CAMBRIDGE

Cambridge University Press
978-1-108-49414-4 — Merging Interests
Sarah Bauerle Danzman
Excerpt
More Information

1 *Introduction*

We have no horror of **FOREIGN CAPITAL** – if subjected to (domestic) management (Niles' Weekly Register, cited in Wilkins, 1989: 85)

We are always prepared to provide the necessary security to foreign capital *on the condition that its profits be regulated by law* [emphasis added] (Mustafa Kemal Atatürk, quoted in Lipson 1985, 72).

In June 2016, the Indian government announced sweeping changes to its foreign investment laws that eliminated government approval processes for most sectors and substantially increased the maximum foreign equity allowed for firms in several sectors, including retail, food, defense, airlines, broadcasting, and pharmaceuticals. In response, several Indian trade unions voiced their strong disapproval. Unions representing government employees announced an indefinite strike.[1] Far-left and far-right affiliated trade unions issued strong condemnations of the proposed liberalizations, arguing such moves would not increase employment but would lead to increased labor law violations and push small firms out of business.[2]

In contrast to labor unions, business groups reacted positively to investment policy changes. Indian pharmaceuticals expressed support for loosened restrictions on foreign direct investment (FDI) in that sector, arguing decreased scrutiny of foreign funded mergers and acquisitions (M&A) would benefit domestic firms.[3] Industry watchers emphasized the fact that private Indian firms would be more able

[1] "1L Central govt staff to go on indefinite strike." *The Times of India*. June 27, 2016.
[2] "Trade unions slam govt's FDI policy initiatives." *Daily News and Analysis*, June 22, 2016.
[3] Mishra, Lalatendu. "M&As to be an active ingredient in pharma." *The Hindu*, June 21, 2016.

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE
Cambridge University Press
978-1-108-49414-4 — Merging Interests
Sarah Bauerle Danzman
Excerpt
More Information

to monetize their shares. And, in 2016, the value of inward pharmaceuticals M&A deals increased by over 80 percent year-over-year.[4]

In the wake of the 1997 Asian financial crisis, Malaysian manufacturing firms made similar arguments that embracing policies of openness to FDI, and the financial capital foreign firms could bring, were necessary to ensure the viability of the entire industry.[5] But domestic firms do not always support policies of openness toward multinationals. Indonesian firms largely opposed liberalizing direct entry in the years following the Asian financial crisis, instead advocating for a Chinese-style approach to foreign firms in which governments allow select investors into priority sectors while reserving the majority of industries for domestic and state-owned firms.[6]

The patterns of protest against and support for changes to foreign investment laws in India challenge conventional wisdom regarding the politics of FDI.[7] The most prominent existing explanations of FDI liberalization use factor proportion models from international trade theory to argue that domestic capital is disadvantaged by multinational entry while workers benefit from the jobs new investment creates. These models predict liberalization will occur when workers gain political power over capital – mainly through democratization. Yet, as the above example illustrates, workers can oppose liberalizing reforms to investment law while domestic firms may support these changes.

In contrast to the widespread coverage the Indian reform received, the minutiae of investment policies rarely generate popular political action. A search of news stories about "Foreign Investment" and "Protest" returned 21,326 articles globally between 1970 and April 6, 2016. In comparison, "Trade" and "Protest" returned 448,819 articles over the same time period. If reformist pressures came from publics,

[4] Ernst and Young (2017), 20.

[5] Toh, Eddie. "Businessmen Urge Malaysia to Ease Foreign Equity Cap in Key Sectors; They Also Seek to Mothball Foreign Investment Panel." *The Business Times Singapore*, April 9, 2002.

[6] "Indonesia Commerce Body Urges Government to Restrict Foreign Investment." *BBC Monitoring Asia Pacific*, October 25, 2013.

[7] FDI is defined as "an investment involving a long-term relationship and reflecting a lasting interest and control" by an enterprise domiciled in a different jurisdiction. United Nations Conference on Trade and Development (2006), p. 293.

