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## COMMENT

# THE ROLE OF TRADE & FOREIGN DIRECT INVESTMENT IN DEVELOPMENT

*Kevin A. Hassett\**

Of all the intellectual victories accomplished by economic science in the past two-hundred years, the view that trade can improve human welfare is perhaps the most important, dating back to Adam Smith and David Ricardo. What started out as a purely theoretical analysis of comparative advantage has, over the years, been buttressed by empirical analysis.

Foreign direct investment (FDI) has been a key component of trade for decades, and has been the focus of a tidal wave of academic research as well. Conceptually, FDI must have an important role in providing welfare gains associated with trade. One of the key differences between countries, after all, is the relative quantity of capital available to its citizens. In my remarks, I intend to provide a bird's eye view of the literature on FDI with a focus on the developing country's perspective.

First and foremost, we must ask ourselves what impact FDI has on the welfare of developing countries. On this, the literature and economic theory are on relatively solid ground. Inflows of capital into developing countries increase the marginal product of domestic laborers, and increase their wages as well. In theory, this link is obvious, and in the empirical literature, the link is perhaps too strong, as suggested in a recent review.<sup>1</sup> A number of studies have found, for example, that foreign firms pay significant wage premia over domestic firms when they begin activity in developing nations. Graham, for example, found that U.S. multinationals pay about double the local wage in developing countries.<sup>2</sup> This observation has been supported by numerous other studies. Lim reports that Nike subcontractor wages were about triple the average local minimum wage in Indonesia.<sup>3</sup> Lukacs found a similar—though slightly less dramatic pattern—in Mexico.<sup>4</sup>

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\* University of Michigan Law School, William Davidson Institute April 18th, 2003.

1. DRUSILLA K. BROWN ET AL., *THE EFFECTS OF MULTINATIONAL PRODUCTION ON WAGES AND WORKING CONDITIONS IN DEVELOPING COUNTRIES* (Nat'l Bureau of Econ. Research, Working Paper No. 9669, 2003).

2. EDWARD M. GRAHAM, *INST. FOR INT'L ECON., FIGHTING THE WRONG ENEMY: ANTIGLOBAL ACTIVISTS AND MULTINATIONAL ENTERPRISES* (2000).

3. Memorandum from Linda Lim, *My Factory Visits in Southeast Asia and UM Code and Monitoring*, to Larry Root (Sept. 6, 2000), at <http://www.fordschool.umich.edu/rsie/acid/Documents/LimNotes00.pdf>.

4. AARON LUKACS, *CATO INST., WTO REPORT CARD III: GLOBALIZATION AND DEVELOPING COUNTRIES* (2000).

It is worth noting that the empirical literature has also found that there may be wage spillovers from FDI. Aitken, Harrison, and Lipsey found some evidence of spillovers, that is, that wages are higher in locally owned plants because of FDI.<sup>5</sup> The evidence was stronger in the United States than elsewhere, however. Feenstra and Hanson find a quite plausible wage premium for skilled workers, with the fraction of firms that are foreign owned in an industry significantly increasing wages.<sup>6</sup> Thus, foreign investment might also be expected to help provide developing countries with a strong incentive to increase human capital investments. Taken together, there seems to be a reasonable consensus that FDI significantly improves the welfare of workers in target countries.

But what about the source countries? Popular discussions have aroused concern of late that “outsourcing” is an important drag on employment in the United States. The argument, propounded most visibly by television host Lou Dobbs, is that U.S. firms place capital abroad to take advantage of low wage foreign workers, thus shifting jobs abroad. Are the gains from FDI one-sided?

While the literature in this area is much less developed, the answer is probably negative. U.S. multinationals compete in a world marketplace against competitors who also have access to foreign workers. If U.S. firms shunned “outsourcing” or “offshoring” then the results would likely be negative at home as foreign competitors could establish a significant cost advantage. In a recent paper, Slaughter suggests that the data may support this view.<sup>7</sup> He found that foreign and domestic employment are complementary. Firms that increased foreign employment in the study’s sample also increased domestic employment.

If the Slaughter analysis stands, then FDI offers possible symmetric benefits to countries. The investors gain a competitive edge, and the targets experience increased wages. How, then, might countries act to increase FDI activity?

Once again, we are back to an area that has been studied extensively. A natural policy candidate would be to reduce taxes on FDI. Since tax policy has been found to have a significant effect on business fixed in-

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5. Brian Aitken et al., *Wages and Foreign Ownership: A Comparative Study of Mexico, Venezuela, and the United States*, 40 J. INT’L. ECON. 345, 345–71 (1996).

