Quid Pro Quo Foreign Investment

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The theory of international trade took off in two major directions in the 1980's. First, while the 1950's through the 1970's had witnessed major developments in the theoretical analysis of *factor* market imperfections, the 1980's were marked by the theoretical exploration of *product* market imperfections. The latter effectively implemented, in the sphere of trade, the agenda that the classic works of Edward Chamberlin and Joan Robinson on monopolistic competition and imperfect competition had set before the profession more generally in the 1930's.

Second, trade theorists participated in pioneering the revolutionary shift in economic theorizing that has brought political processes explicitly into the analysis of economic phenomena and policy. Among the important early theoretical developments were the analysis of directly unproductive profit-seeking (DUP) and rent-seeking activities by Anne O. Krueger (1974) and Bhagwati (1982) and a variety of endogenous-tariff models.[1]

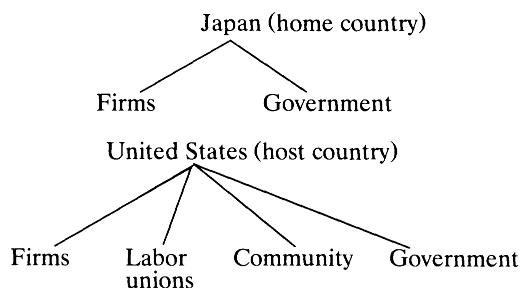
The political-economy-theoretic reformulation and explanation of the classic questions of international economics continue to grow apace. This is manifest also in the theory of direct foreign investment (DFI), which has recently been refocused so as to include explicitly the fact that the policy framework in the host country can be endogenous to the direct foreign investment in ways that needed to be formally incorporated in the positive and normative analysis of DFI.

In particular, one can identify a novel form of DFI in which it occurs at a loss in period 1 (from the viewpoint of myopic one-period profit maximization), with a view to (endogenously) defusing the threat of protection in period 2, therefore maximizing the two-period payoff from the interlinked decisions on trade and investment. In Bhagwati (1985) where this possibility was identified, the phenomenon was christened "quid pro quo DFI" because the quid pro quo for a DFI incurring a first-period loss is the improvement in the expected second-period payoff from the increased probability of keeping the export market open in period 2.

I. Alternative Possibilities

The classic case of tariff-induced DFI occurs when the tariff (or quota) is exogenously specified and tariff-jumping investment occurs. Quid pro quo DFI, by contrast, occurs as an attempt to reduce the probability of protection being successfully imposed: it is tariff-defusing. How does such defusion of the threat of protection arise?

Casual empiricism readily suggests alternative possibilities. Consider the following economic agents in the home country (Japan) and the host country (United States):



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[1]For an analytical synthesis of the volumous literature, see Bhagwati et al. (1984).

With DFI from Japan into the United States at issue and the threat of protection (say, voluntary export restraints [VER's]) in the United States against Japan in response to Japanese export success a perceived danger, quid pro quo DFI can arise in several ways. For instance, consider the following.

1. The Japanese government may encourage DFI in the United States with a view to buying goodwill from the U.S. government and reducing the probability that it will grant protection to the lobbies seeking it. Therefore, this route operates through the "supply of protection" in the United States.

2. In oligopolistic industries where the quid pro quo in terms of the enhanced probability of maintaining market access will accrue to the firms themselves, the incentive to undertake such quid pro quo DFI obtains at the firm-level itself.

3. Again, in both cases, the quid pro quo may operate, not through affecting the supply of protection in the United States, but through affecting the "demand for protection" by the economic agents in the United States:

(i) The quid pro quo DFI may co-opt the U.S. firms that seek to lobby for protection against Japanese rivals. For example, the Toyota–General Motors joint venture in 1984 was followed by General Motors breaking ranks in 1985 when the rest of the auto industry sought renewal of the VER restraint on Japanese autos.

