An Analysis of Changes in Wealth Distribution and Economic Development upon the Entrance of an Foreign Direct Investment Firm

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Abstract

This paper examines the changes of an economy relevant to wealth distribution and development upon an entrance of an FDI firm. The framework is based on the economic development model generalized by Matsuyama (2011), where the question of how credit constraints affect household wealth distribution and development dynamics is discussed. In this framework, the participation of an FDI firm is introduced to the theoretical literature in the context of a closed economy as an actual foreign factor. According to the computational analysis and the simulation result, it shows that the joining of an FDI firm may play a role as a "big push" or "underdevelopment trap" to the social equality and development. Any change in the set-up cost for starting a new business, or in altruism toward the next generation have an influence on this role.

Over the last few decades, foreign direct investments (FDI) firms have played a very relevant role in wealth distribution and development in an economy. There are numerous empirical researches which study such impacts of FDI firms, i.e., Tsai(1995), Choi (2006) and Sylwester (2006). However, there is a lack of a research that deals with a theoretical model working on this matter. The motivation of this paper is to develop a framework to examine the changes of an economy relevant to wealth distribution and development upon an entrance of an FDI firm.

To an economy, a representative FDI firm comes from the rest of the world (ROW). The ROW is large enough to make sure that as long as the profit remains positive, there always exists an FDI firm that can afford the set-up cost to join the economy. Thus, the representative FDI firm can be assumed to be so credit worthy that it does not have to face any borrowing constraint. This is the main difference of an FDI firm compared to other domestic firms in the credit market. This characteristic is discussed in this paper.

Much has been written on the question of how credit constraints affect wealth distribution and development dynamics. Banerjee and Newman (1993) build a model of interacting households with fixed borrowing thresholds. Aghion and Bolton (1997) and Matsuyama (2006)build models of interacting households with variable borrowing thresholds. However, these models deal with only a closed economy. Therefore, the particular significance of this paper is that it will introduce the joining of an FDI firm as an actual foreign factor and analyze how this factor affects the results of previous studies.

This paper is based mainly on the theoretical model in Matsuyama (2011). Matsuyama (2011) discusses some key results in the theoretical literature on credit market imperfections, household wealth distribution and development. Thus, the model used in Matsuyama (2011) can cover almost all properties of the relation between imperfect credit markets and wealth distribution. Moreover, the model in

Matsuyama (2011) is simple enough to allow for the extension of these properties for the purpose of introducing such a new factor like the participation of an FDI firm.

The contribution of this paper is two fold. First, it has developed a framework to analyze the impact of an FDI firm on wealth distribution and economic growth. Second, it shows that the joining of an FDI firm may play a role as a “big push” or “underdevelopment trap” to the social equality and development. And any change in the challenge in starting a new business, or in the altruism toward the next generation have influence on this role.