



# A signaling model of foreign direct investment attraction<sup>☆</sup>

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Received 10 January 2017; received in revised form 17 April 2017; accepted 18 April 2017

## Abstract

Foreign direct investors face uncertainty about government's type of the host country. In a two period game, we allow the host country's government to mitigate such uncertainty by sending a signal through fiscal policy. Our main finding states that a populist government may mimic a conservative one in order to attract foreign direct investment (FDI), and this choice depends mainly on its impatience degree and the originally planned FDI stock. We highlight the role of the government's reputation in attracting foreign capital and thus provide some policy implications. Moreover, our model explains why some governments considered to be populist adopt conservative policies in the beginning of its terms of office.

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*JEL classification:* F41; F34; C72

*Keywords:* Signaling; Foreign direct investment; Game theory

## 1. Introduction

It is well known that developing countries, in general, suffer from low availability of capital stock domestically. One of the possible solutions for this shortcoming is to attract foreign capital through foreign direct investment (FDI) (Bengoia and Sanchez-Robles, 2003; De Mello, 1997). From the investor's point of view, however, the investment in a foreign country has additional sources of uncertainty, when compared to a domestic one. However, as many of economic and political variables are under the government's control (Cantor and Packer, 1996; Kamin and Von Kleist, 1999; Min, 1998), it can use economic policies to affect the perception of risk – by keeping a balanced budget and fighting inflation, for example – and then to encourage inward FDI in its country.

We model the investment decision of a foreign direct investor through a signaling game of two periods. By assuming he faces uncertainty – he does not know whether taxes on foreign capital will increase or whether it will be expropriated

<sup>☆</sup> We thank the editor, an anonymous referee, and the participants of GAMES 2016, the 5th World Congress of the Game Theory Society, held at Maastricht University from 24 to 28 July 2016, for their constructive comments. All the remaining errors are ours.

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Peer review under responsibility of National Association of Postgraduate Centers in Economics, ANPEC.

<http://dx.doi.org/10.1016/j.econ.2017.04.001>

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in the future, for instance – we are able to study how government can affect this decision by implementing contractionary policies, which might indicate a government committed to pay its debts and to maintain a good institutional environment. Our main finding states that the populist government may mimic the conservative one in order to attract FDI, and this choice depends mainly on its impatience degree and the originally planned FDI stock.

The core of our model is the assumption that fiscal policy can send a signal to the investors about how foreign-capital-friendly the host country is. However, we must highlight that the link between fiscal policy and FDI we model in this paper is substantially different from that in most empirical literature. Instead of repelling foreign capital, as we assume, active fiscal policy has been found to attract it. As the survey provided by [Simões et al. \(2014\)](#) shows, such literature focuses on how FDI is affected by the income tax rate enforced in the domestic country, the fiscal harmonization, the complexity of the fiscal system and the relationship between territories with non-existent (or extremely low) fiscal regimes and FDI. Thus, given that in our model the only fiscal policy tool is the public goods provision (see Section 2.1), our effects tend to be different from those found by those studies. Nevertheless, depending on the type of public good provided – education services, for example – our link may generate a result similar to those found in the literature.

The idea underlying our novel framework is that, regardless its use, large public expenditure requires either increases in government debt or collecting large amount of tax. The former option clearly repels foreign capital by raising the default probability. Regarding the latter, as high tax on income and on spending on goods and services may decrease consumption, they make the domestic market less attractive to the foreign investor. Further, taxes on profit and on capital gain reinforce this negative effect. This implies that even if the government budget is balanced, as we assume below, large public expenditure may repel FDI. Our assumption is supported by empirical evidence reported by [Le and Suruga \(2005\)](#), which analyzed a sample of 105 countries for the period 1970–2001 and found that excessive public expenditure might have a negative impact on FDI inflow.

The main contribution of this paper is therefore to highlight the role of the government’s reputation in attracting FDI. On the one hand, our findings have a normative aspect by suggesting that conservative policies may signal a foreign-capital-friendly government and thus increase the foreign investor’s confidence. This makes the inward FDI stock increase, which makes the capital stock increase as well, and consequently promotes economic growth. On the other hand, our results explain why some politicians who are considered populist adopt conservative policies in the beginning of their terms of office, and engage in expansionary ones as the end of their terms approach. In this regard, we offer an alternative explanation for political business cycle in developing countries. In fact, our results may be seen as complementary to those surveyed by [Alesina et al. \(1997\)](#).

### 1.1. Related literature

Given that we use economic policy as a signal of government’s “quality”, our model is close to the approach suggested by [Niepelt and Dellas \(2014\)](#), which discusses the function, properties and optimal size of austerity – defined as the shortfall of consumption from the level desired by a country and supported by its repayment capacity – using the standard sovereign debt model augmented to include incomplete information about credit risk.

The study we develop is also related to the literature that considers the government’s debt choices as signals of solvency and fiscal responsibility of the policymaker. In such models, financial markets, instead of the foreign investor, do not know the type of policymaker in place, but try to infer its type by looking at its financial choices. Some examples of this approach are provided by [Acharya and Diwan \(1993\)](#) and [Fernández-Ruiz \(2000\)](#). While the former develops a general signaling game, the latter uses a multi-period model of debt overhang to explain the shift in debt policy implicit in the Brady Plan. Their findings suggest that repurchasing and debt reduction are more informative signals than rescheduling. In fact, [Acharya and Diwan \(1993\)](#) shows empirical evidence that creditors grant debt relief only to countries with buyback programs. When the country is credit constrained, an alternative is studied by [Marchesi and Thomas \(1999\)](#), which adds the possibility of undertaking an IMF programme in return for debt reduction and possibly an IMF loan, finding similar results.

In a sense, our model and those of the aforementioned literature may be considered complementary. Another paper in the field, [Aizenman and Fernández-Ruiz \(2006\)](#), explicitly shows such a complementarity. This study develops a model in which a government (dubbed tough), using debt and reserves to smooth tax collection costs – measured by the deadweight loss – has to be cautious about not being mistaken for one seeking to maximize current resources (the soft one). It is assumed that the differential discount factors of the two policymakers have repercussions for future output,

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