Check In

Grab an index card, write your name, and answer the following:

What is an MNC? What is FDI?

The Politics of MNCs: Are they too powerful? Are they fair?

Recap

Multinational corporation (MNC)
A firm that owns/manages productive facilities in two+ countries

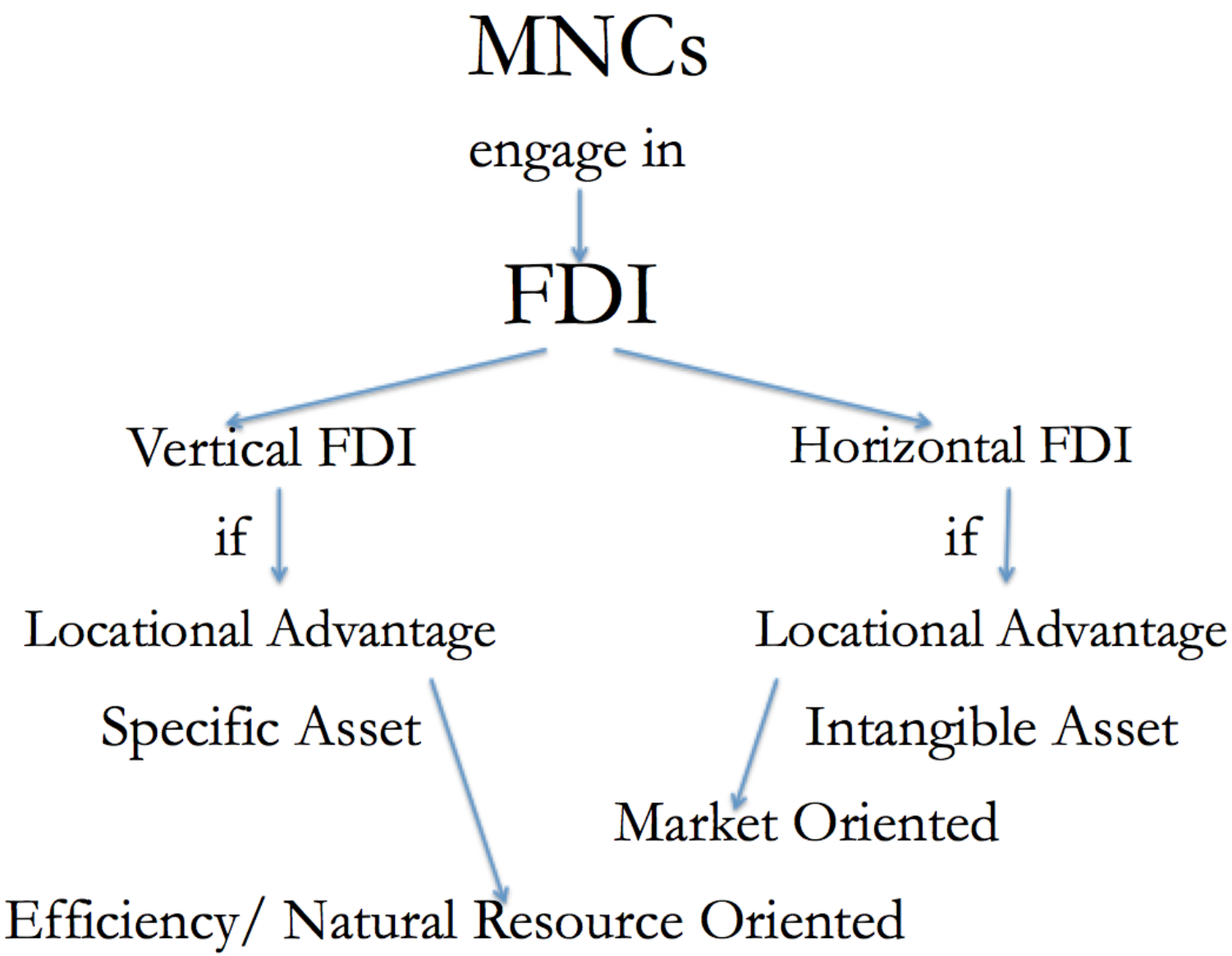
MNCs engage in **Foreign Direct Investment (FDI)**
Investments in a foreign country via the acquisition of a local facility or the establishment of a new facility (managerial control)

- Horizontal FDI: Same good produced in multiple countries
- Vertical FDI: Control different stages of worldwide production

To engage in FDI, MNCs require a **locational advantage and market imperfection**

- Locational advantages can be Natural resource, efficiency or market based
- Intangible assets + locational advantage = horizontal FDI
- Specific assets + locational advantage = vertical FDI

Recap


MNCs
engage in
FDI
Vertical FDI
Horizontal FDI
if
if
Locational Advantage
Locational Advantage
Specific Asset
Intangible Asset
Market Oriented
Efficiency/ Natural Resource Oriented

Benefits of MNCs to host countries

MNCs can:

- Transfer savings to host countries
- Bring capital, technology and managerial experience
- Provide host country producers with connections to the international market
- Improve a country's balance of trade (increase their exports of intermediate goods)
- Create jobs by hiring locals

Costs of MNCs to host countries

MNCs can:

- Reduce government's policy autonomy
- Reduce funds available for domestic investment
- Drive established host country firms out of business
- Only hire foreigners for top-level managerial positions
- Exploit labor and create downward pressure on wages
- Damage the environment

Today's Focus

MNCs can:

- Reduce government's policy autonomy
- Reduce funds available for domestic investment
- Drive established host country firms out of business
- Only hire foreigners for top-level managerial positions
- Exploit labor and create downward pressure on wages
- Damage the environment

Are MNCs too powerful? Are MNCs fair?

Question 1

Are MNCs too powerful? Do they reduce host governments' policy autonomy? What can developing countries do to minimize this?

Trade Off

Host country governments face a tradeoff from international firms:

- MNCs provide potentially large benefits that can spur development
- MNCs might clash with the economic objectives of the government

Trade Off

Host country governments face a tradeoff from international firms:

- MNCs provide potentially large benefits that can spur development
- MNCs might class with the economic objectives of the government

Governments use national regulations to control MNCs. The ability of host governments to regulate MNCs affects whether they win or lose from FDI.

MNCs in developing countries

Developing countries have historically been more skeptical about MNCs

- Legacy of colonialism
- Concern about foreign domination
- Result $\rightarrow$ greater regulation of FDI

"The association of foreign companies with former colonial powers, their employment of expatriates in senior positions, their past history (real or imagined) of discrimination against local works, and their embodiment of alien cultural values all contributed to the suspicion with which foreign [MNCs] are regarded."

