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Governance, foreign direct investment and domestic welfare☆

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ABSTRACT

The issue of economic governance is highly discussed pertaining to the question of industrialisation of a country, but the literature on trade and foreign direct investment (FDI) hardly pays attention to this aspect. We develop a simple model to show how good economic governance in the domestic country, reducing domestic marketing and distribution costs, affects inward FDI and domestic welfare. Whether good governance in the domestic country attracts FDI depends on the way it affects the marketing and distribution costs. The effect of good governance is ambiguous on domestic welfare and depends on the cost difference between the firms, international transportation cost and the extent of cost reduction. Our analysis reveals strategic reasons for poor governance in some situations in the presence of foreign competition.

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1. Introduction

Better economic governance for improving investment climate is an important objective of many developing countries in recent years, and is getting significant attention in both academic and policy circles. As mentioned in the World Development Report (2005), "A good investment climate provides opportunities and incentives for firms – from micro-enterprises to multinationals – to invest productively, create jobs, and expand." There are several factors, such as policy uncertainty, macro instability, corruption, cost of access to finance, crime, regulation and tax administration, courts and legal system, electricity, labour regulations, transportation, access to land and telecommunications, affecting investment climates (World Development Report, 2005), and many, if not all, of which can be improved through better economic governance.

As mentioned by Rodrik (2008), "The focus of reform in the developing world has moved from getting prices right to getting institutions right." … "Governance reforms have become the buzzword for bilateral donors and multilateral institutions, in much the same way that liberalization, privatization, and stabilization were the *mantras* of the 1980s." Due to the belief that good governance is important for investment, economic growth and development, its effects on foreign direct investments (FDIs),

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which are believed to promote economic growth and are important for many developing countries,[1] certainly deserve attention. However, to our knowledge, this aspect did not get much attention in the literature.[2]

Some efforts have been made to show the relationship between economic governance and FDI empirically, yet the theoretical literature did not pay much attention to this aspect. A number of scholars like Sin and Leung (2001), Globerman and Shapiro (2002), Gani (2007) and Fan, Morck, Xu, and Lien (2007) show that economic governance and FDI are positively correlated. However, Chang (2007) points out that the performances of some countries with weak governance are better than their counterparts with strong governance. Weller and Ulmer (2008) mention that "… China has attracted significant foreign investment despite notoriously persistent corruption". Hence, the effects of economic governance on international trade, investment and welfare may not be trivial, and it is due to the fact that real-world economies operate in a second-best environment because of multiple distortions of reform policies (Rodrik, 2008). This paper is an attempt to understand such phenomenon in a more systemic way.

We develop a simple model to show the relation between good governance and inward FDI by analysing the effect of governance on the non-production costs in the domestic economy. To be more specific on the economic governance, we assume that economic governance by the domestic country reduces domestic marketing and distribution costs, which are likely to affect the domestic and foreign firms symmetrically irrespective of exporting or FDI decision taken by the foreign firm. Thus, our paper focuses on a specific but an important economic aspect of governance. Our motivation for looking at the domestic marketing and distribution costs comes from recent works showing the importance of these costs on a firm's foreign-market entry decision (Ishikawa, Morita, & Mukunoki, 2010; Nocke & Yeaple, 2007; Qiu, 2010). The reduction in the domestic marketing and distribution costs can be the outcome of investment by the domestic government on road and infrastructure. It may also be due to better economic governance that is reducing corruption in the transportation sector.[3]

We consider an international duopoly market with a foreign firm and a domestic firm. These firms compete in the domestic country. The foreign firm can either export or undertake FDI. Exporting requires the foreign firm to incur a per-unit international transportation cost, while FDI requires the foreign firm to invest a fixed amount. These firms also incur per-unit domestic marketing and distribution costs, comprising of transportation cost and labour costs related to sales. In this framework, we examine the effects of economic governance (affecting either domestic transportation costs or the labour costs related to sales) on inward FDI and domestic welfare.

We show that whether economic governance reduces the cost of domestic transportation or the labour costs related to sales may have important implications on inward FDI. If better governance reduces the transportation cost, which is considered to be independent of labour productivity in sales, it increases an incentive for inward FDI. However, if economic governance reduces the labour costs, which depend on the labour productivities, it may reduce the incentive for inward FDI. Our analysis can be extended easily to capture the situation where economic governance reduces the transportation cost as well as the labour costs related to sales.

We further show that, irrespective of the way good governance affects the per-unit costs of the firms, the effects on domestic welfare are ambiguous, and they depend on the factors such as the domestic marketing and distribution cost (which is the sum of transportation and labour costs), international transportation cost and the extent of marginal cost reduction.[4]

Our results can be summarised in the following way. Whether good governance reduces domestic transportation costs or the labour costs related to domestic sales, we get that:

(i) Good governance increases domestic welfare by attracting FDI, if the domestic marketing and distribution cost difference between the firms is large compared with international transportation cost.
(ii) Good governance may reduce domestic welfare by attracting FDI if the domestic marketing and distribution cost difference between the firms is small compared with international transportation cost, since the benefit of good governance may be taken away by the foreign firm. Hence, good governance, reducing domestic marketing and distribution cost, may not be beneficial to the domestic country even if it attracts FDI when other benefits of FDI such as knowledge spillover, and the policies, such as taxation to extract foreign profits, remain the same.

Good governance creates two further implications, if good governance reduces the domestic marketing and distribution costs by reducing the labour costs related to domestic sales:

(iii) Good governance reduces domestic welfare by preventing FDI if the domestic marketing and distribution cost difference between the domestic and the foreign firms is large enough compared with international transportation cost. Hence, the domestic country may not have the incentive to improve governance unless they are complemented by other FDI-attracting policies.

[1] As mentioned in UNCTAD (2006), FDI dominates international trade in recent years.
[2] Dong and Gou (2010) and Wang et al. (2013) show the effects of corporate governance on R&D investment and FDI respectively. Kim et al. (2013) show that social capability of a country plays an important role in determining the effects of trade and FDI on domestic investment.
[3] Rahman (2011) points out that illegal payment to ease passage through the system may create high transportation costs.
[4] Mukherjee and Sinha (2007) show the effects of marginal cost reduction in the domestic firm, either due to innovation or knowledge spill-over, on inward FDI and domestic welfare. Unlike that paper, better governance in the current paper reduces the marginal costs of both the domestic and the foreign firms, and makes the type of cost reduction important.

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