



Brotherhood of competition: Foreign Direct Investment and domestic mergers

Ozgur M. Kayalica^{a,*}, Rafael S. Espinosa-Ramirez^b

^a Department of Management Engineering, and Technology and Economic Development Research Center (TEDRC), Istanbul Technical University, Macka, Istanbul, 34367, Turkey

^b Department of Economics, University of Guadalajara, Guadalajara, Mexico

ARTICLE INFO

Article history:

Received 12 January 2007

Accepted 14 July 2007

Available online 26 February 2008

Keywords:

Foreign Direct Investment

Merger

Subsidy

ABSTRACT

We examine the effects of mergers on Foreign Direct Investment (FDI), and on shaping national policies regarding FDI. In this work we develop a partial equilibrium model of an oligopolistic industry in which a number of domestic and foreign firms compete in the market for a homogeneous good in a host country. It is assumed that the number of foreign firms is endogenous and can be affected by the government policy in the host country. The government sets the policy (subsidies) to maximise social welfare. We allow domestic mergers. Our main results suggest that when the host country government imposes discriminatory lump-sum subsidy in favor of foreign firms, a merger of domestic firms will increase the number of FDI if the subsidy level is exogenous. With an endogenous level of subsidy, a merger of domestic firms will decrease (increase) the welfare if the domestic firms are more (less) efficient.

© 2008 Elsevier Inc. All rights reserved.

1. Introduction

According to UNCTAD (2000), cross-border M&A (Mergers and Acquisitions) was the main force behind the major rise of Foreign Direct Investment (FDI) around 2000. During the period between 1990 and 2000, most of the growth in international production has been via cross-border M&As rather than greenfield investment. The total number of all M&As worldwide (cross-border and domestic) has grown at 42% annually between 1980 and 1999. The value of all M&As (cross-border and domestic) as a share of world GDP has risen from 0.3% in 1980 to 8% in 1999 UNCTAD (2000).

Governments' policy measures regulating M&A activities affect the welfare of billions of consumers, as discussed in Benckroun and Chaudhuri (2006), as well as the welfare of other economic agents such as employees and employers. For example, Bhattacharjea (2002) claims that if foreign mergers and export cartels can be treated as a reduction in the effective number of foreign firms, this can actually reduce home welfare below the autarky level, as the free-rider benefits that greater concentration bestows on domestic firms who are not party to the merger are insufficient to compensate for the loss inflicted on domestic consumers. This is a very serious regulatory issue in the world economy. The countries should pursue local and international policies in order to regulate possible unfair competitive strategies in case of mergers. This question has been addressed by Bhagwati (1991), Gatsios and Seabright (1990) and Neven (1992). These researches claim that the regulatory policies should be subject to international negotiations or assigned to higher levels of government.¹ Bulk of the studies in the literature analyse the affect of foreign mergers on welfare.

* Corresponding author. Tel.: +90 212 2912391; fax: +90 212 2407260.

E-mail addresses: kayalica@itu.edu.tr (O.M. Kayalica), rafaelsa@cucea.udg.mx (R.S. Espinosa-Ramirez).

¹ In 2002, The Fair Trade Commission (FTC) of the South Korea government announced that it would introduce regulations by the end of that year. The FTC claimed that this would allow it to track mergers between foreign firms which could seriously impair relevant domestic industries. FTC signed an agreement with Australia in 2003 for the mutual application of Korea's fair competition law and would pursue similar agreements with the United States, European Union and Japan. Similarly, the European Commission has regulated mergers between foreign firms when they are affecting negatively the European interests.

Domestic firms also merge for several reasons, for instance in order to obtain competitive advantage against foreign rivals. Mergers of domestic firms appear to be a surviving strategy. Following this line, Collie (1997) develops a significant paper on mergers of local and foreign firms and trade policy under oligopoly. Ross (1988) shows that a domestic merger driven by fixed cost-savings leads to lower price increases in the face of unilateral tariff reduction than otherwise. In a two country oligopolistic model, Long and Vouden (1995) show that bilateral tariff reductions increase the profitability of a domestic merger when the asymmetry between the merging firms is large enough. Benchekroun and Chaudhuri (2006) show that trade liberalization always increases the profitability of a domestic merger (regardless of the cost-savings involved). Espinosa and Kayalica (2007) analyse the interface between environmental policies and domestic mergers externalities. Despite these works, domestic mergers have been an issue not explored enough by the economic literature.