Regulation in developing countries

Some of the regulatory options used by developing countries include:

- Shift majority ownership to local shareholders
- Regulate amount of profits that MNCs can repatriate
- Impose export performance requirements (using domestic inputs or exporting so much of the final good)
- Impose technology transfer requirements
- Impose employment requirements
- Limit access to local capital markets
- Establish export processing zones

Regulation in developing countries

Some of the regulatory options used by developing countries include:

- Shift majority ownership to local shareholders
- Regulate amount of profits that MNCs can repatriate
- Local content requirements (buying inputs from domestic firms)
- Impose export performance requirements (exporting so much of the final good)
- Impose technology transfer requirements
- Impose employment requirements
- Limit access to local capital markets
- Establish export processing zones

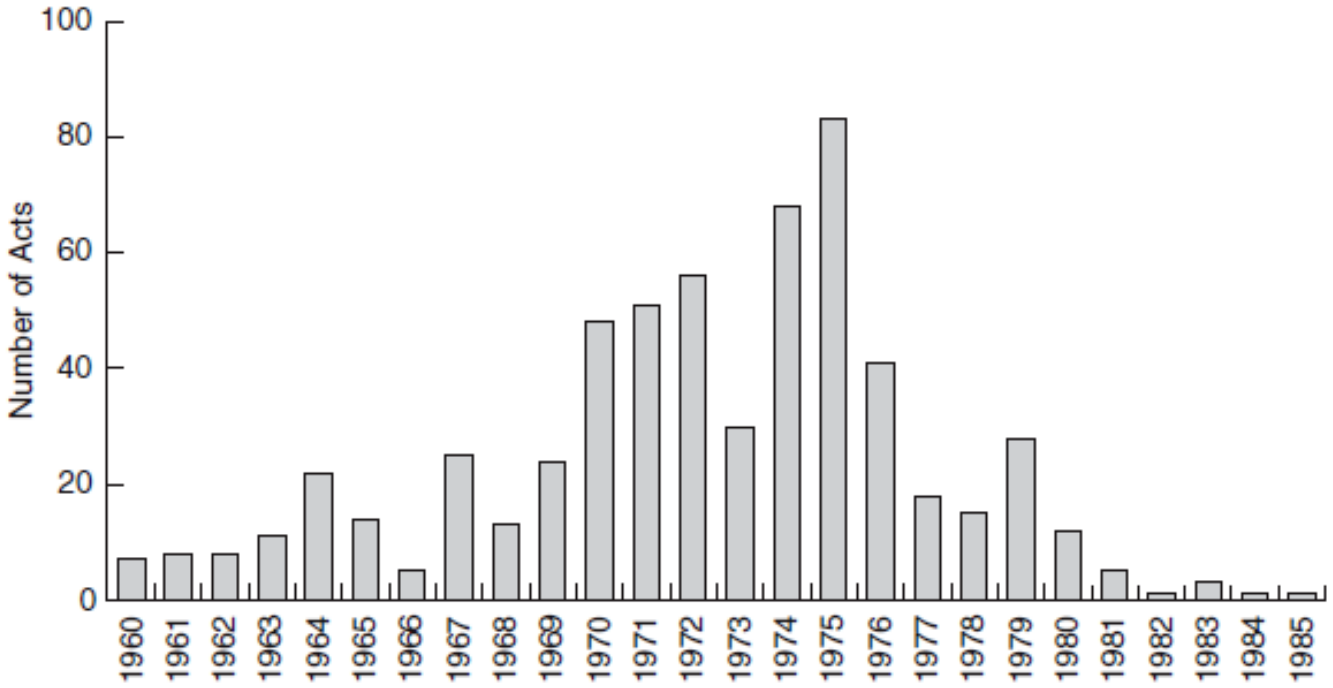
The most extreme form of regulation is expropriation.

Expropriation

The most powerful option available to host governments is to expropriate (nationalize) MNC investments

- Expropriation is considered legal
- Expropriation has to be for a public purpose
- Adequate and prompt compensation must be given
- Disputes over compensation can be heard by ICSID and UNCITRAL

Expropriation



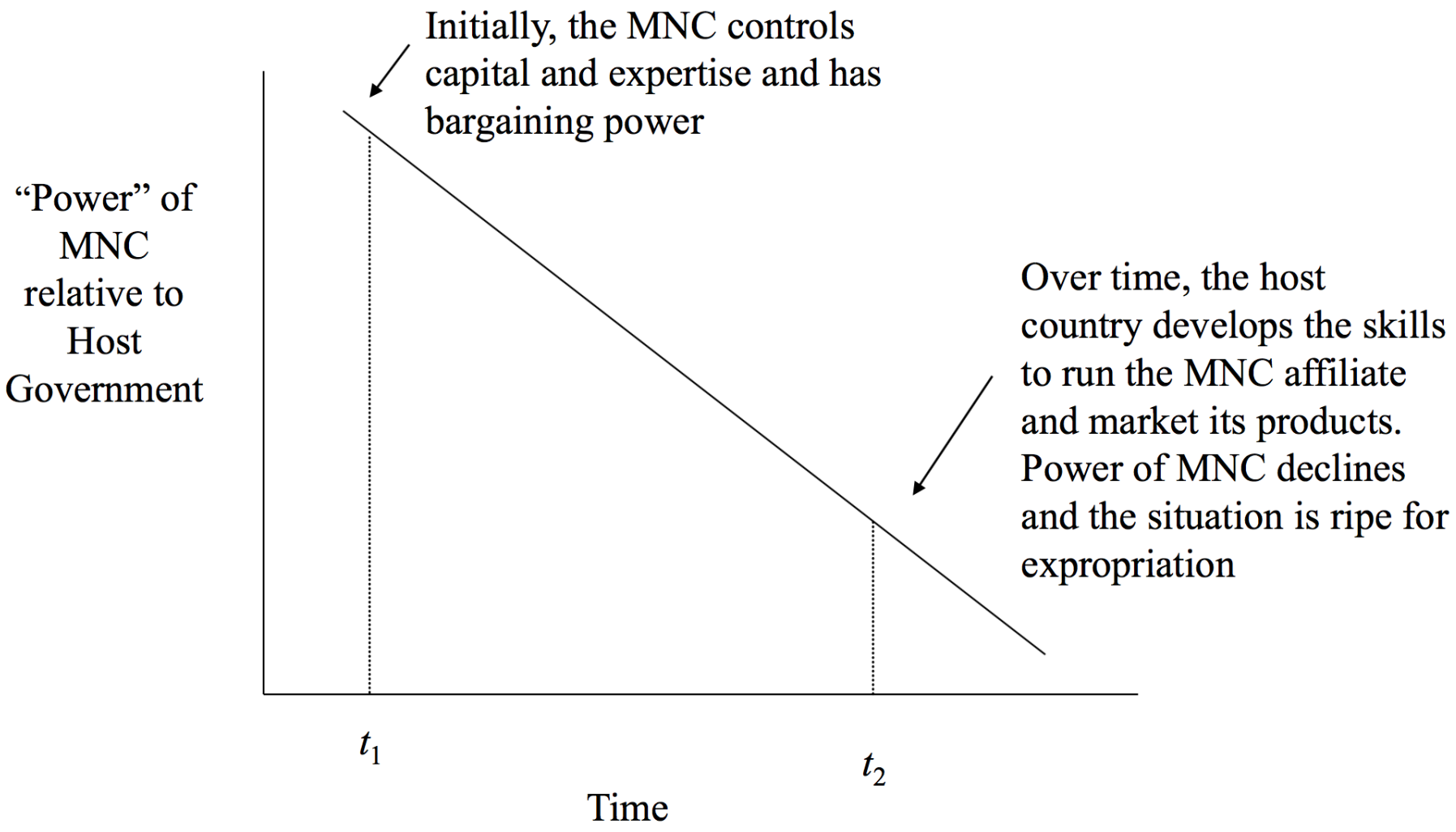
Government policies usually applied to a type of economic activity rather than to a specific firm. Thus, the number of firms affected is much higher than the number of acts of expropriation.