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-49414-4 — Merging Interests
Sarah Bauerle Danzman
Excerpt
More Information

we might expect far greater popular mobilization over investment policy. It therefore seems unlikely that public opinion and voting behavior drive decisions to liberalize investment laws. Instead, most of the time foreign investment laws remain in the purview of what Pepper Culpepper aptly dubs "Quiet Politics," meaning the political dynamics that characterize policymaking when "highly organized interest groups dominate the policy process in arenas shielded from public view."[8]

The Question

What, then, explains governments' decisions to pursue policies that loosen restrictions on FDI? This is an important question because FDI is the primary mechanism through which multinational enterprises (MNEs) expand overseas. MNEs direct the vast majority of global trade, either through trade among affiliates or through trade among intermediate suppliers. Trade among MNE affiliates accounts for approximately one-third of world trade.[9] Some estimate MNEs orchestrate as much as 80 to 90 percent of all trade globally.[10]

Rules governing MNE entry to local markets powerfully influence the ways in which countries' economies are integrated into the global economy. These regulations affect both the type of economic activities that take place within a country and the degree to which the country's economy is integrated into global supply chains. For example, Thailand and Malaysia have undergone extensive liberalization of entry requirements in most sectors, including semiconductors, that allow foreign firms to establish wholly owned subsidiaries in these countries. These laws, and the clarity they provide, have encouraged leading electronics MNEs to locate high value-added activities in these jurisdictions.[11] In contrast, China's complicated and frequently shifting regulations on FDI have made foreign firms hesitant to transfer lucrative intellectual property to subsidiaries in the country. This has resulted in a massive growth in inward investment in low value–added

8 Culpepper (2011), p. xv.
9 Antras (2003).
10 United Nations Conference on Trade and Development (2013a), iii.
11 See Moran (2005).

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE
Cambridge University Press
978-1-108-49414-4 — Merging Interests
Sarah Bauerle Danzman
Excerpt
More Information

activities, such as assembly, but less investment in high value–added activities, such as semiconductor wafer fabrication.[12]

This book considers the conditions under which local capital may benefit from, and consequently advocate for, investment policy liberalization. It articulates a process of economic reforms in which incumbent economic elites initiate and manage structural reforms rather than become victims of disrupted economic and political structures of power. Domestic firms' preferences over openness to foreign equity investors depend on domestic financing conditions, which in turn are a function of both global forces and local politics. Because MNE entry comes with substantial risks, such as higher labor costs and increased productivity pressures, well-connected domestic firms will prefer to limit access to local markets when the costs of debt financing are relatively low. However, when local environments make debt financing increasingly expensive – for example, when governments end practices of directing subsidized credit to key industries and businesses – firms will be more willing to dismantle restrictive investment policies so that they may overcome liquidity constraints with equity financing from abroad.

I argue transformations in the ways in which credit is intermediated in local financial markets disrupt economic elites' access to capital and therefore create incentives for local industrial interests to support loosening restrictions on foreign equity ownership. Access to cheap alternative sources of capital makes elites likely to block regulatory reform. Economic conditions and policy developments that limit access to short-term investment and debt financing will cause elites to re-evaluate the costs and benefits of openness. In particular, governments will be more likely to pursue policies of openness to FDI

[12] Despite promotional policies designed to attract FDI in the semiconductor industry, and despite becoming the largest semiconductor market, China has failed to capture much global front-end production of semiconductor chips. In 2008, the country accounted for 1/227 of the value of global production of integrated circuits. While the country has successfully attracted investment in low valued–added and labor intensive "back-end" microchip production, it still had only two foreign firms invested in front-end production by the end of 2007. See Yinug (2009) for an extended study. Today China remains an industry laggard in high-end chip manufacturing. Its well-publicized China 2025 initiative is designed to foster substantial government investment in advanced semiconductors because foreign firms have been unwilling to transfer high-end production to the country. See Lewis (2019) for further discussion.

