Interventionist Policies

RIDLEY COLLEGE
SINCE 1889

Learning Objectives

Specific Expectations	
AO3	Explain and evaluate interventionist policies including: - Tax policies - Transfer payments - Minimum wage - Education programmes - Health programmes - Infrastructure
AO3	Explain and evaluate foreign direct investment

Tax policies

- Developing countries often face difficulties regarding taxation, leading to low levels of revenues, inequalities, and negative effects on resource allocation.
- The International Monetary Fund (IMF) recommends that developing country governments should.
  - Increase the progressivity of the taxation system
  - Expand the coverage of personal income taxes
  - Expand the use of indirect taxes on luxury goods and goods that create negative externalities
  - Increase taxation from capital income (profits), which is essential to ensure progressivity.
  - Impose or increase taxes on real estate and land
  - Take measures to reduce tax evasion

Transfer payments

- **Transfer payments** payments made by the government to individuals specifically for the purpose of redistributing income, thus transferring income from those who work and pay taxes towards those who cannot work and need assistance.
  - **Conditional cash transfers (CCTs)** – involve money paid on the condition that the household receiving the money undertake activities related to education and health care.
  - **Non-conditional cash transfers** – do not impose restrictions, providing flexibility to households to manage their expenditures freely in accordance with their needs.
  - Universal social protection systems are costly and may be beyond the means of many developing countries suggesting they can not be fully implemented over the short-run.

Minimum Wage

- Minimum wage may be used as a policy to reduce income inequalities.
  - Minimum wages should be set by governments after consulting representatives of workers and employers in order to take all relevant points of view into account.
  - In deciding on the level of minimum wage it is important to consider the needs of workers and their families to monitor and evaluate the effects.
  - It is important to establish measures to ensure compliance and enforcement, to avoid work at wages below the legal minimum.

Provision of Merit goods

- **Merit goods** are goods with positive externalities of consumption that are held to be desirable for consumers, but which are underprovided by the market.

  1. **Positive externalities of education** – education provides many benefits for society, making the social benefits far greater than individual benefits.
     - Increased labour productivity and greater output
     - Improvement in physical capital (technological advances)
     - Lower unemployment, lower absenteeism and increase international competitiveness
     - Political stability, an important condition for economic growth and development.
     - Lower crime rate and a better quality of life.
     - Increased labour force participation and lower birth rates.

Provision of Merit goods

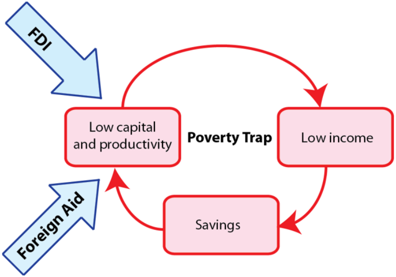
2. **Importance of elementary education and universal literacy** – the greatest contribution to economic growth can be made by primary (elementary) education.
3. **Positive externalities of health care** – an improved level of health also provides benefits beyond individual ones. Ideally, thee should be universal access to healthcare, meaning them everyone should have access.
   - Greater workers productivity and therefore greater output and economic growth.
   - Lower risk of spreading diseases to the community.
   - Immunisation benefits not only the immunised person but also the community by lowering the risk of contracting disease.

Infrastructure

- **Infrastructure** increases productivity (output per worker) and lowers costs of production.
  - Good road and railway systems save time and effort in transporting goods and services, allowing more output to be transported and production costs to be lowered.
  - Availability of effective telecommunications permits faster and easier communications, enabling economic activities to be carried out more efficiently.
  - Irrigation contributes to higher yields (out per unit of land) and expansion of agricultural output.
  - Infrastructure provides services that are essential for maintaining a basic standard of living (safe water, sewer systems)
  - Transportation also affects health and education bringing people in remote rural areas closer to educational and health facilities.

Foreign Direct Investment (FDI) and MNCs

- **Foreign direct investment (FDI)** refers to investment by firms based in one country (the home country) in productive activities in another country (the host country) with control of at least 10 percent of the firm in the host country.
  - Firms that undertake FDI are callend **multinational corporations (MNCs)**.



Foreign Direct Investment (FDI) and MNCs

- Multinational corporations expand into developing countries (as elsewhere) in the hopes of securing higher profits.
- Developing countries offer possibilities of MNCs to:

1. **Increase sales and revenues**
   - Large or rapidly growing markets offer the potential for large increases in sales and revenues
2. **Bypass trade barriers**
   - Producing in countries with trader barriers allows MNCs to bypass these are secure access to local markets.
3. **Lower costs of production**
   - Labour costs take up a large portion of total production costs, and developing countries generally have lower labour costs than in developed countries.

Foreign Direct Investment (FDI) and MNCs

4. **Use of locally produced raw materials**
   - It is far less costly to obtain raw materials locally than to import them, on account of transportation costs.
5. **Further activities in natural resource extraction**
   - Many developing countries are very rich in natural resources, and therefore it is natural for MNCs to want to locate in such resource-rich countries.

- The gap between investment in different regions suggest that MNCs are seeking particular characteristics in a host country including:

1. **Low labour costs**
   - Many MNCs choose to relocate production to countries where the per-unit labour costs are much lower.
   - Lowers overall costs of production for theses goods, even when transport costs are included.