The obsolescing bargain

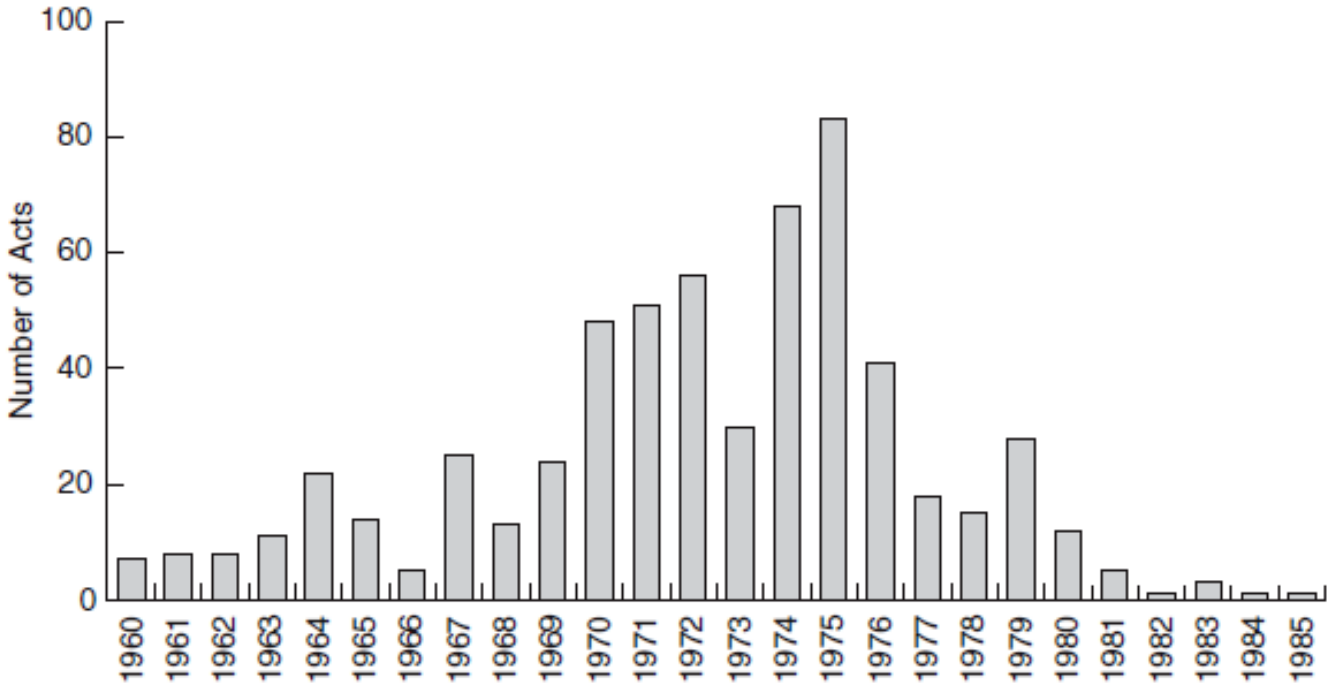
The **obsolescing bargain** provides one explanation for **how and when** host governments can gain power over MNCs, particularly via expropriation

- The obsolescing bargain posits a negative relationship between MNC power over the host government and time
- At the time of the initial investment, MNCs are powerful because they own the capital and skilled knowledge.
- At some point, the host government no longer needs the MNC to operate the affiliate, and it expropriates it

The obsolescing bargain



Expropriation



Government policies usually applied to a type of economic activity rather than to a specific firm. Thus, the number of firms affected is much higher than the number of acts of expropriation.

After 1970

Why did we see less expropriations after the 1970s?

- Extractive and raw materials are must vulnerable to expropriation
  - Locals learned how to operate the affiliate and could easily sell the minerals/oil
  - Finite amount of resources/expropriations to nationalize

After 1970

Why did we see less expropriations after the 1970s?

- Extractive and raw materials are must vulnerable to expropriation
  - Locals learned how to operate the affiliate and could easily sell the minerals/oil
  - Finite amount of resources/expropriations to nationalize
- Expropriation led to declines in FDI
  - Developing country still needed capital to develop

After 1970

Why did we see less expropriations after the 1970s?

- Extractive and raw materials are must vulnerable to expropriation
  - Locals learned how to operate the affiliate and could easily sell the minerals/oil
  - Finite amount of resources/expropriations to nationalize
- Expropriation led to declines in FDI
  - Developing country still needed capital to develop
- Recent MNC investment is not "vulnerable" to the obsolescing bargain because of vertical integration
  - Vertically-integrated affiliates produce **specific** inputs which cannot be marketed and sold outside of the MNC

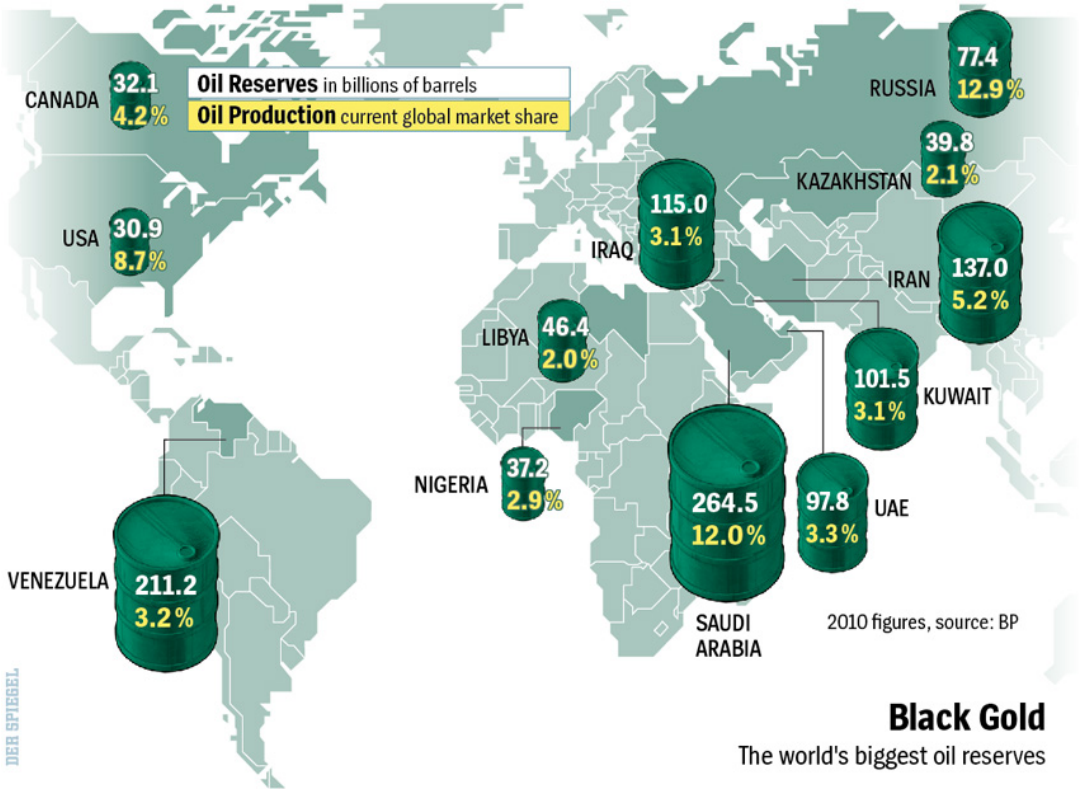
After 1970

Why did we see less expropriations after the 1970s?

- Extractive and raw materials are must vulnerable to expropriation
  - Locals learned how to operate the affiliate and could easily sell the minerals/oil
  - Finite amount of resources/expropriations to nationalize
- Expropriation led to declines in FDI
  - Developing country still needed capital to develop
- Recent MNC investment is not "vulnerable" to the obsolescing bargain because of vertical integration
  - Vertically-integrated affiliates produce **specific** inputs which cannot be marketed and sold outside of the MNC
  - They maintain monopolistic control over final sales

The ability to increase power over MNCs depends on time of investment and specificity of inputs (monopolistic control)

Venezuela



The first Venezuelan oil wells of significance were drilled in the 1910s, when the President granted rights to explore and produce oil to several of his friends. One of these friends passed his rights to a foreign oil company, that would later become Royal Dutch Shell.