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE
Cambridge University Press
978-1-108-49414-4 — Merging Interests
Sarah Bauerle Danzman
Excerpt
More Information

when domestic sources of private credit are limited and governments do not manipulate credit costs through tools of financial repression such as interest rate controls. Consequently, FDI liberalization may be driven less by a need to respond to popular pressures for job creation and more by a desire to provide domestic firms with access to global financing channels.

We should care to explore whose interests are mollified by investment liberalization because who benefits from FDI has important distributive implications. This book provides substantial evidence that openness toward foreign investment is often pursued for the benefit of large domestic business interests, which is an important corrective to dominant narratives that opening markets to foreign investors, capital, and goods dislodges economic elites to the benefit of ordinary citizens, particularly in developing countries. If investment liberalization reflects the preferences of large firms, opening economies to FDI may benefit the largest and most politically influential firms in a local economy while disadvantaging smaller firms and workers. Accordingly, the theory and evidence presented here demonstrates that FDI liberalization can make markets less rather than more competitive. Rather than provide access points to small firms to participate in global value chains or break down structures of crony capitalism, FDI liberalization may benefit a select few well-connected domestic firms while making it increasingly difficult for smaller and newer firms to compete in local markets. In a liberalized FDI environment, large and politically connected domestic firms may cast their lot with MNEs that can provide them greater access to finance and external markets, while smaller firms, potential start-ups, and entrepreneurs disconnected from ruling coalitions may be largely left out of newly formed networks of global production.

The distributive implications of elite-driven liberalization are enormous and troubling, both from an equity and an institutional perspective. If MNE entry benefits elites more than smaller business owners and workers, liberalization does not act as a mechanism to reduce rent seeking and to shift economic power toward labor. Much of the political economic research on FDI emphasizes its upward pressure on wages, at least for skilled labor. This has led most mainstream scholars of economic openness to view FDI as largely having positive implications for ordinary people. But the distributive effects of such investments may be more nuanced. Scholars have become increasingly

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-49414-4 — Merging Interests
Sarah Bauerle Danzman
Excerpt
More Information

focused on explaining the rise of within-country economic inequality, a trend that has worsened in recent years despite the decline in between-country inequality. The theory I present here aids our understanding of how processes of economic liberalization may augment inequalities by disproportionately benefiting the upper echelons of domestic economic and political society. And while scholars continue to argue about the direction of any consistent relationship between inequality and political institutions such as democracy, the current global political environment suggests that international political economy scholars must more rigorously interrogate the widely shared perspective that economic integration largely benefits workers in developing countries to instead reexamine the ways in which engagement with a global economy can perpetuate persistent economic and political inequality.

Conceptualizing Regulation

Before delving deeper into the politics of FDI regulatory reform, it is useful to spend some time defining what we mean when we talk about regulation in the context of FDI. FDI regulatory statutes are multifaceted and encompass a diverse set of rules regarding equity restrictions, screening requirements, licensing laws, legal provisions regarding profit repatriation, export balancing requirements, nationalization, and legal resource for aggrieved firms. Governments engage in various forms of incentive programs such as the development of export processing zones, the granting of special work visas for firm managers, and the granting of tax holidays to new investments. Governments also frequently use entry controls and incentive programs to encourage or require MNEs to contribute to a range of industrial priorities such as generating employment, contributing to foreign exchange, transferring technology to local partners, and cultivating local suppliers. We can broadly classify the range of foreign-investment-related regulation into three categories: (1) entry and establishment, (2) treatment and operation, and (3) promotion and facilitation. The complexity of FDI policy has been a contributing factor to the lack of study of this topic, as measurement remains a challenge to researchers.

While I explore the patterns and politics associated with each type of FDI regulation, particularly in Chapters 2 and 5, my main analytic focus concerns rules related to entry and establishment of foreign firms. I do so for a variety of conceptual as well as practical reasons, which

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE
Cambridge University Press
978-1-108-49414-4 — Merging Interests
Sarah Bauerle Danzman
Excerpt
More Information

I outline in greater detail in Chapter 3. However, it is worth providing an overview of the conceptual focus here. The primary question of this book is: Why and under what conditions would local firms support policies of openness to foreign investors? Regulations on establishment are the cornerstone of a government's policy stance toward FDI. Even if a government has an expansive network of treaties designed to provide legal protections to foreign investors, equity restrictions can prevent MNEs from entering specific industries either at all, as majority partners, or as wholly-owned foreign subsidiaries.

