International Economics
Study Guide/ANSWERS
Chapter 9

1. Define direct foreign investment (DFI).

Ans: DFI, or direct foreign investment is international capital movement where corporate headquarters in home country have control over foreign subsidiary. Control is established through purchase of an existing company, or ownership of a substantial part of its shares, or building and opening of a new enterprise or facility. It should be contrasted with portfolio investment that gives, by and large, no control over foreign assets.

2. What is the overall motivation for corporations to establish a foreign subsidiary? List some of the individual factors that induce companies to invest abroad (i.e., cost considerations and revenue enhancements).

ANS.: The overall motivation for corporations to establish a foreign subsidiary is increased profit.
The individual factors inducing DFI are diverse and any particular investment may involve one or more of the following:
COST CONSIDERATIONS:

- investment in extractive industries to secure raw material supplies
- investment in manufacturing industry to take advantage of cheaper foreign labor
- to locate production close to foreign markets to avoid transportation costs
- to circumvent tariff barriers
- to take advantage of incentives offered by host countries

REVENUE CONSIDERATIONS

- to locate production close to foreign markets to increase foreign sales
- marketing considerations such as above, including establishing distribution channels
- to take advantage of incentives offered by host countries
- to capitalize on changes in the exchange values of currencies

3. Does the economic interest of a U.S. company investing abroad in manufacturing subsidiaries coincide with the interest of the United States? If not, in what ways do the interests diverge? Why does the U.S. labor movement object to foreign investment by U.S. companies?

ANS.: The economic interest of a U.S. company investing abroad in manufacturing subsidiaries does not necessarily coincide with the interest of the United States. There are two main ways in which the firm's interests may diverge from the national interests as explained below:

1. Under present institutional arrangements, foreign tax payments are credited against U.S. taxes due. For the firm the relevant comparison is between the after tax positions in the case of home and foreign investment. The relevant comparison for the nation is between the return after

foreign tax is paid and the home pre-tax position. The firm desires that the after tax position in the foreign investment be greater than the after tax position in the (forgone) domestic investment, making the after tax returns on the foreign investment higher to the firm. That is, the firm is interested in the after tax return on its capital, regardless of to which govt. the tax revenues are rendered. The national interest is served when the after tax returns on the foreign investment is higher than the potential (forgone) gross returns of the domestic investment. Under these conditions the government does not lose tax revenues.

From point of view of **<u>national interest</u>**, DFI is beneficial only if:
net-of-tax returns abroad>gross returns @ home
From point of view of **<u>private firm</u>**, DFI is beneficial only if:
net-of-tax returns abroad>net-of-tax returns returns @ home
From point of view of **<u>world</u>**, DFI is beneficial only if:
gross returns abroad>gross returns @ home

The latter implies better allocation of resources.

2. Overseas foreign investment lowers the productivity of other factors of production (labor and natural resources) relative to their levels had the investment occurred at home. The private firm is interested only in the return to capital.

Why does the U.S. labor movement object to foreign investment by U.S. companies?(con't)
The U.S. labor movement objects to foreign investment by U.S. companies or tends to be critical of overseas investment because it lowers domestic labor productivity and wages. Productivity is lowered because there is less capital per worker than if the investment were made domestically.

4. How are foreign subsidiaries of U.S. companies taxed?

Ans. Foreign subsidiaries of U.S. companies are taxed abroad according to the corporation tax regime in the country where they operate. Taxes paid to foreign governments are credited up to the maximum U.S. corporate tax rate. Companies operating in more than one foreign country may aggregate their tax payments for maximum U.S. tax benefit. A further advantage to companies with foreign subsidiaries is the deferral of U.S. taxes until overseas profits are repatriated.

5. What are transfer prices and how are they affected by differential taxation and tariffs?

Ans. Transfer pricing is the use of internal prices within the firm that differ from market prices. This can enable the firm t distribute its recorded profits to minimize the tax liability. Through transfer pricing profits can be shifted to a low tax nation. Additionally, tariffs may reduced by pricing the firm's exports to its subsidiary in a high tariff nation at artificially low prices, then perhaps increasing the prices at the end of the subsidiary's production process.

6. Examine the effects of direct foreign investment on the welfare of (a) the source country, (b) the host country, and © the world as a whole

Ans.: (a) the **source country** is likely not to gain (although it MAY benefit on balance). The benefits of greater productivity of capital in the source country (capital has been reduced through DFI, thus raising the marginal product of capital–MP_k) may be more than offset by lower productivity in labor and natural resources (there is now post-DFI less capital per unit of other factors).
OPTIONAL: The impact on the balance of payments is negative due to capital outflow, and exports may be reduced. Imports may increase if the investment leads to the export of goods to the source nation.

(b) The **host country** benefits from an inflow of capital. The rate of return on existing capital may be lowered (lower MP_k from increased capital on fixed labor and land), but the productivity of other factors is raised. National Income is raised, (possibly leading to an offsetting increase in imports), and saving rise. The rise in savings leads to a rise in investment in the host country which leads to a higher rate of growth. Positive externalities that affect the overall productivity of labor and capital may be generated. Additionally, the host country benefits through increased diffusion of knowledge and technology.
OPTIONAL: The balance of payments improves due to the capital inflow and also from increased exports and reduced imports.

© The **world as a whole** benefits due to more efficient use of factors on a global scale should lead to an increase in world output. That is the MP_k of the host country is greater than the MP_k of the source country leading to an overall increase in world output. Only if the firms have failed to appreciate the risks of operating in the foreign environment will a reduction occur.

7. What are the effects of labor migration on (a) the world as a whole, (b) the host country, © the source country, and (d) labor in the two countries?

Ans.: (a) the world as a whole: Labor migration will improve resource allocation on a global scale and will enhance world welfare. Exceptions to this may be:

1. Migration motivated by tax differences instead of genuine economic motivation.
2. The loss of skilled labor by the source country leading to the loss of important externalities–brain drain.

(b) the host country: Output in the host country will increase by more than the loss of output in the source country because of the higher labor productivity in the host country (as evidenced by the higher wage there). Capital in the host country will gain because of the increase in the supply of labor and the consequent reduction in labor cost.

(c) the source country: Output will fall and the return to capital in the source country will by adversely affected because of a lower labor endowment.

(d) labor in the two countries: Labor remaining in the source country will be better off, because it will be better endowed with capital on average. Labor in the host country will be worse off.

OPTIONAL QUESTION:

8. Why might the *labor skill theory* of the commodity composition of trade be appropriate in a world where production and trade are handled by *multinational corporations*? (Explain italicized terms.)

Ans.: Recall from Chapter 3, the commodity composition of trade, the labor (or human) skill qualification to the factor endowment theory suggests countries that are well endowed with skilled labor will export commodities that embody skilled labor. Conversely, countries with an abundance of unskilled labor will export commodities that embody unskilled labor. This theory is still valid in a world where MNCs influence patterns of production and trade. The firm will move the mobile factor of production (capital) in order to equalize its return between countries. However, it will divide its productive activities so that the production of goods embodying a high degree of unskilled labor will occur in countries that are well endowed with (cheap) unskilled labor. Activities requiring a high degree of skilled labor (e.g., managerial functions, financial planning, and R &D) will occur in nations well endowed with skilled labor.
multinational corporations–(MNCs) are companies with production facilities in several countries.