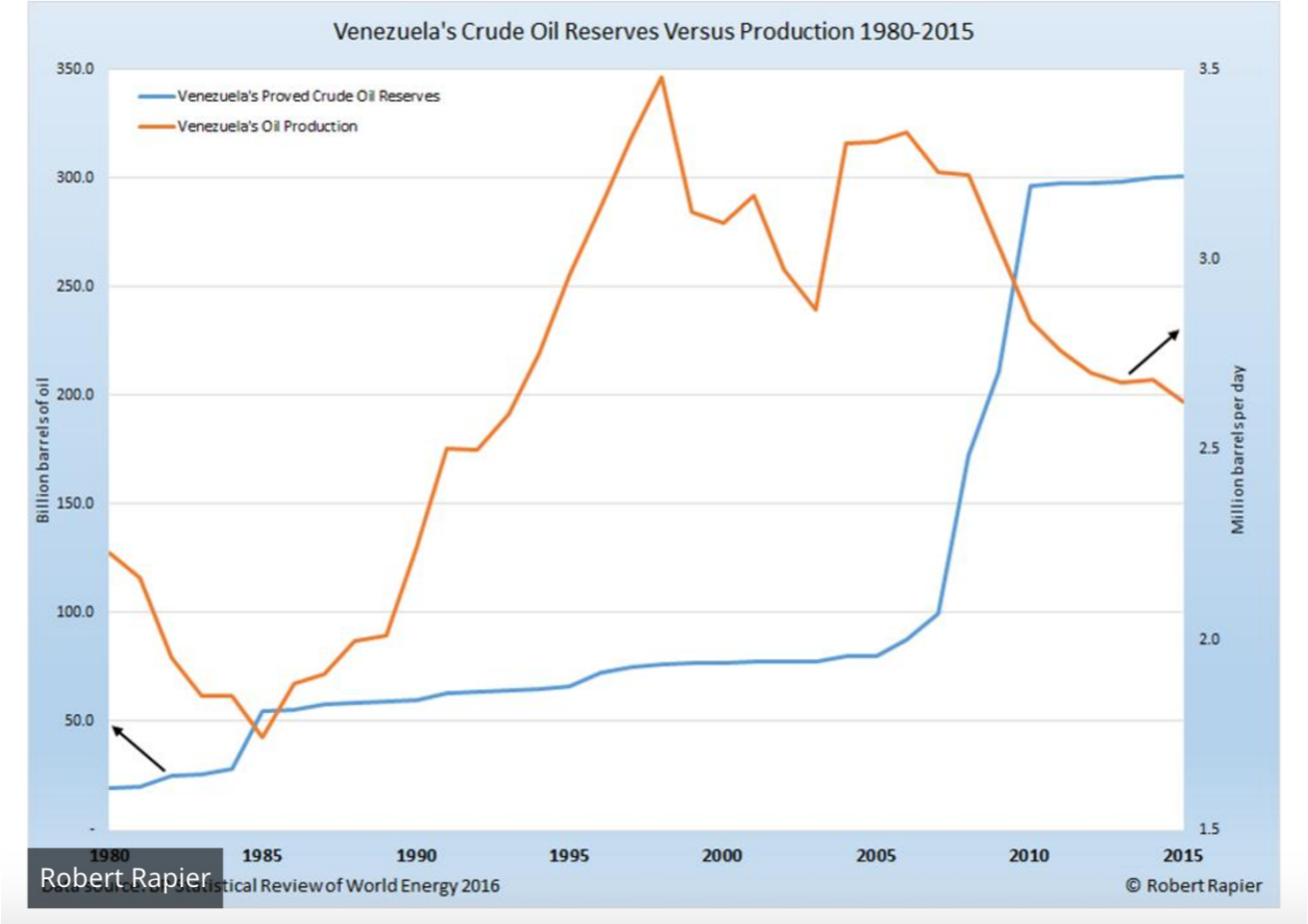
Venezuela

- **1976**: President Caldera nationalizes oil sector
- **1980s**: Budget crisis in Venezuela due to low oil revenues
- **1980s**: Venezuela turns to the IMF. Imposes austerity including the opening of the oil sector to FDI.
- **By 1996**: Venezuela becomes one of the most attractive locations for FDI
  - Focus on 'heavy oil" production in th Orinoco Belt
  - This oil is particularly challenging to produce. Venezuela invited in foreign companies to help with the capital investment
- **1998**: Chavez elected President of Venezuela
- **2000s**: Chavez renegotiates terms of investment
  - In some marginal oil fields, increased local ownership to 60%
  - Transferred $3.7 billion to the local industry
  - Any firm that refused to be bought out had to leave the industry

Venezuela

- **2002-03**: Venezuelan general strike led to 19,000 employees being fired from the state oil company (PDVSA)
- **2007**: Chavez focuses on larger production of "heavy oil" in the Orinoco Belt
  - Increased royalties from 16.7% to 30%
  - Increased taxes on income from 34% to 50%
  - Required national oil company PDVSA have majority control
- **2007**: Some companies agreed and retained minority shares. Exxon and ConocoPhilips refused and were expropriated
- **2007-2014**: Exxon and ConocoPhilips brought cases to arbitration panels. Both companies won initial settlements. Venezuela appealed.
- **2017**: Venezuela won its appeal and decreased its settlement
- **July 2017**: The conflict continues as a US appeals court blocked Exxon from enforcing its (decreased) settlement (argued that Exxon should have used the Foreign Sovereign Immunities Act instead)

Venezuela



How did Venezuela wind up with more control and less oil?

Venezuela

How did Venezuela wind up with more control and less oil?

- Firing PDVSA workers and expelling foreign oil companies removed expertise
- Venezuela failed to appreciate how capital intensive oil production
- Chavez did not adequately reinvest in oil machinery and foreign companies had no incentive to

Trade off for developing countries

Developing countries can increase their power over MNCs by imposing regulations (in the extreme, expropriation), but regulations make them less attractive to FDI

MNCs in developed countries

Developed countries are less skeptical about MNCs.

- Not as dependent on FDI, less concerned about losing sovereignty
- Less vulnerable to foreign domination
- Policy stance is neutrality (regulations should not be biased for or against FDI)
- Result $\rightarrow$ encourage FDI by offering MNCs incentives

Developed countries generally only limit FDI in cases of **national security**

National security

In the US, **The Committee on Foreign Investment in the US (CFIUS)** reviews questionably foreign investment in industries important to US national security (ex. energy and defense)

Recent Chinese FDI in the US has reenergized CFIUS debates

- **2005**: China National Offshore Oil Corporation (CNOOC) tried to purchase Unocal, a US oil company. Deal was withdrawn prior to the full CFIUS review.
- **2011**: CFIUS informed Huawei Technologies that it needed to unwind its $2 million purchase of 3Leaf Systems, a cloud computing company, due to worries about Huawei's connections to the Chinese military

National Security

In the US, **The Committee on Foreign Investment in the US (CFIUS)** reviews questionably foreign investment in industries important to US national security (ex. energy and defense)

Recent Chinese FDI in the US has reenergized CFIUS debates

- **2005**: China National Offshore Oil Corporation (CNOOC) tried to purchase Unocal, a US oil company. Deal was withdrawn prior to the full CFIUS review.
- **2011**: CFIUS informed Huawei Technologies that it needed to unwind its $2 million purchase of 3Leaf Systems, a cloud computing company, due to worries about Huawei's connections to the Chinese military

