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## **FOREIGN DIRECT INVESTMENT: MOTIVATING FACTORS AND ECONOMIC IMPACT**

***Alenka S. Giese, William J. Kahley,  
and Roger F. Riefler\****

Regional scientists long have recognized the open nature of the regions they study. This recognition naturally has translated into an emphasis on the influence of exports and imports (of both goods and services) on regional development patterns. Most practitioners have been weaned on the Heckscher-Ohlin theory of comparative advantage and the literature surrounding this concept. Other models explaining trade flows, such as Vernon's product cycle theory, are also common elements of the professional vocabulary. Although the ramifications of fluctuations in regional exchange rates (or, more properly, terms-of-trade) have been somewhat neglected in the empirical literature, they are part of the theoretical apparatus as well.<sup>1</sup> Because of the growing importance of international trade, regional economists should be familiar with the issues raised in the foregoing articles that address the regional implications of the current account of the international balance of payments (IBOP).

Of equal importance to the study of regional growth is developing an understanding of the capital account of the IBOP. Although the theoretical literature is not silent on the effects of interregional capital flows, shortcomings in data availability have hindered empirical research. Thus, regional scientists may be unfamiliar with the burgeoning literature on the growth impact and motivating factors behind international capital flows. Given the recent rapid surge in foreign direct investment in the U.S. (and therefore its regions), this is unfortunate. Increasing emphasis by state and local development agencies on attracting foreign direct investment further buttresses the need to analyze the factors that motivate such flows and their economic impact. Before turning to three articles that attempt to analyze explicitly the regional dimensions and impact of foreign direct investment, this article attempts to summarize the relevant literature

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\*Economist, The Boston Consulting Group, Inc.; economist, Federal Reserve Bank of Atlanta; and professor, University of Nebraska-Lincoln, respectively. The views expressed are those of the authors and do not necessarily reflect those of the Federal Reserve System. Ms. Giese would like to acknowledge the assistance of David Allardice, Eleanor Erdevig, Robert Schnorbus, and William Testa.

<sup>1</sup>See, for instance, Horst Siebert [32].

concerned with these more aggregate dimensions of international capital flows. It should be pointed out, however, that our approach neglects a significant body of literature, largely of a macroeconomic nature, focusing on the relationship between current and capital components of the overall IBOP.

In the United States (or abroad), foreign direct investment is defined for statistical purposes as ownership or control, directly or indirectly, of 10 percent or more of a U.S. (foreign) enterprise's voting securities or the equivalent by a foreign (U.S.) individual, partnership, group, or organization. Businesses under such control are called U.S. (or foreign) affiliates, and the foreigner's (American's) investment is said to be *direct*. In addition, the following three articles examine foreign investment in the form of new plants. Other investment in a private enterprise, such as the purchase of its stock or bonds by investors seeking to diversify their assets rather than exercise an effective management role, is called *portfolio investment*. Foreign portfolio investment also includes investments in bank deposits, nonvoting securities, and U.S. Treasury issues.

This article will use the terms *foreign investment* and *foreign direct investment* interchangeably and often will use the abbreviation FDI to indicate the latter term. In addition, the term *multinational corporation* (MNC) is used to refer to all foreign investors, even though some are individuals or other entities.

## **Factors That Motivate FDI**

What are the factors that have propelled the recent surge in FDI? How do they differ from those that motivated previous investment? How do they differ from those that act as an incentive to export? Explaining MNC behavior via precise relationships is difficult, if not impossible, because MNC activity can be motivated by numerous and complex conditions, including a myriad of corporate planning factors as well as economic conditions and policies among nations and even within countries. Further, one must be careful in distinguishing short-run factors from long-run considerations. It appears that certain economic and political forces help explain long-run global trends in the types and amounts of foreign investment activity, while some other factors influence the precise timing, geographic location among and within countries, and industrial patterns of investment. With these caveats in mind, this section of the paper first paints a rather broad picture of historical factors that motivate FDI before turning to a more contemporary discussion of current causes that may help explain the recent surge in foreign investment. For ease of presentation, but at the cost of possible (over)simplification, these latter factors are grouped

under three broad headings: economic and strategic factors, transactional and intangible assets, and political factors.

### **Historical Trends in FDI: An Overview**

With regard to long-run trends, innovative MNCs spread across the globe in the post-WW II era, initially led by U.S. companies. To a degree, U.S. MNC activity represented an international extension of the process by which nationwide firms developed in the United States in the late 19th and early 20th centuries. Improvements in transportation and communication that enabled companies to manage from a distance helped spur activity. U.S. companies were attracted to fast growing markets and to countries with low costs of production that provided ample profit opportunities for companies that effectively could package the bundle of capital, technology, and management needed to produce and sell abroad. This global movement of U.S. corporate giants (as well as movement by their large international rivals) represented the second of what may be viewed as three major steps in the evolution of global economic integration at the firm level.

