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Foreign equity participation under incomplete information

Hamid Beladi [a,*], Avik Chakrabarti [b,1]

[a] Department of Economics, College of Business, University of Texas at San Antonio, One UTSA Circle, San Antonio, TX 78249-0633, United States

[b] Department of Economics, 816 Bolton Hall, College of Letters and Science, University of Wisconsin-Milwaukee, P.O. Box 413, WI 53201, United States

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Abstract

This paper demonstrates how an interaction between ownership rules and trade policy provides a rationale for a host government to impose local equity requirement (LER) on a foreign multinational. It presents a model where, in the presence of an import tariff, LER can serve as an effective instrument for a host government in removing any incentive for the multinational to mimic an inefficient firm when the government does not have complete information on the cost of the multinational's foreign unit. It is shown that the LER can increase national welfare by removing possible distortions under incomplete information. It is also shown that product market competition lowers the LER.

JEL classification: F1; F2; D2; D8; O1

Keywords: Local equity requirement; Trade policy; Incomplete information; Signaling; Multinational corporations; FDI; TRIM

1. Introduction

The importance of foreign direct investment (FDI) as a source of capital in the developing world has increased significantly over the last couple of decades. By the dawn of the millennium more than half of all capital flows to developing countries took the form of FDI.[2] Aid and concessional loans used to account for the bulk of resource flows from the OECD to developing economies a couple of decades back. However, FDI has now become the main source of development capital. The scope for multinational production has expanded as GATT's Uruguay Round and various regional integration agreements have reduced the barriers to international trade and investment, at the same time as important technical innovations in telecommunications and information technology have facilitated the coordination of international production networks. Many developing countries, with an increasing skepticism about import-substituting trade strategies, have been participating in what has been termed a "location tournament": policy

* Corresponding author. Tel.: +1 210 458 7038; fax: +1 210 458 7040.
E-mail addresses: hamid.beladi@utsa.edu (H. Beladi), chakra@uwm.edu (A. Chakrabarti).
[1] Tel.: +1 414 229 4680; fax: +1 414 229 3860.
[2] *Source*. World Bank (2001).

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Table 1
Local equity requirements

Host country	FDI[a]	Explicit LERs[b] (%)
Bahrain	25	51
Colombia	1486	30–50
Honduras	237	51
India	2169	26
Korea	9333	51
Kuwait[c]	72	51
Malaysia	1553	30–51
Philippines[d]	573	60–100
Poland	7270	51–67
Thailand	6213	51–75
United Arab Emirates (UAE)[e]	0.16	51

[a] Net inflows of investment acquiring at least 10% voting stock in an enterprise operating in an economy other than that of the investor, measured as the sum of equity capital, reinvestment of earnings, and other long-term and short-term capital appearing on the balance of payments, reported in current U.S. dollars (million). *Source*. World Bank (2001).

[b] *Source*. U.S. Department of State (2001).

[c] Excludes small service oriented firms.

[d] Exemptions exist for firms with equity exceeding $200,000.

[e] Excludes the nine UAE free zones.

adjustments, promotional campaigns, and incentive programs designed to attract investment by multinational firms.[3] Some countries negotiate over "National Treatment" (NT) clauses, which set out the commitments of host countries to treat foreign-controlled firms operating in their territories no less favorably than domestic enterprises. At the same time several developing countries maintain local equity requirements (LERs) by which a statutory floor is set for the share of domestic ownership in a foreign establishment (Table 1).[4]

Among a wide range of instruments that host governments deploy in attempting to influence the investment decisions of multinational corporations, LERs appear to be particularly common in developing countries following inward oriented trade regimes. The recent renewal of academic interest in LERs is not only due to the fact that the issue was included on the agenda of the Uruguay Round of GATT, but that it continues to be repeatedly cited as one of the most pervasive trade related investment measures (TRIM) on the WTO's agenda of multilateral trade negotiations as well. On the one hand, the practical relevance of LERs for FDI policies is significant due to the fact that foreign competition is an important component of privatization that has increasingly become nearly synonymous with industrial restructuring in the third world. The market for FDI continues to be contested in the sense that host governments compete to attract multinational corporations while continuing restrictions such as the LERs work as disincentives in the sense that they oblige a multinational to organize its activities contrary to its own best interests by redistributing the rents generated by FDI away from the multinational and towards citizens of the host country. On the other hand, while discriminating among multinationals is not permissible under the MFN clause of the WTO, it is widely known[5] that departures of actual tariffs on intermediate goods from MFN tariff levels are often due to a host government's attempt to adjust its tariffs to the efficiency of the exporter of the intermediate good.

In the policy debate, LERs have often been questioned on the grounds that they might "crowd out" FDI by shifting profits from foreign to local firms,[6] and a rationale for LERs has usually eluded economic reasoning. The presumption of economists at international organizations seems to be that LERs are undesirable since they present a form of

[3] Some countries have even tilted the balance toward foreign firms by offering special incentives, and the maquiladora firms in Mexico pay no income taxes; foreign firms of the Carribean receive income tax holidays, import duty exemptions, and subsidies for infrastructure.

[4] See Table 1 where we present a catalogue of *explicit* LERs faced by multinationals. There are further instances of *implicit* LERs. For example, in Saudi Arabia there is no requirement that a non-Saudi investor have a Saudi partner. At the same time, businesses having a minimum of 25% Saudi ownership are eligible for soft government loans, which are generally unavailable to firms lacking Saudi ownership. In Tunisia government authorization is required for a foreign capital share of more than 49%. In Russia prior approval is required for investment ventures in which the foreign share exceeds 50%.

[5] See Hwang and Mai (1991) for a thorough discussion.

[6] See Persson and Norback (2005) for a neat exposition of this continuing policy debate.