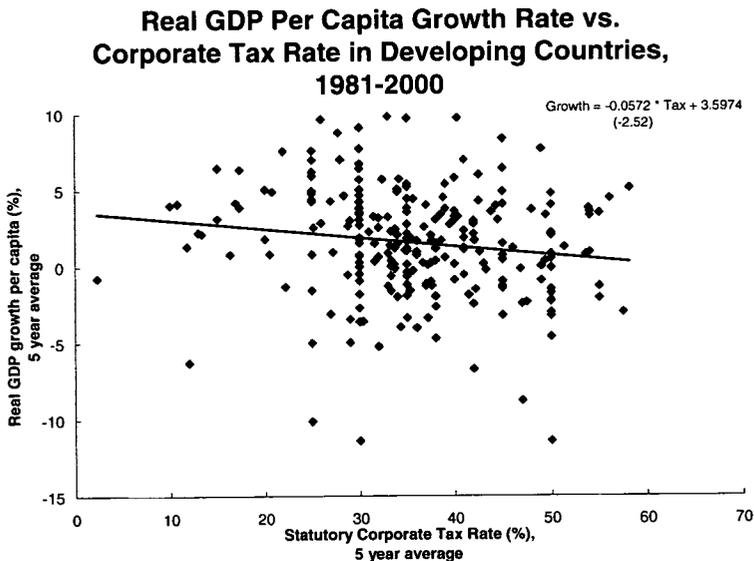
6. Robert C. Feenstra & Gordon H. Hanson, *Foreign Direct Investment and Relative Wages: Evidence from Mexico’s Maquiladoras*, 42 J. INT’L ECON. 371, 371–93 (1997).

7. Matthew J. Slaughter, *Globalization and Employment by U.S. Multinationals: A Framework and Facts*, DAILY TAX REPORT, Mar. 26, 2004, at J-1.

vestment in numerous studies<sup>8</sup> one might expect that FDI is also responsive.

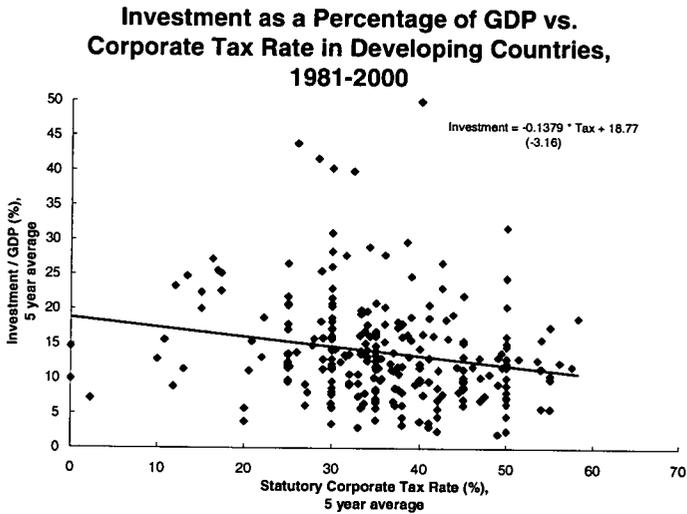
As first noted by Auerbach and myself,<sup>9</sup> however, this issue is much more complicated than you might think at first glance. Tax policy that stimulates investment can drive a wedge between the price of new and old capital. (A hotdog stand owner is not pleased if a tax credit is passed for new purchases of hotdog stands, which will subsidize his competition.) A large share of FDI has often been accounted for by acquisitions. Something that reduces the price for new capital may discourage such acquisitions. Such complications are a confounding factor for empirical research, but despite this, a number of papers have found a solid link between tax factors and FDI.

In a work in progress that draws on a new international tax database we have constructed at the American Enterprise Institute (AEI), we have begun to track the links between taxes, FDI, and economic growth. We have collected marginal tax rate data for almost every country on earth from 1980 through 2002, and can thus perform panel data estimates that have not been possible in the past.



8. For a recent survey, see Kevin Hassett & R. Glenn Hubbard, *Taxes and Business Investment*, in 3 HANDBOOK OF PUBLIC ECONOMICS 1293-1338 (Alan Auerbach et al. eds., 2002).

9. Alan Auerbach & Kevin A. Hassett, *Taxation and Foreign Direct Investment in the United States: A Reconsideration of the Evidence*, in STUDIES IN INTERNATIONAL TAXATION (Alberto Giovannini et al. eds., 1993).



Given the links that appear in the literature between taxes and FDI, and FDI and domestic welfare, it perhaps is not surprising that the correlations between tax rates and overall growth are as strong as they are. Our preliminary judgment is that highly mobile capital flows to jurisdictions that tax it the least, and away from high tax nations, and that these flows have a significant impact on output. Accordingly, there is ample room for developing nations to consider tax policy reforms that will encourage the capital spigot to turn in their direction. It is an open question whether, however, whether the benefits would be so apparent in the data if every nation set its corporate tax rate at a very low level. Absent beggar-thy-neighbor competition, the benefits would depend more on the responsiveness of the supply of world saving to higher after-tax returns. In the meantime, however, there appear to be clear costs to falling behind in world tax competition.