This type of FDI regulation remains rare

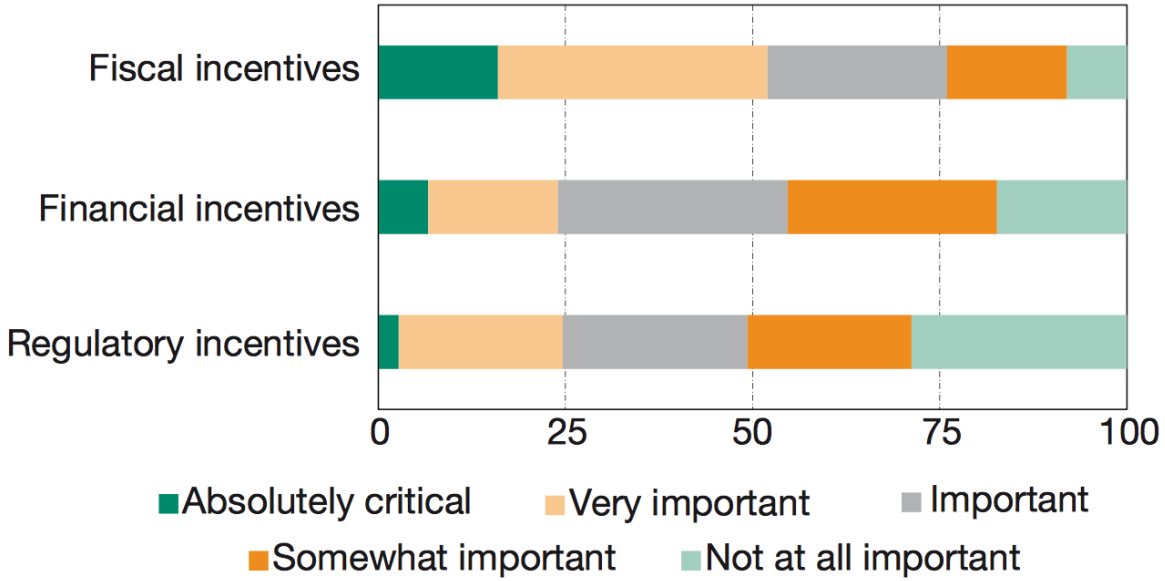
Incentives

To encourage FDI, developed countries offer MNCs generous **investment incentives**. These are non-market benefits that are used to influence the behavior of investors. They can be offered by national, regional and local governments

- Subsidies
- Tax Breaks
- Infrastructure development
- Land purchases
- Market privileges

Incentives

Figure III.2. Importance of investment incentives in the country's overall strategy to attract and benefit from FDI
(Per cent)



Source: UNCTAD survey of IPAs (2014).
Note: Regulatory incentives only refer to the lowering of standards.

Incentives

Some examples of investment incentives include:

- **Mercedes-Benz, 1993**: Received $300 million in incentives from Alabama (free land, employee salaries, tax relief, etc). The cost of incentive per job = $160,000
- **BMW, 1994**: Received $130 million in incentives including tax incentives and road improvement. The company invested $2.2 billion in the region and created 5000 jobs.
- **Hyundai, 2002**: Received about $252 million in incentives (training facility, site preparation, operating funds). The cost of incentive per job = $117,000
- **Mamtek, 2011**: Received $57 million in incentives (special bonds and tax breaks) from the city of Moberly and the state of Missouri. However, the Chinese parent company missed loan payments and stalled factory construction.

Tradeoff for developing countries

Developed countries can increase their inward FDI (and therefore their growth) by offering incentives to MNCs but competition between localities can lead to perverse incentives and distort the market.

Question 2

Are MNCs fair? Do they put downward pressure on wages and environmental standards? Is there a race to the bottom?

Race to the bottom

Does multinational investment lead countries to adopt lower labor and environmental standards out of fear of a loss of competitiveness?

Race to the bottom: Countries open to trade and investment adopt weaker labor (or environmental) regulations out of fear of a loss in competitiveness

Two main arguments:

- The progressive movement of production processes around the world **does lead** to a competitive lowering of labor standards and regulations
- MNCs **have no effect** on labor standards - differentials in standards are a result of other structural discrepancies

Why a RTB would occur

Firm motivations (demand side):

- Firms are profit maximizing and seek to minimize their costs/maximize their profits
- Open borders and heterogenous markets allow firms to capture advantages
- They will continually move to less expensive/less onerous locations (regulatory arbitrage)

Host motivations (supply side):

- MNCs bring capital, technology and jobs
- Host countries want to attract inward FDI
- Host countries competitively lower wages and loosen restrictions in order to compete with each other for investment

Anecdotal evidence of a RTB

Rana Plaza building collapse in Bangladesh - April 24, 2013

Anecdotal evidence of a RTB

Rana Plaza building collapse in Bangladesh - April 24, 2013

- Housed 5 garment factories manufacturing goods for major retailers in Europe and North America
- Collapse killed 1,100 people and injured thousands more
- Deadliest disaster in the garment industry
- Collapse blamed on shoddy construction, too many floors and too much heavy equipment
- Human Rights Watch survey in 2017: only 17/72 apparel/footwear companies in Bangladesh have agreed to implement a transparency pledge of labor practices

Anecdotal evidence of a RTB

The True Cost

Anecdotal evidence of a RTB

The Dark Side of Chocolate

Why the RTB is a myth

Are these anecdotes sensationalized? Daniel Drezner says **yes**

Why the RTB is a myth

Are these anecdotes sensationalized? Daniel Drezner says **yes**

If the RTB were true then we should see:

- Countries that are more open to trade and investment also have fewer labor regulations and lower wages
  - MNCs often pay higher than average wages for fewer hours **in comparison to other domestic industries**
- MNCs should flock to countries with the lowest regulatory standards
  - FDI is generally directed to high income, advanced countries.

Wage ratios

TABLE 16.2

Compensation by Multinational Corporations (MNCs) and Local Firms

	High-Income Countries	Middle-Income Countries	Low-Income Countries
Average Compensation Paid by MNC Affiliate	32.4	9.5	3.4
Average Compensation Paid by Local Manufacturing Firm	22.6	5.4	1.7
Ratio	1.4	1.8	2.0

Source: Graham 2000, 94.