In the first stage of internationalization, companies generally produce in the home market and export to foreign markets. In this stage, foreign subsidiaries, if any, are predominantly sales and service establishments. In the second stage, firms move beyond exporting and servicing their products abroad to direct production in plants they own in foreign markets. Often, managers of the foreign plants are exported to the host country in this stage, while production workers are drawn from the local labor force. In the third stage, a multinational corporation's foreign subsidiaries are integrated thoroughly into their host country economies, with much local autonomy given to indigenous managers. In this advanced stage, top company headquarters officials are drawn from an intracompany international talent pool. Often, these mature MNCs, of which there are already several, resemble confederations of independent yet interdependent entities. These global organizations also form alliances with rival MNCs via licensing, joint ventures, partnerships, consortiums, and cooperative agreements in research and development, production, and marketing activities. The automotive industry is a good example of a global industry that has advanced to this stage; chemicals, petroleum, and computers are other good examples.

### **Economic Factors That Motivate FDI**

At the top of the hierarchy of motivators of FDI are economic factors such as the minimization of cost of production and materials and

the expansion of foreign market share. These factors often are coupled with saturated domestic markets and surpluses of savings and dollars (due to trade surpluses with the U.S.). Trade barriers, such as tariffs, restrictive import quotas, and domestic content legislation which could be placed under either the economic or political rubric are included with the economic factors because they play a prominent role in the price competitiveness and market share of foreign goods.

In order to explain the economic factors that motivate FDI in the U.S., traditional international economic theory must be expanded. The reason is that the economic factors that drive FDI in the U.S. extend beyond those included in traditional theories such as Heckscher-Ohlin's (which focus on comparative cost advantages and factor endowments) and Vernon's product cycle theory (which emphasizes the role of phases of production, innovation, scale economies, and imperfect knowledge).<sup>2</sup>

Before going beyond these theories, however, it is useful to describe how they assist in partially explaining the factors behind FDI. The basic foundation of the Heckscher-Ohlin theory is the familiar concept of comparative cost differences between nations. Although this model was constructed to predict trade flows, it can be used partially to explain the behavior of FDI. The Heckscher-Ohlin theory states that a country's comparative advantages in production vis-a-vis those of other countries is a function of its endowment of factors of production. In terms of explaining FDI flows, the theory predicts that if there are, for example, three factors (labor, capital, and natural resources), FDI will go to countries whose factor endowments allow the source country to minimize its labor, capital, and/or resource costs while maximizing its return on capital. Going slightly beyond the basic premises of the Heckscher-Ohlin model by assuming differential access to know-how, at the firm level FDI becomes lucrative when a firm can transfer its comparative advantage(s) in production activities to another country and thus is able to compete successfully against the domestic firms. This theory, however, does not explain FDI flows adequately because it makes assumptions such as perfect markets, free trade, and knowledge (technology) as a free universal good that are unrealistic in the context of FDI. Some potentially important motivators of FDI that Heckscher-Ohlin does not take into consideration include trade barriers, differences in economies of scale, and differences in technological know-how.

In order to supplement the Heckscher-Ohlin framework and better explain the impetus behind FDI in the U.S., additional considerations

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<sup>2</sup>For a detailed description of the Heckscher-Ohlin theory, see Baldwin [8]. For Vernon's theory, see Vernon [40].

must be included. Other factors that should be examined include trade barriers, exchange rates, and market expansion opportunities in both the source country and the recipient country (i.e., the U.S.). These additional factors can be incorporated into a broader theory on FDI by drawing from Vernon's product cycle theory. The product cycle theory holds that FDI as opposed to exports becomes optimal when the marginal production cost of exporting to the U.S. plus transportation costs exceeds the average production cost of producing in the U.S. (Vernon [40]). Vernon does not limit the factors that enter the cost equations and includes differing economies of scale. In addition, he considers noneconomic factors such as patent protection and communication between the firm and its customers and suppliers. He does not directly include political factors, however.

Among the additional factors that Vernon takes into consideration are those that threaten a company's position in a foreign market. He states that "any threat . . . is a powerful galvanizing force to action; in fact, if I interpret the empirical work correctly, threat in general is a more reliable stimulus to action than opportunity is likely to be" (Vernon [40, p. 200]). His theory on threats provides an explanation why trade barriers are a key factor in a foreign firm's decision to produce in the U.S. as opposed to export. Trade barriers are a clear-cut example of a threat to a foreign firm's share of the U.S. market.

Regarding the connection between trade barriers and FDI, Richard Caves cites over a half dozen studies that have found a close positive relationship between the raising of trade barriers and the change in FDI across all sectors (Caves [9]). A case in point is the influx of Japanese FDI to build autos in the U.S. that coincides with the looming threat of increased protectionism. Another example of how the threat of protectionism spurs FDI is seen in the recent acceleration of U.S. FDI in Europe that is primarily attributable to fears that a fortress Europe will emerge in 1992.

In addition to tariffs and restrictive import quotas, the threat of protectionism comes in the form of domestic content legislation.<sup>3</sup> Unlike tariffs which are implemented in reaction to a strong influx of imports, domestic content legislation usually is proposed in reaction to an influx of FDI. The primary objective of the legislation is to expand the economic benefits of FDI by requiring foreigners operating in the U.S. to buy their inputs from domestic firms as opposed to favoring firms in their own country. This goal may be circumvented, however, because foreign firms may choose to procure their materials from another U.S.

