

FDI IN THE LITERATURE

Benefits and costs of Foreign Direct Investment (FDI)

	Benefits	Costs
FDI	<ol style="list-style-type: none"> 1) Employment 2) Technological externalities 3) New/more dynamic sectors and firms 4) Demand/supply linkages 5) Pecuniary linkages: <ul style="list-style-type: none"> • wage rents • fiscal revenue • forex • savings 6) Competitive effects on industrial structure and complementarity 7) Exports and trade 	<ol style="list-style-type: none"> 1) Export of jobs 2) Inappropriate technological structure 3) Economic islands 4) Attraction of more FDI 5) Pecuniary costs: <ul style="list-style-type: none"> • wage pressure on local firms • tax incentives • terms of trade + profit expatriation + imports • displacement of domestic savings 6) Excessive competition and reduction of market share of local firms 7) Import content of production and consumption and deterioration of terms of trade.
Interest Groups	Government Foreign investors Domestic firms that benefit from linkages Foreign firms that benefit from linkages Foreign and domestic lending banks	Domestic firms put out of business Workers who lose their jobs Domestic non-lending banks

Governments attempt to attract FDI by providing incentives. One of the most commonly used forms of incentives (in addition to tax incentives) is related to the labour market, involving the subsidisation of labour costs and/or the limiting of unions' powers and de-regulation of the labour bargaining process. These incentives are based on three assumptions:

- FDI always generates welfare gains;
- Labour market conditions are crucial in the foreign firms decisions to re-locate; and
- Foreign firms prefer always prefer unregulated bargaining processes.

Evidence shows that the first two assumptions are wrong: FDI has costs that may well outweigh benefits; and labour market conditions are one amongst many variables that foreign firms consider in their decisions to re-locate, and do not rank amongst the crucial variables. This article discusses whether the third assumption is true, and argues that except in very specific conditions it is not.

Wage bargaining process, welfare gains and MNEs preferences

	Non-Product Market Interaction	With Product Market Interaction
Wage decision	<ul style="list-style-type: none"> $w^* > w$, because local firms' Q/L is lower than MNE's; unions extract maximum rent from MNE; $w^* > w^c$ because centralised bargaining links MNE and local firms; and if unions give equal weight to jobs and wages, given that local firms Q/L is lower the centralised wage is going to be a weighted average of w^* and w (the weight depends on the relative market share of the MNE); 	<p>Generalities: Given the interaction between firms in the product market, they will be cost competitors. Hence, the wage bargaining will involve a reaction function (μ), so that:</p> <ul style="list-style-type: none"> MNE's wage setting: $w^* = \mu^*(w, \alpha)$ Local firms's wage setting: $w = \mu(w^*, \alpha^*)$ <p>Where both react to the wage rate and productivity of the other.</p> <ol style="list-style-type: none"> If $(\alpha^* - \alpha) \approx 0$, the competitive advantages of the MNE are small, $w^c > w^*$ because unions can cooperate to extract rents from the MNE without being too concerned with job losses elsewhere. If $(\alpha^* - \alpha) > 0$, the competitive advantage of the MNE is high and so $w^c < w^*$, because unions are concerned with job losses elsewhere. If $(\alpha^* - \alpha) > 0$ very significantly, unions will cooperate to set a centralised firm specific wage. In which case, $w^* < w^c$.
Welfare	<ul style="list-style-type: none"> $Wfdi^j > Wa$, where $j=d,c$, because whatever the MNE and unions do it will not affect negatively the local economy and firms; $Wfdi^d > Wfdi^c$ because if the bargaining is decentralised unions can extract higher rents from MNE without putting any pressure on wage bargaining in domestic firms. 	<p>Exports: If firms export only, FDI will depress terms of trade unless the elasticity of the world demand facing the MNE + local firms exports is very low.</p> <p>In this case, $Wfdi^j < Wa$ because of the terms of trade deterioration, but $Wfdi^d > Wfdi^c$ if $(\alpha^* - \alpha) > 0$, because w^* will be an export tax favouring local residents.</p> <p>Domestic Market: If firms sell in the domestic market, FDI will increase consumer surplus due to competition.</p> <p>In this case, $Wfdi^j > Wa$ because of higher consumer surplus, and $Wfdi^d > Wfdi^c$ because unions extract higher rents provided that $(\alpha^* - \alpha) > 0$, such that $w^* > w^c > w$.</p>
MNE preference	Centralised bargaining because it yields a lower wage rate than the MNE specific wage ($Wfdi^c < Wfdi^d$, $w^c < w^*$)	<p>In case 1), MNE prefers w^* because it is lower than the centralised wage and the MNE has minimal competitive advantage.</p> <p>In cases 2), the MNE prefers w^c.</p> <p>In case 3), the MNE prefers w^* because w^c is a cooperative wage setting by the unions which gives no advantages to the MNE.</p>
Government preference	Governments committed to attracting FDI, and convinced that labour market conditions are crucial, will compensate MNEs for centralised bargaining despite this being the MNE's preferred wage setting in most cases, except in the extreme cases 1) and 3) with product market interaction. Hence, the government may contribute to further reduce welfare from FDI, despite the fact that only in two extreme cases will the government actually attract FDI but in conditions where FDI has a negative social welfare impact.	