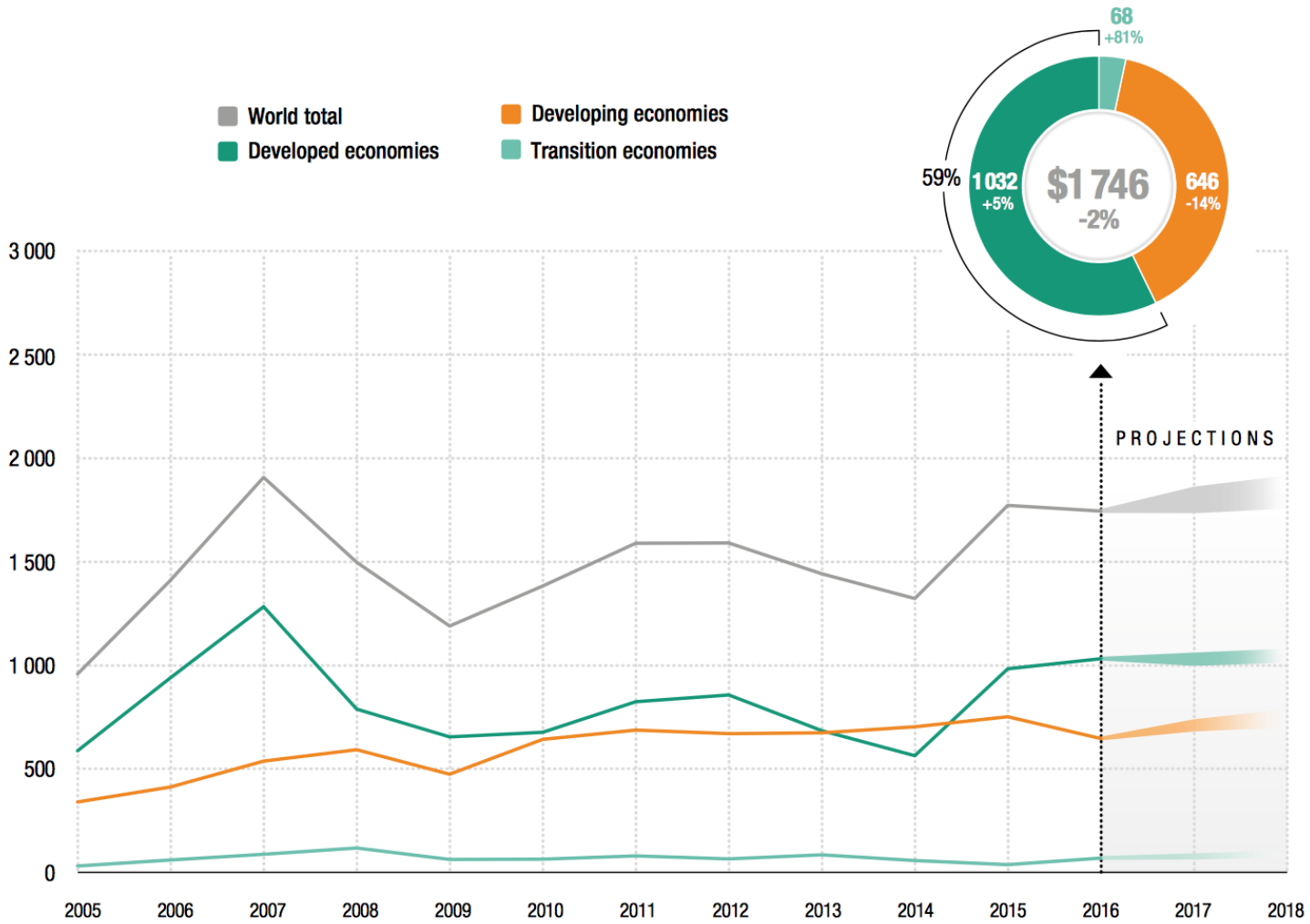
Anecdotal evidence that RTB is a myth

Other anecdotal evidence includes:

- ILO 1998: wages paid to workers in Export Processing Zones (EPZs) are higher than wages available in workers' home villages
- Lim 2006: Even though criticism is often placed on the long hours typical to factory work, in many instances these long hours constitute a shorter day than people are accustomed to working

Anecdotal evidence that RTB is a myth

Figure I.1. **FDI inflows, global and by group of economies, 2005–2016, and projections, 2017–2018**
(Billions of dollars and per cent)



Why the RTB occurs in some places

Is there a middle ground? Spar and Yoffie say the RTB happens **sometimes** under **specific conditions**

Why the RTB occurs in some places

Is there a middle ground? Spar and Yoffie say the RTB happens **sometimes** under **specific conditions**

Necessary conditions:

- **Mobility**: border controls have to be low
- **Heterogenous markets**: there has to be a differential to take advantage of

Facilitating factors:

- **Homogeneity of products**: more likely to compete at the margin
- **Regulatory differentials**: Regulatory restrictions are more/less important to different industries
- **Transaction costs**: stickiness costs that make moving production expensive
- **Sunk costs**: expensive and capital intensive production will be particularly difficult to move

Empirical evidence

Until recently there has been little high-equality research on the relationship between MNC investment and labor standards

- Slight trend in evidence against a RTB
- Enforcement has been particularly difficult to measure

A recent paper uses data advancements to make the case that a race to the bottom is occurring in **labor practices** (i.e. enforcement)

Davies and Vadlamannati 2013

- Uses data from 135 countries (both developed and developing) over 17 years (1985-2002)
- Uses 37 different indicators of labor rights (ability to bargain collectively, can protest, bans on child labor, bans on forced labor, etc)
- 21 indicators capture labor laws: whether or not the requirements are in place
- 16 indicators capture labor practices: whether their are observed violations in the labor rights prescribed by law

Davies and Vadlamannati 2013

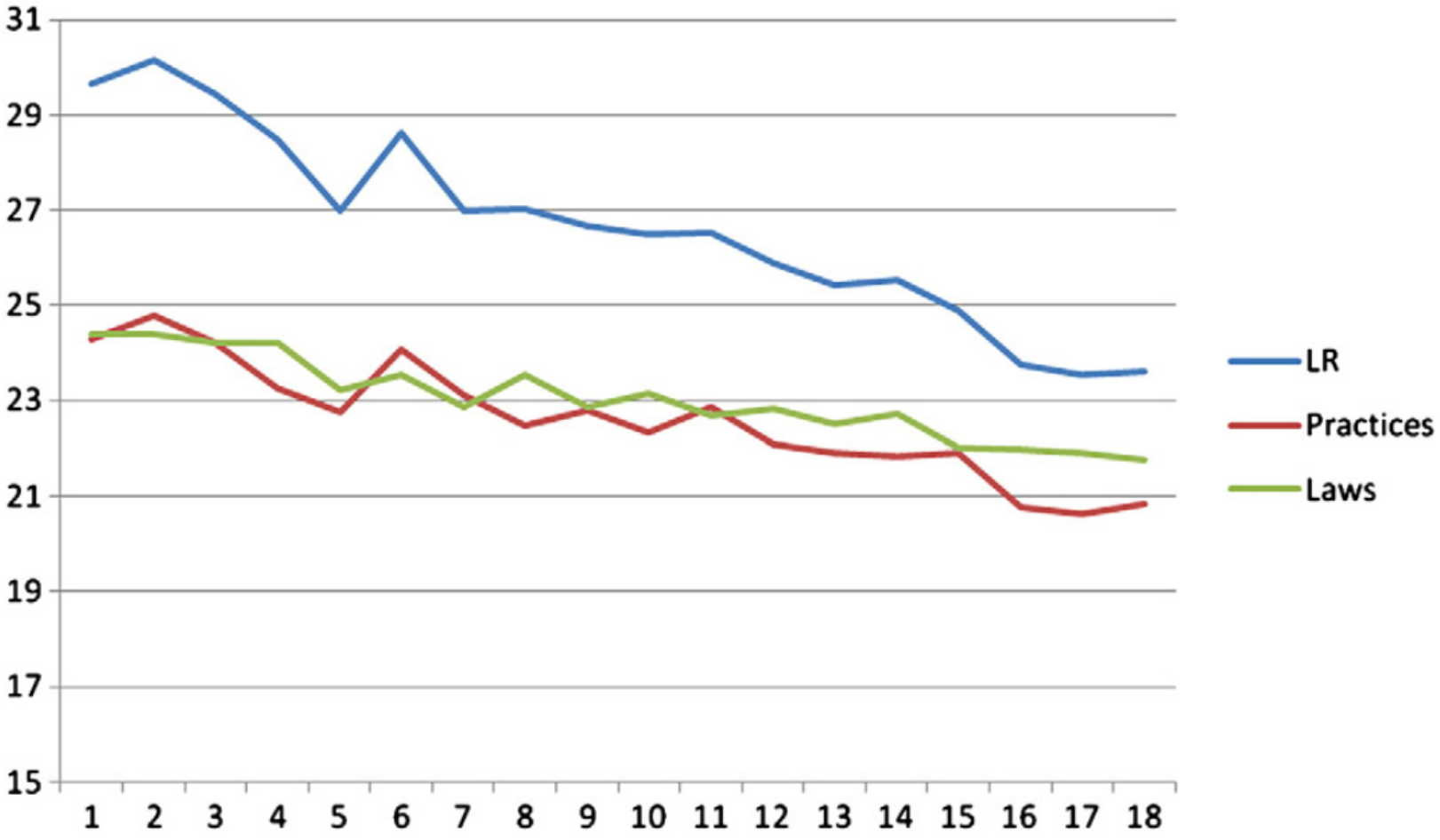


Fig. 1. Labor standards, practices and laws over time.