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<sup>3</sup>Domestic content, as defined by the U.S. General Accounting Office, is the value of parts and materials purchased from U.S. sources (both American and foreign-owned) plus the value of domestic labor, overhead, and markups.

affiliate. For example, many of the Japanese auto makers in the U.S. have encouraged (some critics say coerced) their Japanese auto parts suppliers to locate in the U.S. It has been estimated that 90 percent to 95 percent of the local content of Japanese U.S.-built autos is supplied by Japanese U.S. plants (Iannone [16]).

Another economic factor related to foreign trade that has a similar effect as tariffs do on the price competitiveness of foreign goods is the dollar exchange rate. A significant depreciation in the dollar against the currency of its trading partners has two effects, both of which make FDI more attractive than exporting. First, the price competitiveness of exports to the U.S. is affected adversely. Second, the cost to foreigners of acquiring or establishing companies in the U.S. falls. There are three reasons, however, why current fluctuations in exchange rates may not influence FDI flows in this manner. First, the decision to invest in the U.S. takes time to plan and implement, particularly if a new plant is being built. Thus, FDI cannot be undertaken simply as a short-term reaction to a declining dollar. A foreign firm, however, may have an FDI plan already prepared and may wait for an anticipated decline in the dollar to implement it. Second, there often is large uncertainty surrounding the duration of the fall in the dollar exchange rate. The dollar may reappreciate just as a foreign firm begins producing in the U.S. which could make the firm's product less price competitive than imports of substitutes. Third, the benefits of producing in the U.S. may be diminished if the dollar profits are repatriated when the value of the dollar is relatively low.

Overall the vagaries of flexible exchange rates versus the long-term commitment inherent in most FDI dictates against any simple causal effect between the two. Not surprisingly, empirical research has shown the relationship between exchange rates and FDI to be significantly weaker than the positive relationship between trade barriers and FDI. For example, the depreciation of the dollar was not cited as a significant factor in several surveys of the Japanese FDI decision (LTCB of Japan [24]).

Although comparative advantages in production as well as trade barriers are often important factors in the final decision to produce in the U.S., market forces and surpluses in savings and dollars often play an important role. Market factors include limited domestic market expansion potential and shortage of domestic investment opportunities. Shrinking domestic market opportunities have been important motivators in Japanese and European FDI in the U.S. In addition, over the past decade, savings in Japan and West Germany have surpassed domestic investment needs. Savings thus have flowed abroad, primarily to the U.S. whose savings/investment situation is the converse and whose market, one of the largest and richest in the world,

offers relatively strong growth opportunities. Another factor that has facilitated FDI has been surplus dollars resulting from positive trade balances with the U.S. Japan, in particular, has had a large stock of dollars that it can draw upon to finance its FDI.

The Department of Commerce [36] has suggested some economic factors explaining the accelerating pace of foreign investment in the United States. First, the rise in both the wealth and number of large foreign companies and the growing numbers of large foreign MNCs whose experience contending with American firms abroad convinced them they could compete successfully in the U.S. domestic market possibly helped fuel the surge. Second, the narrowing spread between American and foreign production costs have rendered production here relatively more attractive to foreign firms than exporting to the U.S. Finally, the wooing of foreign investors by state development agencies, particularly in the South, may have resulted in some acceleration of the FDI trend. In a similar vein, the industrial restructuring that U.S. companies are going through may have facilitated foreign entry by providing ample amounts of assets for sale to the highest bidder. In addition, the propensity of some foreigners to save more than Americans may have lowered the cost of capital to foreign concerns relative to that of American MNCs. This thereby indirectly encouraged overseas production by the foreign concerns.

### **Factors That Motivate FDI: Transaction and Intangible Assets**

In addition to the quantitative factors referred to above, there are qualitative factors that motivate FDI. These factors include comparative advantages in intangible assets (e.g., technology and patents, skilled labor, and extensive transportation and communication systems) and nonproduction activities (e.g., R&D, advertising, and marketing). The transactional theory approach outlined by Caves explains why a foreign firm would prefer to optimize the benefits of these intangible assets abroad by retaining exclusive rights over them and exploiting them internally through FDI as opposed to licensing or selling them (Caves [9]). According to the theory, firms choose to establish their own multinational plants because the other options to optimize their intangible assets are often impossible to undertake due to market imperfections and transaction impediments.<sup>4</sup>

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<sup>4</sup>Caves states that "intangible assets are subject to a daunting list of infirmities for being put to efficient use by conventional markets: 1. They are, at least to some degree, public goods . . . 2. Transactions in intangibles suffer from impactedness combined with opportunism (i.e., pricing is difficult because it is in the best interest of the seller not to reveal all the details about the intangible asset and it is in the best



In the real world there are many reasons why markets for a great range of goods and resources do not work according to the textbook model of perfect competition. A small list includes ownership of patents on products or on brand names that have strong customer following; possession of a unique or unusual technical or marketing advantage for a product or service; administrative ability to produce efficiently at an appropriate scale to serve foreign markets; and onerous government-imposed restrictions on output, market entry, or product safety and production standards.

