
Theoretical Considerations about Host-Country Intervention in Investment Promotion, Domestic-Content Requirements, and Export-Performance Requirements

Host-country interventions to influence the operations that foreign direct investors engage in carry an array of costs and risks. Do the benefits and opportunities outweigh these costs and risks? What might be the penalty for not intervening? What is the likelihood of being able to carry out appropriate interventions successfully?

This chapter raises theoretical considerations about host-country intervention that will help to illuminate the discussion in the subsequent three chapters on public-sector efforts to attract FDI, on the imposition of domestic-content requirements, and on the use of export-performance requirements.

Even so popular and seemingly benign an activity as investment promotion carries possible dangers for host countries. The expenditure of public revenues to try to attract FDI draws off resources from the rest of the economy, penalizing other industries and making them less competitive. To the extent that FDI promotion programs are selective and concentrated on particular sectors (if only for economy of effort), they lead to industrial-policy problems, placing the government in the position of trying to measure externalities and pick winners and losers better than the market would. FDI promotion programs may create distortions and introduce a rent-seeking dynamic into the economy and potential beneficiaries may use their political clout to influence the targeting process.

Turning to more complex and controversial efforts on the part of host authorities to impose domestic-content or export-performance requirements, the evaluation of public-sector intervention seems deceptively simple.

Under neoclassical assumptions of perfect competition, a host-country requirement that mandates a certain amount of domestic content on the

part of foreign investors forces the local subsidiaries to substitute more expensive (by definition) indigenous goods and services for less expensive imports. Like any kind of trade barrier, this generates inefficiencies, diverts resources from more productive uses, raises prices, reduces consumption, and penalizes users and consumers. Protected from cheaper imports, the foreign firms in the sector with the domestic-content requirement may reap high rates of return, resulting in what Brecher and Diaz Alejandro (1977) identified as a special case of immiserizing growth, as foreign corporations siphon off excess profits at the expense of local consumers.

Within the neoclassical framework, a host-country requirement to export exacerbates the difficulties for the host economy. Because production costs in the local market must (by definition) be higher than world prices (or else domestic subsidiaries of foreign corporations would already be exporting on their own), a public subsidy must accompany the export requirement to render the operation viable. In effect, that subsidy levies an implicit tax on the rest of the economy, leaving other sectors less competitive and imposing a drag on the prospects for growth.

As for combining domestic content and export requirements in a trade-balancing strategy to bolster the balance of payments, Grossman (1981) and others (Davidson, Matusz, and Kreinin 1985; Herander and Thomas 1986; Rodrik 1987) have found that the domestic content mandate may reduce a country's export potential so much that it leads to a deterioration in the balance of payments.

In short, under neoclassical assumptions of perfect competition, the imposition of domestic-content and/or export requirements on foreign firms damages the prospects for economic development of the country that adopts them.

The relaxation of the assumption of perfect competition, within the domestic economy and within the industries where foreign investors reside, complicates the analysis considerably.

Infant-industry arguments have traditionally been based on the possibility that imperfections in local capital or labor markets might prevent would-be investors from demonstrating that local operations could in fact be successful. To compensate for such imperfections, according to infant-industry logic, public authorities should intervene to help firms to provide the needed demonstration effect; if the more efficient route of offering subsidies were not available, then trade protection could constitute an alternative.

But there has never been good evidence on how pervasive such hypothetical imperfections in local capital or labor markets might be. And, accompanying uncertainty about the need for public-sector intervention, questions about implementation of an effective infant industry strategy have loomed large: how might a government decide which industries to offer special treatment and which to ignore (leaving the latter to bear

the penalty of preferences for the former)? How might the selection process be insulated against capture by special interests? And how could infant industries dependably be pushed toward maturity, so that they shed their need for public support promptly rather than remaining in diapers indefinitely?

Strategic-trade theory gives new life to traditional arguments about intervention on behalf of foreign-investment-driven infant industries. The strategic-trade framework, in contrast to neoclassical analysis, assumes imperfect competition, with barriers to entry into the industry that include increasing returns to scale and that generate rents for the participants (Brander and Spencer 1983; Krugman 1986). Such rents may sometimes emerge in the form of higher than normal profits, but more often they show up in terms of high wages and benefits and strong research and development expenditures (Katz and Summers 1989). The prospects for externalities, that is, spillovers that provide benefits to the domestic economy that exceed those that can be captured by investors themselves, are favorable.