Davies and Vadlamannati 2013

This paper concludes that **a cut in labor standards of one country reduces labor standards in other countries**

- Relationship is stronger for labor practices (i.e. enforcement). Competition is driven more by an unwillingness to enforce labor laws.
- Effects are strongest among developing countries with weak labor standards. The race to the bottom is being driven by the poorest countries.

International Regulation?

Why is there no international organization to regulate investment?

Attempts at international regulation

Why is there no international organization to regulate investment?

- Governments have tried and failed
- Attempt after WWII to create an International Trade Organization
- Other attempts to regulate investment within the WTO and OECD

Attempts at international regulation

Given these potentially harmful effects, why is there no international organization to regulate investment?

- Governments have tried and failed
- Attempt after WWII to create an International Trade Organization
- Other attempts to regulate investment within the WTO and OECD

Conflict between capital-exporting industrialized countries and capital-importing developing countries has prevented agreement

- Industrialized countries want rules that **limit** the ability of host countries to regulate MNCs
- Developing countries want rules that **increase** their rights to regulate foreign firms operating within their borders

BITs

Instead, countries use **Bilateral Investment Treaties (BITs)**

- Bilateral between one host country and one home country's MNCs
- Specify the rights and protections to MNCs
- Goal for the capital importing host country is to attract FDI
- Goal for the capital exporting home country is to safeguard investment

BIT regulation

BITs can regulate:

- FDI admission
- FDI treatment
- FDI expropriation
- FDI dispute settlement

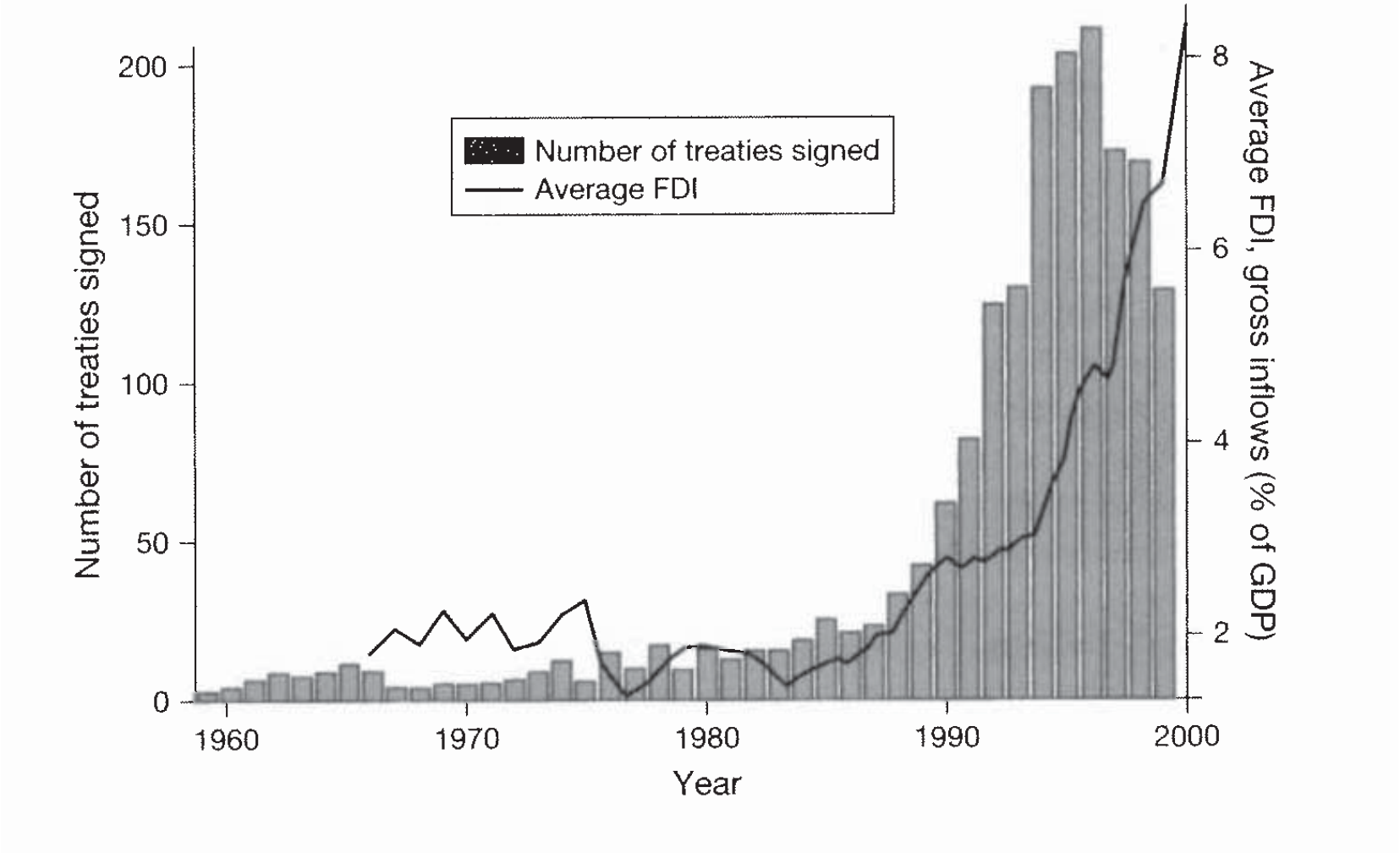
More specifics

BITS can incorporate specific rules

- National treatment principle (similar to the WTO)
- MFN principle (similar to the WTO)
- Protection of contractual rights
- Prohibition of performance requirements
- Provide dispute settlement
  - International Centre for Settlement of Investment Disputes (ICSID)
  - United Nations Commission on International Trade Law (UNCITRAL)

BITs serve to provide investment security for both the host country and MNC

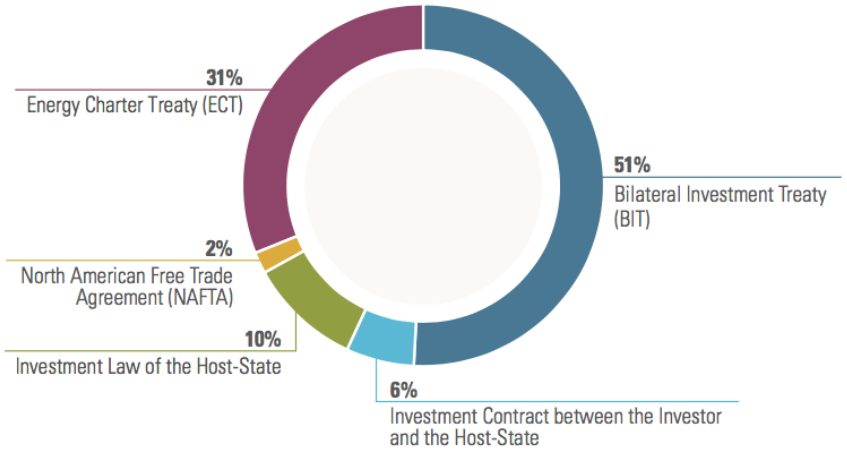
Historical Development



Historical use of dispute settlement

ICSID CASES ADMINISTERED BY THE SECRETARIAT (FY2003–FY2016)

BASIS OF CONSENT INVOKED TO ESTABLISH ICSID JURISDICTION IN NEW CASES REGISTERED IN FY2016 UNDER THE ICSID CONVENTION AND ADDITIONAL FACILITY RULES



Who signs?