Even when options other than FDI are feasible, they may diminish the benefits to the foreign firm of having an edge in a particular nonproduction activity, particularly if the activity is R&D- or technology-related. Alternatively, options such as licensing of technology may be impeded by pricing difficulties caused by the seller's hesitancy to fully reveal information about the technology or by buyer uncertainty of its worth. A fairly strong body of theory supported by empirical research maintains that a company will produce abroad only if it possesses some advantage that more than offsets the difference between its necessarily higher transportation and communication costs and those of companies based in the potential host country (Kahley 19)]. Otherwise the firm clearly would earn higher profits by producing in its home country and exporting its product or by licensing its products to a foreign producer in exchange for royalties.

Although Caves provides a sound argument in favor of maximizing comparative advantages in intangible assets through FDI in the form of a new plant or acquisition, it may not be economically or technically possible to undertake these types of FDI. An alternative way for a foreign firm to use its intangible assets in the U.S. is to form a joint venture and share its intangible assets with a U.S. company. Alternatively, a company seeking technology or access to a market may find that a joint venture operation is the most effective form of direct investment. Synergies and complementarities also can make joint ventures the preferred mode for foreign investment. As suggested previously, mature MNCs are likely to engage in all forms of globalization and all modes of foreign investment. These globally integrated companies' production costs and market sales are less variable when they produce and sell in several countries. Therefore, they shift resources, intermediate goods, and final products from place to place in response to changing economic and political conditions.

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interest of the buyer to be wary of exaggerated claims about the intangible asset by the seller) . . . 3. An element amplifying the problem of impactedness is uncertainty (revolving around whether or not the buyer will be able to successfully use the seller's intangible asset)." (Caves [9, pp. 4-5]).

## **Political Factors That Motivate FDI**

The third category of factors in the FDI decision are political. Although several political considerations have been alluded to above, this subsection restricts itself more to what may be called basic political attitude than to specific policy actions. Among the primary political factors that attract FDI are a stable government and laissez-faire attitude. In terms of these two factors, the U.S. historically has been a safe haven for FDI. Foreign investors do not have to worry about their U.S. assets being expropriated by the government or their U.S. profits and capital being burdened with repatriation restrictions. In addition, foreign-owned companies benefit from the American free enterprise doctrine. Over the past decade, the U.S. has appeared even more attractive to FDI than developing countries because the political situation of many of these latter countries has become more tenuous while their economic situation has become more depressed, mainly due to a growing and yet unresolved external debt problem and soaring inflation. In contrast, domestic demand in the U.S., fueled in part by an expansionary fiscal policy, has been growing at a faster pace than GNP while inflation has been held in check.

A second political factor, briefly mentioned above, is the effort of states to attract FDI. Although state governments have a long history in the area of attracting economic activity (the so-called competitive approach to growth), it is only relatively recently that FDI has attracted a lot of interest from state and local politicians who see it as a means of creating jobs in and supplying capital to their community (and as a source of generative growth). Although these local efforts to attract FDI may have little bearing on the level of FDI flows into the U.S., they appear to have some influence over its final location and thus merit attention (Kahley [18]; LTCB of Japan [24, 25]). A survey by the U.S. Government Accounting Office on state government policy toward FDI revealed that 35 states strongly encourage FDI overall and have budgeted state funds to attract it (all 50 states were surveyed; USGAO [37]). At the same time, 45 states were promoting FDI in the form of new manufacturing facilities and joint ventures. Their efforts range from investment missions to industrial incentives (e.g., subsidization of job training programs, bond financing, and tax incentives). The GAO found that in order to establish closer ties with foreign investors, 33 states had established offices overseas. In the period since the GAO report, these efforts undoubtedly have increased. For instance, a recent report by the National Governors' Association found 43 states with overseas trade offices (Office of State Services, National Governors' Association [27]).

A final political factor encouraging FDI may reflect internal industry considerations. Direct investment, rather than exporting or licensing abroad, also may be encouraged by microeconomic considerations such as rivalry among U.S. and foreign MNCs. Their global planning strategies may compel them to develop a direct presence in each other's home markets, particularly if long-run profit opportunities are healthy because of the size and growth prospects of these markets.

### **The Economic Impact of FDI: Pros and Cons**

The surge in FDI has been met with contrasting reactions from persons within the business community, academia, labor unions, and the public sector. Embraced by most state and local public figures, particularly economic developers, FDI is known as reverse investment and is touted as a source of capital and jobs to rejuvenate a sagging industrial sector. Decried by others, FDI is viewed as the gradual selling of America and loss of control over our mainstay industries. Exemplary of the debate has been the divisiveness surrounding the employment repercussions of FDI. Most state governments, for instance, are steadfast in their belief that foreign investment creates jobs and promotes economic growth. In contrast, certain special interest groups, such as the UAW and various trade organizations, have warned that FDI will lead to net job losses.

The myriad of opinions about the effects of FDI on the U.S. economy, competitiveness, and employment are divided below along the straightforward lines of pro and con. The discussion attempts to be impartial and presents summary evidence supporting or disproving each argument. A definitive conclusion either way is not offered because it would be based on too many uncertainties and conjectures given the current state of our knowledge.