Once such imperfectly competitive industries are in place, the possibility of dynamic learning emerges, giving a purely historical advantage on which to base further growth. "Indeed, by focusing on learning effects," observes Rodrik (1988), "the new literature has provided some of the best arguments for infant-industry protection since Alexander Hamilton and Friedrich List."

Under strategic-trade conditions, relative production costs may still play an important role in the locational decisions of international companies. But the absence of perfect competition means that the pressures that might push firms along the path of international comparative advantage are much less strong and deterministic than the neoclassical model indicates. Imperfect competition provides firms a measure of leeway and discretion on where to locate their activities; they can behave as satisficers rather than profit maximizers. Exactly where international investors choose to produce and the consequent arrangement of trade among nations are not exogenously determined. A semirandom overlay of scale-economy specialization may diverge significantly from the broader structure of international comparative advantage.

In these circumstances, the possibility of capturing a share of the rents and externalities raises the stakes for those authorities who are successful in attracting (or retaining) FDI in their countries and imposes large opportunity costs on those who are not successful or who do not take part in the competition for investment.

Strategic-trade-type competition for international investment requires a broad canvas: investment policy cannot be artificially isolated from grants, subsidies, special tax treatment, and other locational incentives or from investment-distorting aspects of trade policy.

But the rationale for activism embedded in strategic-trade theory is matched by equally powerful caveats about the dangers: whereas under

imperfect competition the outcome from public intervention cannot be assumed to be automatically distortionary and harmful, neither can it be assumed to be beneficial or welfare enhancing. Improperly constructed public policies, especially those that perpetuate exclusivity and protection from competition, may have a disproportionately malign impact on the potential for growth and development (Richardson 1989).¹

Moreover, strategic-trade theory does not allow host-country authorities to escape from the dilemmas already identified in the more traditional infant-industry arguments: How can these authorities choose which industries to target (because rents and externalities are notoriously difficult to isolate and detect)? How can they ensure that the benefits from encouraging the movement of resources into favored sectors outweigh the drag on the rest of the economy? How can they ensure that industries launched with special help subsequently “grow up” to competitive stature instead of remaining dependent on public support? And how can host authorities prevent special interests from capturing the process by which industries are selected to receive special support?

Finally, there are adverse systemic implications to consider. Strategic-trade theory introduces a disturbing zero-sum dimension into the usual win-win structure of trade and investment policy. Strategic-trade theory not only opens the door to rigorous justification for action to influence the decisions made by international firms but also suggests that countries that intervene most aggressively will benefit at the expense of those that do not. How can these beggar-thy-neighbor dynamics—in which all actors are likely to end up worse off—be muted or eliminated?

The dangers of misusing strategic-trade analysis—and the fear that strategic-trade rhetoric could easily be used by special interests seeking protection or privilege for themselves—has introduced considerable wariness into debates about the design of public policy in the developed world. As for developing countries and economies in transition, as one analyst has quipped, perhaps discussion of strategic-trade theory should be stamped “‘classified’ as ‘for economists’ eyes only’ until we have time to assess the full implications” (Yarbrough 1988).

To what extent, then, should strategic-trade-type calculations influence the design of public policy toward FDI in the developing countries and the economies in transition? To anticipate the analysis that follows in the next four chapters, mild host-country efforts to engage in investment promotion can be justified on the basis of asymmetries and imperfections in information markets, without need to appeal to strategic-trade-policy considerations. But transforming the marketing aspects of investment promotion into hefty grants, subsidies, and incentives as part of the

1. Richardson finds that losses in efficiency from constraints on trade are two to three times higher under conditions of imperfect competition than under perfect competition.

promotional package can trap participants in a strategic-trade-like rivalry to influence the externality-rich sourcing patterns of multinational investors. Such rivalry may leave all players—in particular host governments in the developing countries and economies in transition—worse off.

Turning from investment promotion to local-content mandates, the still-popular idea of imposing domestic-content requirements on foreign investors, in contrast, finds little support on infant-industry grounds, strategic-trade grounds, or any other grounds.

The assessment of export-performance requirements, however, poses a much more complicated challenge. Export-performance requirements turn out to have played an important role in correcting for market imperfections and in offsetting locational distortions during the globalization of the major manufacturing sectors examined here—to the benefit of global as well as specific host-country welfare. They have become a tool in the competition for world-scale-sized plants that does fit well—all too well—within the strategic-trade framework, with complex and ominous policy implications for all concerned. A specification of the conditions under which their use might be abandoned by developing countries and economies in transition requires quite careful examination, with consideration of how to eliminate other sources of distortion simultaneously.