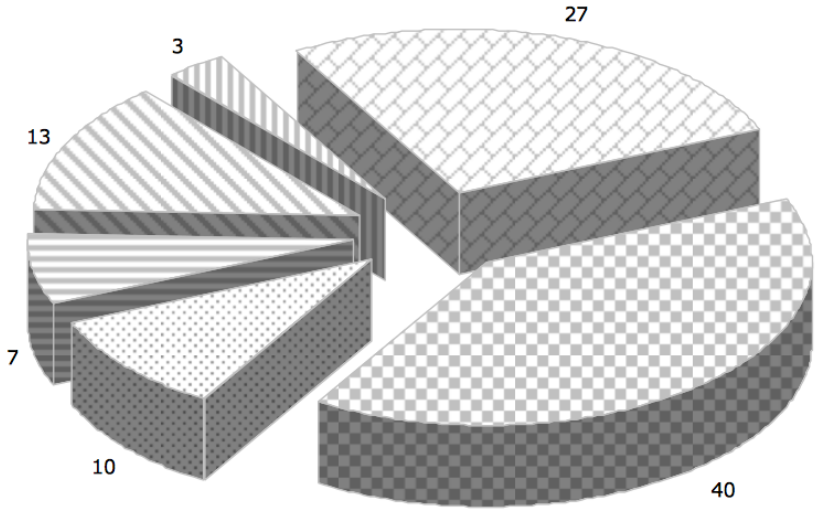
1,855 BITs were signed before 2000, of which:

- Between developed countries: 17 (0.9%)
- Between developed and **developing** countries: 780 (42%)
- Between developed countries and CEE: 234 (12.6%)
- Between **developing** countries: 498 (26.8%)
- Between **developing** countries and CEE: 258 (13.9%)
- Between CEE: 68 (3.7%)

Source: UNCTAD

Who signs?

Figure 7. BITs concluded as of end 2006, by country group (Percent)



- Between developing countries
- Between developed and developing countries
- Between developing countries and South-East Europe & Commonwealth of Independent States
- Between developed countries
- Between developed countries and South-East Europe & Commonwealth of Independent States
- Between countries of South-East Europe and Commonwealth of Independent States

Who signs?

United States of America (58)

Party	Signature Date	Entry into Force Date	Reference to ICSID
Albania	Jan 11, 1995	Jan 04, 1998	✔
Argentina	Nov 14, 1991	Oct 20, 1994	✔
Armenia	Sep 23, 1992	Mar 29, 1996	✔
Azerbaijan	Aug 01, 1997	Aug 02, 2001	✔
Bahrain	Sep 29, 1999	May 30, 2001	✔
Bangladesh	Mar 12, 1986	Jul 25, 1989	✔
Belarus	Jan 15, 1994		
Bolivia	Apr 17, 1998	Jun 06, 2001	✔
Bulgaria	Sep 23, 1992	Jun 02, 1994	✔
Cameroon	Feb 26, 1986	Apr 06, 1989	✔
Congo, Democratic Republic of	Aug 03, 1984	Jul 28, 1989	✔
Congo, Republic of	Feb 12, 1990	Aug 13, 1994	✔
Croatia	Jul 13, 1996	Jun 20, 2001	✔
Czech Republic	Oct 22, 1991	Dec 19, 1992	✔
Czech Republic	Dec 10, 2003	Aug 10, 2004	
Ecuador	Aug 27, 1993	May 11, 1997	✔
Egypt, Arab Republic of	Sep 29, 1982	Jun 27, 1992	✔
Egypt, Arab Republic of	Mar 11, 1986		✔

Puzzle

Remember that developing countries are historically more skeptical and disadvantaged by FDI. Why would they sign BITs in the first place?

Puzzle

Explanations put forward for the proliferation of BITs among developing countries includes:

- Power approach
- Signaling approach
- Competition approach

Puzzle

Explanations put forward for the proliferation of BITs among developing countries includes:

- **Power approach**: MNCs require BITs to invest in new markets
- **Signaling approach**: Signing a BIT is a costly signal that the developing country is a pro-investment climate and subject to enforcement
- **Competition approach**: Developing countries have used BITs as an incentive to attract MNC investment. BITs are a defensive tool for developing countries concerned about investment being diverted to other countries.

Evidence for competition

Evidence of the competition approach:

- Ratification of BITs usually occurs in waves
- BITs focus on the protection of MNCs over hosts
- There are no developing country coalitions that bargain together with MNCs
- There are also contagion effects for stricter provisions. A developing country is more likely to sign an agreement with strong investment provisions if other developing countries that compete for FDI have previously signed agreements with strong provisions. (Neumayer et al 2014)

Consequences of competition

The incentive to get an advantage over other competing countries leaves all developing countries worse off:

- Hosts accept less control and worse conditions then they need to
- Bargaining power decreases when host countries bargain alone

Ratification of BITs is a prisoner's dilemma

Do BITs increase trade for developing countries

- **Hallward-Driemeyer 2003**: Signing a BIT with another country does not significantly increase FDI with that country
- **Neumayer and Spess 2005**: There is a payoff to developing countries that sign BITs; they significantly increase the flow of FDI.
- **Kerner 2009**: Once we apply the appropriate statistical techniques, FDIs do significantly increase investment
- **Tobin and Rose-Ackerman 2010**: FDIs can increase investment if there are strong domestic institutions and not too much competition from neighbors with their own BITs

Do BITs increase trade for developing countries

- **Hallward-Driemeyer 2003**: Signing a BIT with another country does not significantly increase FDI with that country
- **Neumayer and Spess 2005**: There is a payoff to developing countries that sign BITs; they significantly increase the flow of FDI.
- **Kerner 2009**: Once we apply the appropriate statistical techniques, FDIs do significantly increase investment
- **Tobin and Rose-Ackerman 2010**: FDIs can increase investment if there are strong domestic institutions and not too much competition from neighbors with their own BITs

There is some suggestive evidence that signing BITs does increase trade for developing country. But it is still being debated.

Recap

FDI can bring benefits and tradeoffs for host governments. Today we evaluated two potential tradeoffs:

- Potential benefits of FDI vs. Limitation of domestic policy autonomy
  - Developing countries: outcome depends on regulating MNCs
  - Developed countries: outcome depends on incentivizing MNCs
- Potential benefits of FDI vs. Lowering of labor standards and wages
  - Some anecdotal and empirical evidence for the existence of a race to the bottom. Not conclusive.

Can an international organization regulate these potentially perverse outcomes?

- No organization exists and investment is regulated with BITs.
- Developing countries are more likely to sign BITs as part of competition to attract FDI.