Foreign Direct Investment (FDI) and MNCs

2. **Natural resources**
   - Access to natural resources can attract foreign investment.
3. **Political stability**
   - MNCs prefer countries where the political environment is stable, as it ensures greater economic stability.
4. **Large domestic market**
   - The attraction of foreign investment is often to export to the rest of the world and to expand the market for the MNCs goods by direct presence in the country.
5. **Access Firm Specific Knowledge**
   - Firms may purchase foreign firms as a subsidiary in order to acquire knowledge to maintain the competitive edge.
6. **Risk Diversification**
   - Production in various countries minimizes risks associated with market downturns (recessions), strikes and political instability.

Foreign Direct Investment (FDI) and MNCs

7. **Relaxed regulatory environment**
   - **Profit repatriation** – allowing MNCs to more freely redirect profits to the home country.
   - **Tax rules** – tax rules for corporations may be reduced to entice investment.
   - **Property rights** – a respect of property rights, so that firms are not dissuaded from investing by fear of government takeover or confiscation of assets.
   - **Health, safety and environmental regulations** – MNCs may be drawn to a country because reduced health, safety and pollution regulations mean lower production costs for the firm.
8. **Liberalized free market conditions**
   - **Free trade** – foreign firms that need to secure imported factor inputs will want open trade, free of protectionist measures.
   - **Privatization** –the privatization of state industries means new opportunities for foreign firms as a purchaser of the industries, or as a supplier of services.

Advantages of FDI

- Since expansion of FDI is expected to continue, it is critical for developing countries to assess the value of FDI for their own development plans.
- There are several key benefits of direct foreign investment:

1. **Supplement insufficient foreign exchange earnings**
   - Invest funds flowing into a country from abroad appear as credits in the financial account, and can help offset a current account deficit.
2. **Improve technical skills, managements skills and technology**
   - MNCs bring technical and managerial expertise, as well as new production technologies, which can be used and adopted by the local labour force (workers and managers) and local businesses.
3. **Supplement insufficient domestic savings and increase investment**
   - The inflows of FDI funds into a country can add to insufficient domestic savings, increasing the amount of investment.

Advantages of FDI

4. **Greater tax revenue in the host country**
   - If multinational corporations are taxes by the government of the host country, there will be increased tax revenues.
5. **Promote local industry**
   - When MNCs buy locally produced inputs, they promote the development of local industries.
   - This may lead to growth of existing local firms, or the establishment of new local firms.
6. **Increase local employment and lower unemployment rate**
   - MNCs can increase employment by hiring local workers
7. **Increase economic growth in the host country**
   - Increased levels of investment, improved technology and increase in human capital as well as the promotion of local industry and greater tax revenues, can lead to higher economic growth in the host country with increased possibilities for pursuing development objectives.

Disadvantages of FDI

- The benefits of foreign direct investment by MNCs may not always be realized.

1. **Insufficient foreign exchange earnings**
   - While MNCs bring foreign exchange into the host country, they also engage in activities resulting in foreign exchange outflows (profit repatriation, imports of raw materials and other inputs).
   - The net inflows of foreign exchange (inflows minus outflows) may be small.
2. **Lack of investment in technical skills, management, & technology**
   - Links between MNC activities and the local economy are often limited, in which case local workers do not have the opportunity to learn from the MNC.
   - MNCs often hire personnel from the home country.

Disadvantages of FDI

3. **Lack of tax revenue in the host country**
   - MNCs enjoy many tax privileges and benefits, often lowering the amount of tax paid.
   - **Transfer pricing** is a form of regulatory arbitrage where corporations shift profits out of countries with high tax rates to those with low tax rates.
4. **Lack of promotion of local industry**
   - Th MNC sometimes forces local competing firms to go out of business, or alternatively does not permit new local firms to establish themselves in industries that are directly competitive with the MNC.
5. **Limited reduction in unemployment in the host country**
   - If MNCs prevent the development of local industry, then their job-creating impact will be limited.
   - Some MNCs may import into the host country capital-intensive technologies that are inappropriate for local conditions, thus contributing to unemployment and the growth of the informal economy.

Disadvantages of FDI

6. **Environmental degradation**
   - MNCs often pursue activities that cause serious environmental degradation.
   - Preferring to invest in countries with few environmental restrictions, they are known to engage in activities that have caused tremendous environment damage.
7. **Inappropriate consumption patterns**
   - Critics charge that MNCs, through advertising, create new consumption needs and promote inappropriate consumption patterns.
8. **Resources diverted toward infrastructure rather than poverty**
   - MNCs sometimes require infrastructure (road systems, ports, telecommunications) which the developing country must make available if it is to become attractive as a host country.
   - To build these types of infrastructure, it may have to shift some its scarce resources away from needed merit goods (clean water, sanitation, schools and health care services).

Disadvantages of FDI

9. **Political and economic power**
   - The very large size of many MNCs gives them exceptional economic and political power that they can use to influence host governments to pursue policies that are in their own interests, but against economic development.
10. **Competition between developing countries**
    - Many developing countries compete with each other over which will create better conditions to attract MNCs.
    - The desire to host MNCs may involve sacrifices in terms of needed policies for economic growth and development.