Thus, the impact of any other FDI policy depends on whether foreign firms are allowed to enter a given industry, and, if so, to what extent. Governments also sometimes use various screening mechanisms to retain the flexibility to reject investment projects that are politically problematic and to provide governments with leverage over foreign firms who must retain the good graces of government officials to invest. Investment approval requirements can create legal environments in which economies are statutorily open to FDI but foreign firms remain largely excluded from participation. From the perspective of domestic firms, laws that decrease restrictions on foreign equity ownership of local businesses and laws that reduce regulatory flexibility to deny entry to specific foreign entities circumscribe the statutory space reserved for local capital. Therefore, the passage of liberal FDI laws and the promulgation of executive decrees that open the economy to more foreign investment represent important moments in political battles over the role of the state, local firms, and global capital in the domestic political economy. The policy preferences over whether to restrict foreign ownership in the local economy have profound implications for economic development, the distribution of economic benefits from growth, and the ways in which different societal groups can exert political influence. For these reasons, I am primarily interested in the politics of laws regarding the entry and establishment of FDI.

Existing Explanations of FDI Policy

The first wave of scholarship on governments' regulation of foreign investment occurred when many countries embraced state-led development strategies to varying degrees and were relatively antagonistic toward multinational firms. Scholarship on foreign investment in the 1960s through the mid-1980s often placed the development financing

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-49414-4 — Merging Interests
Sarah Bauerle Danzman
Excerpt
More Information

needs of states as central to understanding government policies toward foreign investors. Writing on the cusp of the Latin American debt crisis, Jeffry Frieden marveled at less developed countries' (LDCs) swift and unprecedented ability to attract massive foreign portfolio capital inflows.[13] The rapid growth of LDC commercial bank debt to foreigners changed the nature of how development was financed. Rather than rely on multinational corporations to bring industrial development and integration into a global economic system, governments could support the development of indigenous firms owned by locals and financed by international capital channeled through state banks. Under these conditions, many developing countries set about limiting direct investment, often in response to domestic elite pressures for protection and buttressed by popular nationalistic opposition to foreign firms.[14] Prominent scholars subsequently pointed to the ensuing debt crises that swept much of the developing world as the cause of liberalizing policies in the 1980s and 1990s.[15]

In comparison, recent research on investment policy has taken an open economy politics approach. Drawing on distributive models of economic conflict, researchers have extended models of trade openness to explain FDI liberalization.[16] This research has typically focused on factor proportion models to anticipate the distributive effects of FDI and then consider how domestic institutions influence the relative political power of capital and labor. In this framework, the labor market effects of FDI inflows are central. There is robust evidence that

[13] Frieden (1981).
[14] See Frieden (1981); Lipson (1985). The sense that policies toward FDI had substantially and permanently changed is perhaps best encapsulated by Lipson's stark assessment: "the rules dealing with foreign investment have changed significantly and irreversibly. Regardless of the incentives for new foreign investment or the existing regulations, there are no real long-term guarantees . . . What has been lost, perhaps irretrievably, is a sense of certainty about the way investments will be treated in the future" (Lipson, 1985, 24).
[15] Feenstra (1999); Lipsey et al. (1999).
[16] Others have emphasized policy diffusion as driving liberalization among countries competing for capital (Simmons et al., 2006). While there is evidence that policy innovations do tend to spread regionally, a diffusion theory is incomplete on two accounts. First, it is unclear if governments are responding to the policy innovations of competitors or if governments are simultaneously responding to similar structural changes that shift domestic coalitions' willingness to support restrictiveness or liberalization. Second, if FDI policy innovations occur due to cross-border diffusion, what instigates the decision by the leading state to liberalize?

