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On the welfare effects of foreign investment

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Abstract

Modern growth theory emphasizes endogenous technological change as the engine of growth. A policy implication for developing countries that has been drawn from this theory is that foreign direct investment increases growth. However, welfare assessments must recognize that investment returns may be repatriated. In this paper we show that foreign investment may decrease national welfare due to the transfer of capital returns to foreigners. Taking into account all the relevant effects, we show that welfare does not change monotonously with FDI and we characterize the conditions that imply a positive or a negative welfare effect of foreign investment. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Recent literature in growth theory points to research and innovation as the engine of growth. A policy implication for developing economies that has been drawn from this theory is that foreign investment increases growth through the access to better technologies. Romer (1993) emphasizes the point and advises developing countries to open their economies to foreign investment. Several empirical studies support the argument. Blomström et al. (1994), Balasub-

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ramanyam et al. (1996) and Borensztein et al. (1998) present evidence that inward direct investment has raised the growth rate of many developing countries. Also, the results obtained by Barrel and Pain (1997) and Borensztein et al. (1998) suggest that the transfer of technology is an important channel through which this happens. The strength of the empirical result that FDI increases growth may overshadow the fact that FDI does not necessarily increase welfare.

This paper discusses the welfare effect of foreign direct investment, when foreign investors have lower costs of introducing new goods in the economy because they already know the technology.[1] Specifically we address two, intrinsically linked, effects. First, the decrease in the innovation cost which increases the rate of growth. Second, the loss of investment returns to foreigners, as national investment becomes unprofitable. A final effect of foreign investment is the change in the cost of capital due to the access of foreign investors to the international capital market.

Cardoso and Dornbusch (1989) summarize the traditional analysis of FDI in trade models. If capital is paid at its marginal product, a discrete inflow of capital increases national income, as the increase in output is larger than the returns to foreign capital. If some distortion implies that capital is paid more than its marginal product, foreign investment may imply a decrease in welfare.[2]

These results were obtained in a static environment. Investment meant more physical capital. When technological development is brought to the center of the analysis, the meaning of investment changes. If investment means better capital, or better technology, then 'new investment' may put away 'old investment'. Thus, when innovation is the engine of growth, creative destruction effects must be taken into account.

Feenstra (1996, Section 6.2) considers FDI by multinational firms in an environment similar to the one considered in this paper. However, he does not evaluate the welfare effect of FDI. He states that 'the rapid decline in consumer prices suggests long-run welfare gains (. . .). The only qualification to this concerns the asset holding of consumers (. . .). This would have to be taken into account in the welfare analysis.'[3] He considers that 'it will be unprofitable to engage in any R&D' in the home economy, so there is a 'capital loss for shareholders' in the home economy.

Feenstra (1996) formalizes technological change as an increasing variety of goods. We use a rising product quality specification. The stronger creative destruction effect implied by this specification makes it more interesting for our study. In a closed economy creative destruction is a market failure that redistributes income between nationals. With foreign investment creative destruction may imply redistribution from nationals to foreigners decreasing national income.

[1]Markusen (1995) presents a very complete discussion of the several forms that FDI may take.
[2]Johnson (1967) and Brecher and Diaz-Alejandro (1977) gave the classical examples.
[3]See Feenstra (1996, pg. 246).

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