GOVERNMENT POLICY TOWARDS MNEs IN THE PRESENCE OF FOREIGN EXCHANGE SCARCITY

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Control of foreign-owned firms in developing countries (LDCs) has been advocated on numerous grounds; the infant-industry argument is probably the most well-known. The recent literature on strategic trade policy analyzes other justifications for restricting foreign firms. Restrictive policies have been explained as means of promoting exports (Krugman, 1984), of transferring profits to domestic firms (Brander and Spencer, 1984) or both (Spence, 1984). Papers by Davidson, Matusz and Kreinin (1985) and Herander and Thomas (1986) are mostly concerned with the effects of specific policies (export requirements or export-import linkages) on a given welfare function. There is also a large literature on the effects of government tax policies on multinational enterprises (MNEs).

None of these works study the effect of the tradability of the foreign firm’s output good on government policy. In this paper it is shown that this issue is of crucial importance in ascertaining the effects of government policy on the foreign firm. In order to analyze this issue, the government’s optimal policy is obtained under two alternative specifications of the output good. In the first case, the output has no market outside the host country, i.e., it is produced solely for domestic consumption. In the second, the good is tradable, i.e., it may either be sold domestically or exported. It is shown that the effects of government policy in these two scenarios is often radically different.