#### **Arguments in Favor of FDI**

The proponents of FDI argue that it can help boost our economy and the competitiveness of U.S. industries, thereby creating jobs and increasing overall levels of welfare. As a *New York Times* headline reads, "Japan's Money Helps Build America" (*New York Times* [28]). In answer to the question of how FDI builds America, there are four broad responses: FDI increases national wealth and offers competitive advantages; it facilitates cooperation and the transfer of technological know-how; it stimulates investment; and it generates jobs. According to FDI advocates, FDI not only builds America, but also represents a long-term commitment by others to do business in the U.S. because the

majority of foreigners are acquiring real assets that are relatively less liquid than nonvoting security ownership.

The first response to how FDI builds America, increased national wealth, is based on free trade theory. It argues that just as free trade is beneficial to all countries involved and increases national welfare, so does free FDI. Although the usual free trade argument is static, the free FDI argument is dynamic. The chain of causation is roughly as follows: FDI promotes greater competition because it increases the number of new entrants in an industry. Faced with more vigorous competition and in the search for a competitive edge, industry participants implement cost reducing, efficiency- and quality-improving methods. Those who hesitate usually do not survive the ensuing industry shakeout. The implementation of new methods usually translates into lower prices and/or increased quality and service. The ultimate beneficiary is the consumer. Along a related vein is the viewpoint that in order to excel in global competition, the U.S. must open its doors to foreign production on its own soil.

The view that FDI is only a source of competition is one sided. FDI also can benefit recipient countries by acting as a source of cooperation in the form of joint ventures. It is the benefits of joint ventures that are the focus of the second pro-FDI response. In their article "Cooperate to Compete Globally," Perlmutter and Heenan tout the advantages of cooperative efforts across borders (Perlmutter and Heenan [30]). The general advantages of a joint venture include risk diversification, capital requirement reductions, utilization of established marketing and sales networks, and (thus) lower start-up costs. Those industries that benefit the most from sharing capital requirements tend to be those in R&D and tech-intensive industries such as pharmaceuticals and high tech equipment. Perlmutter and Heenan cite several examples such as the alliance between General Electric and SNECMA (a French state-owned company) to produce a low pollution, high performance aircraft engine whose high R&D costs would have prevented either company from producing the engine on its own. An example of potential marketing and sales synergies was the union between AT&T and Olivetti (an Italian firm). Through this union, AT&T was to gain access to the European market and Olivetti was to get a foothold in the U.S. market.

Another argument in favor of FDI is derived from the cooperate-to-compete view. It focuses on the technological transfer benefits that arise from FDI either through joint ventures or spillover and spin-offs. As explained above, one of the motives to invest in the U.S. is to optimize the use of an intangible asset such as technological know-how. One avenue of technology transfer is a joint venture between a U.S. firm and a foreign firm, in which one or both of the firms possess a

technological edge in their industry. Examples of such a marriage are the GM-Toyota (NUMMI) and the Chrysler-Mitsubishi (Diamond-Star) joint ventures. Both GM and Chrysler hope to learn the sophisticated production technologies of their Japanese partners. The use of Japanese technology also has facilitated the technological catch-up of U.S. firms that have fallen behind in the technology race. For example, Westinghouse, which missed the technological leap from vacuum tubes to semiconductors, has been able to shake the moth balls from its plant in upstate New York thanks to a joint venture with Toshiba. Toshiba will transfer crucial technological know-how to Westinghouse engineers that will allow them to develop technologically advanced color television tubes.

Technological and management skills transfer, via joint venture FDI, is a two way street, as FDI often flows in both directions across international borders. Measurement of net beneficiaries is often difficult and contentious, especially in the emotionally charged political environment surrounding international trade negotiations. Nowhere is this more apparent than in the area of U.S.-Japanese joint ventures. Not surprisingly, given the recent surge in Japanese FDI in this country, popular media and some professional literature have exhibited a good amount of Japan-bashing or Japanphobia and hence pointedly have hypothesized that Japan has been the net beneficiary of the opportunities inherent in U.S.-Japan joint ventures. In a recent article, however, Dorothy B. Christelow tests this contention and finds that:

existing joint ventures in manufacturing provide more opportunities for the transfer of technology and management skills from Japan to the United States than from the United States to Japan (Christelow [10, p. 37]).

A fourth benefit of FDI offered by its proponents is that it stimulates investment that often has a multiplier effect. This argument is, obviously, stronger for FDI in the form of new plant and plant expansion than it is for FDI in the form of acquisition. For example, when a Japanese car maker builds a plant in the U.S., its FDI represents an infusion of new capital whose benefits accrue in part to sectors outside manufacturing such as construction and services. Similarly, when a foreign firm forms a cost sharing joint venture, the foreign firm often provides crucial capital. Acquisitions also may be a source of capital, though the size of the multiplier is probably smaller and the time phasing of investment different.

The impact of FDI in the form of acquisitions has been studied extensively by Jane Sneddon Little (Little [20, 21]). Her findings suggest that in the long run, FDI has a positive impact on the U.S. firms

acquired. Foreign buyers do not focus solely on acquiring healthy strong growth companies; that is, companies that do not have dire capital needs. In fact, the 78 publicly owned firms acquired by foreigners in her survey tended to be less profitable than the average firm in their industry and thus may have been facing difficulties in raising capital. Another finding is that there were regional variations in the acquired firms' profitability that suggest that acquisitions in the beleaguered northern manufacturing belt had relatively stronger potential for generating financial benefits. She noted an apparent acceleration in sales and asset growth of the acquired firm that could be attributable to the foreigner's contribution of capital, technology, and/or management skills. Little concludes that

foreign acquisitions of U.S. companies confer some benefit on the U.S. economy" and that "foreign ownership . . . appears to strengthen the competitive position of the acquired firm and allows them to expand their market share (Little [20, p. 17 and p. 53, respectively]).