As an important element of global economic activity, FDI has received enormous attention from scholars worldwide.² This includes the issue of increasing competition amongst countries trying to attract FDI. The Trade Related Investment Measures (TRIM) agreement that is based on the GATT principles on trade in goods and regulates foreign investment, does not govern the entry and treatment regulations of FDI, but focuses on the discriminatory treatment of imported and exported products and not the services. This suggests that national governments can encourage or discourage foreign investors in a discriminatory manner by choosing the policy tools that do not have a direct effect on international trade.

In this work, we develop a partial equilibrium model of an oligopolistic industry in which a number of domestic and foreign firms compete in the market for a homogeneous good in a host country. It is assumed that the number of foreign firms is endogenous and can be affected by government policy in the host country. The host country government uses lump-sum profit subsidies to attract FDI. The government sets the policy to maximise social welfare. The most important feature of the model is to allow mergers of domestic firms and to analyse the flow of foreign firms going into/out of the host country. This distinguishes our model from the previous works mentioned above.

Under the above specification, we examine the optimal policies. The basic structure is given in the next section. In Section 3 we determine the optimal lump-sum subsidy which is used in a discriminatory fashion in favor of FDI. Later in this section we analyse the effect of domestic mergers on welfare once the optimal policy has been set. The effect of domestic mergers on FDI is examined in Section 4. For the above scenario, we also investigated the response of government's reaction to mergers when merger creates a negative externality on welfare. We conclude in the last section.

2. The basic framework

We consider an economy in which there are m identical domestic firms and n identical foreign firms competing in an oligopolistic industry. Consumers have identical quasi-linear preferences and are given some exogenous level of income, \bar{Y} .³ The government collects the subsidy cost from consumers by lump-sum taxation. Denoting the total cost of the subsidy by TR and the consumers' surplus by CS, we can derive the consumers' indirect utility as $CS + \bar{Y} - TR$. Let also π^d be the domestic profits. Using these we can define the government's welfare (W) maximisation problem as the following.

$$W = \pi^d m + CS + \bar{Y} - TR \quad (1)$$

Totally differentiating (1) we get

$$dW = m d\pi^d + dCS - dTR \quad (2)$$

where the terms at the right hand of Eq. (2) are the total profits of domestic firms, consumer surplus and tax revenue respectively.

The domestic and foreign firms compete in the domestic market of a homogeneous good. The inverse demand function for this commodity is given by⁴

$$p = \alpha - \beta D, \quad (3)$$

where D is the sum of outputs by domestic and foreign firms, i.e.,

$$D = m x^d + n x^f, \quad (4)$$

where x^d and x^f are the output of a domestic and a foreign firm.

² See, for example, Brander and Spencer (1987), Ethier (1986), Helpman (1984), Hortsman and Markusen (1987), Itagaki (1979), Janeba (1995), Kayalica and Lahiri (2007), Markusen (1984), and Smith (1987).

³ The preferences of the consumers are represented by $u(y, D) = y + f(D)$ where y is the consumption of a numeraire good produced under competitive conditions with a price equal to 1. There is also just one factor of production whose price is determined in the competitive sector. We denote the consumption of the non-numeraire good by D , while function f is increasing and strictly concave in D . Hence, with income \bar{Y} each individual consumes $D = g(p)$ of the non-numeraire good and $y = \bar{Y} - pg(p)$ of the other goods (where p is the price of non-numeraire good).

⁴ The inverse demand function is derived from one specific case of the preferences mentioned in the beginning of this section. That is, $u(y, D) = y + \alpha D - \beta D^2 / 2$.

متن کامل مقاله

دریافت فوری ←

ISIArticles

مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات