 offers the profits of a project formed under it to be exempt from tax on industrial and commercial profits and from corporate tax.  
*b* More restrictions apply on domestic corporations than on foreign corporations.  
*c* 1998 budget abolishes payment of excise duties.  
*d* Tax priority status giving exemption (or a reduction) from various taxes and custom duties for up to 10 years can be obtained by notification of agreement.  
*e* Excise and sales and service tax exemptions are granted to exporters of manufactured goods.  
*f* In general, exemption from payment of import duties on machinery and equipment and on raw and packaging materials and from income tax is available for those corporations classified as exporting companies. These exemptions also apply to free trade zones.  
*g* Industrial entities established in the jungle, frontier zones and free trade zones are exempt from income tax.  
*h* Exemption from value-added tax (VAT) is provided for industrial entities established in the jungle and frontier zones.  
*i* New industrial undertakings satisfying certain conditions established in a free trade zone, software technology park, or electronic hardware technology park, or a 100 per cent export-oriented undertaking is entirely exempt from income tax.  
*j* Income tax holiday giving full exemption from corporate income tax for six years for pioneer firms and those locating in less-developed area, and four years for non-pioneer firms from the date of commercial operation; expanding export-oriented firms are given three years.  
*k* Local purchases of goods and services from VAT-registered entities are either VAT exempt or zero rated.

## FDI promotion policies

- ▶ Individual subsidies
- ▶ Harder to find details, but they exist everywhere
- ▶ GM in Brazil: \$1.5 billion over 15 years → Subsidies to build roads and ports; VAT exemption; import duty exemption
- ▶ BMW in N. Carolina: \$150 million → Employment training program; manage recruiting and screening of employees; modernize airport
  
- ▶ Domestic large firms often get these too...

## Should governments promote FDI?

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- ▶ Econ 102: Are there market failures?
  - ▶ No? Do not subsidize.
  - ▶ Yes? Maybe. Becomes a quantitative question.
- ▶ MNE market failures
  - ▶ Spillovers to upstream and downstream firms
  - ▶ Some evidence of spillovers...
  - ▶ Case-by-case evaluations needed