A specific example of the financial benefits that result from foreign acquisition is the Renault-AMC deal. When Renault acquired nearly half of AMC in 1979, it gave AMC desperately needed capital that allowed it to maintain production and to modernize in the early 1980s. (The deal, however, did not endure because Renault sold its interest in AMC to Chrysler.)

A final reason given to promote FDI, one popular among economic developers, is that it generates jobs. This argument has been challenged by persons who believe that the opposite is or will be the case. The contrasting views stem from different assumptions about the factors included in net employment change calculations. FDI proponents claim that there is a net employment gain because products produced by foreign firms on U.S. soil primarily replace imports. This replacement translates into a shift in jobs from the foreign country to the U.S. FDI opponents counter that replacement, if it occurs at all, is only partial and that the foreign firms' products compete directly with domestic firms' products. Thus, there is no net job gain. Some argue that there is even a net job loss because foreign firms tend to substitute more capital for labor than domestic firms and have relatively higher labor productivity rates.

Few studies have been undertaken to gauge the employment impact of FDI. The probable reasons for this are that there are few data available and that insufficient time has passed to determine the impact of the influx of FDI. Nevertheless, for certain industries in which the employment impact has raised exceptional concern, studies have been

attempted. For example, the impact of FDI on employment in the auto parts industry has been examined by the U.S. International Trade Commission (USITC [39]). Based on evidence that Japanese auto parts producers in the U.S. primarily supply the Japanese auto makers located in the U.S., the ITC concluded that presently there has been a net gain in auto parts employment. There is uncertainty, however, about the future job impact. If the Japanese producers expand their market to include the U.S. Big Three auto producers and the aftermarket, U.S. auto parts producers will feel the pinch and may have to cut production and, consequently, reduce their labor force. Similar uncertainty on the ultimate impact of FDI is illustrated by the U.S. Government Accounting Office's study of the auto industry. Given possible scenarios based on different (present and future) displacement ratios (i.e., the percentage of sales by U.S. auto makers displaced by Japanese auto production in the U.S.), they argue that determining whether there is a positive or negative net employment impact is plagued with conjectures about displacement (USGAO [38]). Only time and an *ex post* analysis will tell how much displacement occurs.

### **Arguments Against FDI**

Although there are many convincing arguments in favor of FDI, there are several sound arguments against it and many articles criticizing it. Reich and Mankin titled their article on the topic "Joint Ventures with Japan Give Away our Future" (Reich and Mankin [31]). *The Economist* [11] described the long-term effect of Japanese FDI in the auto industry as "creeping colonization." The arguments against FDI can be divided into two categories. First, there are opinions highlighting what are perceived to be FDI's near-term adverse effects. Second, there are the negative views that cover FDI's long-term repercussions. The near-term effects include overcapacity and unfair competition. The long-term concerns comprise the loss of economic and technological control and the prediction that FDI will cause a transformation of U.S. manufacturers into hollow corporations or, in other words, a corporation that is less a manufacturer and more an assembler and/or marketing organization. Because the argument of employment loss has been detailed above, it will not be duplicated here.

One of the immediate concerns regarding FDI is that it will exacerbate domestic overcapacity problems. Stagnant or declining demand and surging foreign competition have resulted in overcapacity problems in many of our mature industries such as steel and autos. As a result, these industries have had to retrench and reduce capacity. FDI investment in these industries, assuming that it results in a

competitive enterprise(s), will lead to further retrenchment on the part of U.S. producers.

The concern over additions to domestic capacity due to FDI is most pronounced in the auto and auto parts industries. The WEFA Group/Ward's Automotive Research has estimated that excess auto supply based on current production capacity will grow from 1,269,000 in 1988 to 1,515,000 by 1992 (includes Big Three, Japanese production in the U.S., and imports). Because the demand for autos is predicted to grow relatively slowly, any increase in domestic capacity due to FDI probably will lead to capacity reductions on the part of U.S. producers. U.S. auto parts producers face a similar situation.

The second concern is unfair competition. U.S. producers have complained that they face an unlevel playing field vis-a-vis foreign competitors on U.S. soil because of direct or indirect subsidies funnelled to foreign producers (primarily Japanese). These advantages include tie-ins with other foreign producers in the U.S. and state and local government incentives to attract foreign producers. One domestic industry that has been outspoken on this topic is the auto parts industry. U.S. auto parts producers claim, with convincing evidence, that Japanese auto parts suppliers enjoy high barriers to entry to supplying Japanese auto makers in the U.S. The relationship between supplier and assembler in Japan appears to be much tighter and more long term than the relationship between U.S. suppliers and the Big Three. For example, a few Japanese suppliers were encouraged directly by a Japanese assembler to establish operations in the U.S., and several have organizational or financial ties with Japanese auto makers. In addition, those that do not have direct ties still have an edge over U.S. suppliers because they are more familiar with the demands of Japanese auto makers and more capable in meeting their quality specifications.<sup>5</sup>