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-49414-4 — Merging Interests
Sarah Bauerle Danzman
Excerpt
More Information

MNEs pay wage premiums to comparable domestic firms. A lot of research in the literature on wage spillover effects suggests the labor market competition that MNEs engender also places upward pressure on wages in domestic firms.[17] Skilled labor frequently has the most to gain from FDI inflows as MNEs tend to employ more capital-intensive production techniques that require more highly skilled workers.[18] These insights suggest workers, especially highly skilled workers, will benefit from FDI openness. Sonal Pandya finds evidence from mass opinion polls in Latin America that more highly educated individuals are more likely to report support for FDI than are their less educated peers.[19] She interprets this as evidence that more highly skilled workers support FDI. From this microfoundational basis, she argues democratization leads to FDI liberalization as skilled workers gain more political voice and demand openness to MNEs in order to facilitate job creation. Using data on equity restrictions from 1970 to 2000, she finds that democracies restrict about 6 percent less of the manufacturing and services industries on average than do nondemocracies.[20] Starting from a similar theoretical framework in which FDI benefits labor and erodes domestic capital's rents, Pablo Pinto develops a partisan theory of political risk in which left governments incentivize FDI when in power in order to generate jobs, and right governments favor restrictions on FDI so that they can protect domestic firms.[21]

Scholars who place their analytic focus on developed countries have, conversely, emphasized the disruptive effect of FDI flows on workers. In their study of British manufacturing workers in the 1990s, Kenneth Scheve and Matthew Slaughter find employees who work in industries with higher levels of FDI perceive their jobs to be less secure.[22] The effect they measure is quite large substantively; a one standard deviation increase in industry-specific gross FDI flows is associated with a larger deleterious effect on perceptions of job security than is education, income, or even union membership. Erica Owen argues concerns about job security dominate workers' preference formation over FDI policies, and that FDI liberalization is driven by the erosion of union

17 Aitken et al. (1997); Feenstra and Hanson (1997).
18 Driffield and Firma (2003).
19 Pandya (2010).
20 Pandya (2014).
21 Pinto (2013); Pinto and Pinto (2008).
22 Scheve and Slaughter (2004).

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-49414-4 — Merging Interests
Sarah Bauerle Danzman
Excerpt
More Information

power. She finds that industries that are more highly unionized also are more protected from foreign ownership in the United States.[23] Among developed countries more broadly, she finds evidence that countries with higher labor union density are less open to FDI.[24] Scholarship on the development of government screening programs such as the US Committee on Foreign Investment in the United States suggests political leaders can use such screening mechanisms to placate economic nationalist sentiments of voters.[25]

Why We Need New Theory

Moving beyond a factor-based theory of liberalization is important because existing arguments have trouble explaining several empirical regularities that characterize FDI policies and the politics they engender, say little about why advanced democracies were also relatively closed to FDI in the mid-twentieth century, and overemphasize the rise of manufacturing investment in shifting perceptions of FDI's value to local economies.

First, democracy-oriented theories of FDI liberalization are unable to explain three characteristics of FDI policy and politics: the prevalence of FDI liberalization among nondemocracies, that labor groups very rarely engage in rhetoric or activities that champion policy reform policies, and that it is often business groups that support such liberalizations. And while factor proportion models predict capital inflows will reduce returns to capital, FDI can bring with it technology, know-how, capital, and purchasing needs that may benefit at least a subset of domestic firms. Accordingly, we need a theory of MNE regulation that pays greater attention to the complex interest of domestic firms. In his seminal work on the role of FDI on the Brazilian development model, Peter Evans argues states can construct a mutually (though not equally) beneficial alliance between MNEs and domestic firms, mediated by state-owned enterprises that offer foreign firms market access in exchange for technology transfer.[26] Others have also pointed to domestic firms' desire to access technological developments to explain why few countries have historically banned

[23] Owen (2013).
[24] Owen (2015).
[25] Kang (1997).
[26] Evans (1979).

© in this web service Cambridge University Press www.cambridge.org