(ii) Alternatively, the quid pro quo DFI may coopt the labor unions and weaken their incentive to lobby for protection to "save jobs."[2]

(iii) Equally, by setting up such DFI, the Japanese government or investor may seek to develop countervailing "anti-Japan-bashing" lobbies at the level of the communities that obtain visible, direct benefit from the DFI. This would also help to contain the protectionist threat against Japan.

These different possibilities have in common the postulate that, through one kind of political process or another, the quid pro quo investments lead to a linkage between first-period and second-period profitability from trade and investment. However, each possibility generates its own model.

From an analytical point of view, the models can be divided into three categories: (i) those that use perfectly competitive market structures and those that use oligopolistic market structures; (ii) those that model the (Japanese) government as the agent deciding on the investment and those that focus on the (Japanese) firm's decision instead; and (iii) those that treat the probability of the (U.S.) government imposing protection as specified exogenously as simply a function of the DFI and those that determine it endogenously from the utility-maximizing behavior of the lobbying agents (in the United States).

Evidently, the choice of assumptions within each of these three categories can entail compatible choices in others. Thus, if the analyst uses the perfectly competitive model, the agents deciding on the quid pro quo DFI cannot be atomistic firms, which do not behave strategically; however, the protectionist threat could be modeled either exogenously or endogenously.

The existing theoretical analyses of quid pro quo DFI exhibit a considerable diversity of approaches. They not only develop the positive (i.e., explanatory) theory of quid pro quo DFI; they also examine its welfare implications. However, whereas the focus of the tariff-jumping welfare-theoretic analyses has been on the impact on the host country (since the analysis was motivated by tariff policies in developing countries designed to attract such tariff-jumping investments), the welfare-theoretic analysis of the tariff-defusing quid pro quo models began with the impact on the home country (Bhagwati et al., 1987) and have only subsequently been extended to the impact on the host country (Dinopoulos and Wong, 1991).

[2]Given the insider–outsider problem, this type of quid pro quo DFI is likely to arise only when the beneficiaries are members of the same union as those who are threatened with layoffs due to the protectionist threat.

The formal analysis of quid pro quo DFI was first undertaken by Bhagwati et al. (1987), who used the general equilibrium $2\times2\times2$ model of trade theory. This model had been utilized earlier by Bhagwati and T. N. Srinivasan (1976) to analyze the optimal policy for a country in regard to its current trade if the proposed policy affects the probability of trade restrictions being invoked later by the other country. In a generalization of that analysis, Bhagwati et al. (1987) analyzed the optimal policy in regard to trade and DFI abroad if exports and DFI now were *both* to affect the probability of trade restrictions being invoked by the other country later.

Their analysis therefore produced an argument for intervention to encourage quid pro quo capital outflow, while the firm-level outflows were determined entirely by atomistic, myopic firms. The model reflected, though in a deeper way, the presumed encouragement being provided by the Japanese government to firms to invest abroad.

The oligopolistic case in which a firm itself will undertake quid pro quo DFI, "overinvesting" in period 1 so as to maximize two-period profits by defusing the threat of protection, was analyzed in Dinopoulos and Bhagwati (1986) and Dinopoulos (1989).[3] Dinopoulos also considered the free-rider problem (as when Toyota undertakes DFI in the United States and the quid pro quo benefits accrue equally to Nissan, which does not), showing that the quid pro quo DFI level varies inversely with the number of firms in the investing country.

Despite the key differences noted above, the Bhagwati et al. (1987) analysis and the analyses of Dinopoulos and Bhagwati (1986) and Dinopoulos (1989) shared one critical assumption: the protectionist threat was specified as a function of the first-period DFI, exogenous to any specific "lobbying" activity.[4] The view was that the mere act of DFI would serve to reduce the threat by earning goodwill. A grateful community in the area of investment perhaps might provide the political counterweight to protectionism via their Congressmen.