Another argument regarding an unlevel playing field is that foreign companies are given unfair advantages through state and local government incentives. Incentives include reduced taxes, low interest loans, assistance in site acquisition, and infrastructure improvements such as roads and utilities. Charges of bias in favor of Japanese producers over U.S. firms have been leveled against these types of state incentives. It should be noted, of course, that many of the same state and local incentives often are made available for certain domestic investments. The foreign incentive packages that have drawn the most

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<sup>5</sup>A qualification regarding the unlevel playing field argument of the U.S. auto parts producers is necessary. Japanese OEMs claim that they do not prefer Japanese suppliers because of nationalistic reasons but because Japanese suppliers are better able to meet their quality and price demands than are U.S. suppliers.



attention and criticism have been those used to attract the Japanese auto makers. Two examples are Kentucky's \$125 million support package to Toyota (15 percent of Toyota's planned investment) and Michigan's \$52 million support package to Mazda (12 percent of Mazda's planned investment) (USITC [39]). Several Japanese auto parts suppliers also have been courted by local economic development organizations near the auto plants.

In addition to the bias charge, the overall benefits of such incentives have been challenged. There is some validity in the arguments that state incentives are a zero sum game in terms of national economic growth and a negative sum game for U.S. producers. In regards to the negative sum game, for example, when incentives are given to foreign producers in industries facing overcapacity, it is likely that U.S. producers will be forced to cut capacity. With regards to the zero sum game, when states are vying for the same FDI project, one state's gain is another's loss.

In terms of the long-term repercussions of FDI, concerns have been raised over the potential loss of economic control and technological edge. The loss of economic control argument is based on the conjecture that FDI will expand infinitely and dominate certain industries. The chemical industry, in which FDI accounts for around one-third of total employment, often is highlighted as a case in point. The loss of technological edge is predicated on the belief that U.S. companies will fall technologically behind their foreign competitors as the U.S. firms are bought by their competitors or form joint ventures with them. The culmination of FDI's adverse effects is claimed to be the hollow U.S. corporation that is more a marketing organization and assembler than a producer or value-added generator.

The loss of economic control argument does not have a strong foundation because of three major flaws. First, it does not take into consideration that FDI is often in the form of a joint venture with a U.S. company who shares production and managerial responsibility. Second, it does not recognize that U.S. companies have been undertaking their own FDI and thus have been expanding their production and marketing base in a similar fashion. Third, it assumes that FDI is not regulated. To the contrary, FDI has been under surveillance in industries tied to national security (e.g., defense, nuclear and hydroelectric power, semiconductors, and broadcasting). A case in point is the blockage of Fujitsu's (of Japan) attempt to acquire an 80 percent share of Fairchild Semiconductor Corp. Fujitsu's announcement of its intentions stirred such controversy and negative responses from the Secretaries of Commerce and Defense that Fujitsu decided to withdraw its offer. The controversy revolved around the deal's potentially adverse impacts on national security and stemmed

from the perception that the Pentagon was becoming uncomfortably dependent upon foreign suppliers. The irony of this case is that Fairchild at the time was owned by the French company, Schlumberger.

A stronger argument against FDI is that it has the potential to lead to a gradual loss of our technological edge. Reich and Mankin, in their article against joint ventures with Japan, present their case of technological degeneration (Reich and Mankin [31]). They argue that the implicit strategy of the Japanese that are investing in the U.S. is to keep the front end activities (e.g., R&D and prototype development) and high value-added activities in Japan, leaving the more routinized activities to their U.S. plants (e.g., assembly operations). In order to substantiate their view, they cite three deals between U.S. and Japanese auto makers: GM-Toyota, Chrysler-Mitsubishi, and Ford-Mazda. They state that in each case the Big Three delegated most of the responsibility of the plant design and engineering tasks to the Japanese.

Articles in *Automotive News* have reflected a similar view. The concern of U.S. auto and auto parts industries is that the Japanese auto makers probably will have a cost advantage due to the fact that they import a greater percent of their inputs. The negative impact of this on U.S. producers and their technological edge is twofold. First, if there is significant displacement of U.S. auto sales by Japanese auto sales, U.S. auto parts producers could be faced with a shrinking market and could be eliminated from the high tech niche of the market in which the Japanese have a competitive advantage. Second, in order to maintain their cost and quality competitiveness vis-a-vis the Japanese auto makers, the Big Three may be forced to purchase more parts from Japanese suppliers and thereby contribute to the erosion of the U.S. auto parts producers' market share and their ability to invest in cutting edge technology.

In addition to the U.S. producers being relegated to the less tech-intensive activities, Reich and Mankin see another threat. They contend that the flow of technological learning will be from the U.S. to Japan.<sup>6</sup> They focus on the skills gained by Japanese workers in the areas of applications engineering, fabrication, and complex manufacturing. They do not prove, however, that the learning is only unilateral. They omit the fact that U.S. workers can gain similar skills when they work for a joint venture. As demonstrated by the exceptional quality improvements at GM-Toyota's NUMMI plant, U.S. workers can gain invaluable quality control experiences and learn how to boost productivity from the Japanese.

