Heterogeneous Multinational Firms and Investment Liberalization in Developing Economies

Shawn ARITA[ζ]

University of Hawaii at Manoa

Kiyoyasu TANAKA[§]

Institute of Developing Economies

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Abstract:

As developing economies have increasingly implemented investment liberalization to attract foreign investment, its impact on multinational firms is a crucial policy question. This paper seeks to quantify the response of individual multinational firms to a reduction in investment costs in developing countries. Calibrating the firm-heterogeneity model of Eaton, Kortum, and Kramarz (2011) to match micro-level data on Japanese multinational firms, we use the calibrated model to conduct a series of counterfactual policy experiments that reduce fixed or variable costs of foreign production. We find that the greater level of investment liberalization may produce larger welfare gains for the developing economies. In terms of the extensive and intensive margins, the policy reforms tend to induce more productive foreign firms to expand their local production to the larger extent. These results suggest a policy implication for investment targeting at the firm-level.

Keywords: FDI, Firm heterogeneity, Investment liberalization, Developing Country

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[ζ] Department of Economics, University of Hawaii at Manoa; e-mail: aritas@hawaii.edu

[§] *Corresponding author*: Institute of Developing Economies; address: 3-2-2 Wakaba, Mihama-ku, Chiba-shi, Chiba 261-8545, Japan; e-mail: kiyoyasu_tanaka@ide.go.jp