

# Export-performance requirements, foreign investment quotas, and welfare in a small dynamic economy

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## Abstract

This paper examines the welfare effects of trade-related investment measures (TRIMs) in an intertemporal model with accumulations of domestic capital and foreign bonds. The TRIMs considered are foreign-investment quotas and export-share requirements. Given a pre-existing tariff, the second-best policy to the host economy is a foreign-investment quota together with an export-share requirement. Hence, completely eliminating the use of TRIMs in the presence of tariffs, as agreed upon in the Uruguay Round of GATT in 1994, may be sub-optimal from the viewpoint of the host country.

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## 1. Introduction

To circumvent widespread existing tariff barriers in commodity trade, firms have resorted to relocate a part or all of their production activities from home bases to foreign locations. This is known as the “tariff-jumping” motive of foreign direct investment (FDI).<sup>1</sup> Tariff-jumping foreign investment, however, tends to reduce the host country’s

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<sup>1</sup> The other purpose of foreign investment is globalization of the production process to take advantage of an international division of labor. See [Ethier \(1986\)](#) for details.

welfare for two reasons. First, foreign capital inflow exacerbates the existing tariff distortion through “overproduction” of the importable goods, in which the country has a comparative disadvantage.<sup>2</sup> Second, foreign investment may crowd out a substantial amount of domestic investment, thereby slowing down the accumulation of domestic capital.

To mitigate the tariff distortionary effect of foreign capital inflows, Rodrik (1987) suggests the use of an export-performance policy. This policy specifies that a portion of the output produced by foreign firms in the host country must be exported at world prices (which are lower than the tariff-inclusive domestic prices). The subsequent fall in the effective prices leads to a lower return to foreign capital and hence a smaller output. The contraction in the protected sector corrects the distortion exacerbated by foreign investment, rendering the policy of export requirements to be welfare improving.<sup>3</sup>

Alternatively, foreign capital inflows may be restricted to a certain level to avoid crowding out domestic investment. Foreign investment restrictions can be imposed in the form of quantity controls (i.e., foreign investment quotas) and/or by confirming foreign investment in certain sectors where domestic investment is deficient. Although there have been extensive studies on the welfare effect of exogenous inflows of foreign capital in static models,<sup>4</sup> little attention has been given to the crowding-out effect of capital inflows and the effects of the export performance policy in a dynamic setting.

In the agreements reached in the Uruguay Round of GATT in 1994, the export performance requirements, input import limitations and other policy interventions were lumped together under the generic heading “trade-related investment measures” (TRIMs).<sup>5</sup> By now, TRIMs have become a major item for discussing among the member nations of the World Trade Organization (WTO). In this paper, we address two welfare issues relating to TRIMs: First, what is the optimal level of foreign-investment quotas in the presence of a tariff? Second, what is the optimal ratio of export requirements for correcting the tariff distortion exacerbated by foreign capital? To answer these two questions, an intertemporal model will be developed in Section 2, in which the short-run and the steady-state equilibrium will be analyzed. Section 3 examines the crowding-out and the welfare effects of foreign investment quotas and export-share requirements on foreign firms. In addition, individually and jointly optimal policies will be derived and discussed. Section 4 contains concluding remarks.

## 2. The model

In this section we describe the setup of an intertemporal model in which both domestic and foreign firms operate in the home country. By using labor and sector-specific factors, domestic firms produce two types of goods: an importable manufacturing good  $X$  and an exportable agricultural good  $Y$ . The production functions are given by:  $X = X(L_X, K)$  and

<sup>2</sup> This argument was presented by Brecher and Diaz Alejandro (1977).

<sup>3</sup> Chao and Yu (1994) analyzed the welfare effect of export share requirements under quotas.

<sup>4</sup> See Batra and Ramachandran (1980), Batra (1986), and Beladi and Marjit (1992), among others.

<sup>5</sup> Greenaway (1992) provided a detailed list of TRIMs.

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