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<sup>6</sup>See Christelow [10] for an alternative view.

Another argument against FDI in the form of a joint venture is that the U.S. company is less a full participant in the value-added activities of manufacturing and more a marketing arm for the venture. Reich and Mankin state that most of the high tech joint ventures that they examined involved the Japanese company as producer and the U.S. company as marketer and distributor (70 percent of the 33 companies). They studied the machine tool and semiconductor industries in which this phenomenon was prevalent. With regard to the machine tool industry, they found that more than 75 percent of all machining centers sold in the U.S. were made in Japan, although many of them were sold with U.S. brand plates. Although they do not provide any statistics for Japan's presence in the U.S. semiconductor industry, they predict that the Japanese edge in state-of-the-art chip production and relatively low production costs, particularly that of Hitachi, will trigger sales and distribution agreements between U.S. and Japanese producers. A study by the Commerce Department substantiates, in part, the findings of Reich and Mankin. The report states that the Japanese are pursuing joint ventures with U.S. companies in order to gain quick market access and distribution channels (*Automotive News* [5]).

### **Conclusions: The Impact of FDI**

The two polar views of the impact of foreign investment on the U.S. economy were summarized in testimony before the U.S. Senate Committee on Commerce, Science and Technology last year.<sup>7</sup> The negative view was expressed by Susan Tolchin, author of *Buying Into America*:

Some of these foreign investors have hidden agendas, including the destruction of American competitors and the acquisition of American technology; many are motivated by a desire to avoid protective tariffs and view foreign investment as part of their nation's export strategy, to increase their market share. Most important of all: foreign investors have emerged as key players in American politics, making their influence felt on every level of the process. If this continues, the threat of losing a measure of political and economic sovereignty becomes a real possibility (Tolchin [33]).

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<sup>7</sup>These are views of the impact of FDI in the U.S. Analysis of the detailed impact of U.S. investment overseas, on either the U.S. economy or on the economies of host countries, is beyond the scope of this article.

An alternative viewpoint was expressed in testimony by Robert Ortner, then Undersecretary for Economic Affairs in the U.S. Department of Commerce, and supported by the National Association of Manufacturers and other groups and individuals. According to this view,

foreign direct investment is good for the economy and should be encouraged. As a result of such investment, the United States gains new factories, jobs, income, exports, and improved technology and better management techniques (Ortner 29)].

It is tempting to conclude that foreign investment, like domestic investment, promotes economic growth and enhances the competitiveness of U.S. industry. Although it is not possible to make a clear-cut estimate of the net impact of FDI on the U.S. economy, analysis of available information and data support at least some of the arguments advanced by proponents of maintaining a U.S. open door policy for international investors. For example, the existence of many new and efficient foreign-owned plants must be counted as a plus for the U.S. in terms of enhancing productivity and competitiveness of our industries. Yet it is not possible to determine precisely how many U.S. workers' jobs are attributable to foreign investment, nor is it possible to say whether the effect of foreign investment on the distribution of employment has been beneficial.

It is more difficult to assess some of the potential pitfalls associated with foreign investment, such as hidden agendas and the threat of losing a measure of political and economic sovereignty. Although growing interdependency, by definition, may suggest some lessening of sovereignty, the inroad made by foreign investment suggests that this threatened loss is not yet perceptible. More importantly, growing interdependency can generate a positive political return. Direct investment implies that foreigners have a long-run interest in maintaining the health and vigor of the U.S. economy because this investment represents a commitment to industries and communities that can not be easily withdrawn. MNCs in the third stage of evolution alluded to earlier may lose their national identity and acquire a global view that transcends a restricted national perspective.<sup>8</sup>

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<sup>8</sup> A more recent *New York Times* article ("U.S. Businesses Loosen Link to Mother Country," May 21, 1989) that discusses this issue and some of its implications, drawing on interviews with top business leaders, is recommended to the interested reader.

It is unfortunate that, at this point in time, we cannot gauge fully and accurately the benefits and costs of foreign investment. We have attempted, rather, to catalog the various arguments concerning FDI, to cite examples of likely positive and negative aspects, and to refer to some empirical work that has investigated these issues. Further references and evidence are contained in the articles that follow. To some degree, foreign investment in the United States has increased the competitiveness of U.S. industry, strengthened the distribution of manufacturing employment, facilitated transfers of technology, improved management practices, and kept plants open that otherwise would have been shut by U.S. owners. Job and worker income growth also may have benefited from FDI. On the other hand, there also is some evidence that U.S. affiliates' export-generating benefits are not as positive as they typically are asserted to be by proponents of foreign investment.

Obviously, the jury is still out on the issue of the domestic impact of FDI. Regional scientists concerned with issues involving regional development policy should keep this caveat in mind when investigating the development potential of FDI for specific regions. Unlike the export and import of goods and services on current account, where a professional consensus has emerged favoring the efficacy of free flows, the ultimate impact of FDI on current and future growth patterns at the regional level is more contentious. Although our analysis clearly does not indicate that FDI should be eschewed as a vehicle of regional growth, it does indicate that such investment should be monitored closely and that further research is needed in this area of growing importance for the nation as well as its component regions.

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