However, the active lobbying is often by firms and labor under the threat of import competition. To model that, one needs to "endogenize" the threat function. Wong (1989a) proceeded to do that by introducing unemployment (assuming a minimum wage) and a labor union that would lobby for protection from imports. Given the fixed wage, for any level of DFI, protection will raise the product price and hence reduce unemployment. The union is then assumed to lobby for the full-employment-generating protection, and the probability of obtaining protection increases with lobbying resources spent. Thus, the expected level of protection becomes a function of lobbying and DFI.[5] As with previous analyses, the host-country government behavior is not explicitly modeled (this restriction being removed in subsequent analysis by Dinopoulos [1992], who models bargaining among the foreign firm undertaking the DFI, the home-country union, and the home-country government). It is then easy to see that quid pro quo DFI can arise in this model.

The welfare economics of quid pro quo DFI in Wong's model have been analyzed in Dinopoulos and Wong (1991). Following the generalized theory of distortions and policy intervention and focusing primarily on host-country welfare rather than on home-country welfare (as in Bhagwati et al. [1987]), the authors argue that the fixed-wage distortion can be removed at the source as the first-best policy for the host country (assuming, of course, that there are no other distortions to be remedied). It is

[3]Dinopoulos (1989) did not consider optimal policy intervention, but it is evident that the oligopolistic firm-determined quid pro quo investment will not generally be welfare-maximizing for the home or the host country.

[4]Thus, Bhagwati et al. (1987) worked with the probability (of a quota being invoked) function $G = G(E^1, K^1)$, where $G_1 > 0$ and $G_2 < 0$, with E^1 being the period-1 exports and K^1 being the period-1 DFI by the home country.

[5]In a later paper, Laixun Zhao (1991) endogenizes the wage as well.

then shown that, as a second-best policy, a production subsidy does better than restrictions on DFI inflow or "counterlobbying" by the host government.

II. The Evidence for Quid Pro Quo DFI

Economic theorizing often proceeds from casual empiricism. The theorizing of the quid pro quo DFI phenomenon is no exception (Bhagwati, 1990). However, there is certainly some plausible, more-than-anecdotal evidence that the acceleration in Japanese DFI in the United States in the early 1980's was due to a mix of "political" reasons: some partly in anticipation of the imposition of protection, and others partly to defuse its threat. Thus, in a survey of Japanese firms undertaking foreign investment between 1980 and 1986, the ministry of International Trade and Investment (MITI) found that the overwhelming majority of firms cited "avoiding trade friction" as their main motivation (Bhagwati, 1990; see also Wong [1989b]).

Of course, the calculation of the quid pro quo investors may turn out to be invalid. Thus, the DFI may create ill will rather than goodwill. In the case of Japanese DFI in the United States, there has been some backlash, and it is perceived by some now as a threat as well. Then again, there have been demands (by Lee Iacocca, for instance) to add the Japanese DFI production to the Japanese exports in enforcing VER limits. If this is done, it would of course tend to frustrate the quid pro quo investors' intention to invest so as to maintain export market access.

III. Other Political-Economy-Theoretic DFI Possibilities

The distinguishing feature of quid pro quo DFI is the economic exploitation of the political linkage between the investment and the formulation of trade policy; but then other such linkages can be found. Thus, in 1981, MITI allocated over 70 percent of the U.S. VER to Toyota, Nissan, and Honda, allocating the rest to Mitsubishi, Mazda, Fuji, Isuzu, and Suzuki (H. Shibata, 1990). Subsequently, American manufacturers invested in these suppliers (e.g., Ford acquired 24.41 percent of Mazda's stock, and General Motors acquired 5 percent of Suzuki's stock. By pressuring MITI to increase these firms' quotas (i.e., by therefore endogenously determining their quota allocations in Japan), these American manufacturers appear to have made their DFI profitable. James G. Benedict (1992) has therefore proposed that a rent-extracting VER-induced DFI could occur in the VER-restrained country whenever the firms in the VER-imposing country have the clout in the VER-restrained country to lobby for a greater share (of the quota) to be allotted to their partners.

In the future, the theory of DFI will be extended to this and other possibilities, in addition to further developments in the theory of quid pro quo DFI, supplementing the conventional politics-free approaches to the theory of DFI.

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