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Integration and Welfare with Horizontal Multinationals

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OBJECTIVES

Our main objective is to develop a theoretical investigation of the link between liberalization policies and individual welfare in presence of foreign direct investments (horizontal multinationals) and asymmetries in the national shares of capital holdings. More precisely we aim at analysing how, in presence of capital mobility and multiplant firms, an increase in the degree of trade integration affect welfare at the national and aggregate level and, also, welfare inequality. Finally, we aim at identifying the role of asymmetries in the share of capital holdings at the country level in shaping the previous relationship. To this purpose we introduce horizontal multinational firms in an otherwise standard footloose capital model with 2 countries, 2 sectors and 2 production factors with capital mobility and asymmetries in the share of capital holdings at the country level.

MAIN RESULTS

While in standard models of international trade with monopolistic competition liberalisation - by increasing foreign sales and purchasing power - is unambiguously good for welfare, the introduction of horizontal multinationals may radically change this figure. We find that, when multiplant firms are taken into account, trade integration has ambiguous effects on welfare. The sign of this effect crucially depends, among all the parameters, on the degree of markets integration and on the share of world profits owned by each country so that the effect of integration on welfare differs according to whether a country is "rich" (i.e. it owns a relatively high share of capital) or "poor" (i.e. it owns a relatively low share of capital).

More precisely, it is shown that integration is good for welfare only if the country is rich enough. The intuition lies on the two competing and opposite effects that integration has on profits and on the perfect price index. On the one hand, trade integration always increases profits due to a positive effect on foreign sales which is always good for industrial firm enjoying increasing returns. This positive effect on profits translates into a positive effect on real income and then on consumer welfare. On the other hand, trade integration always increase the perfect price index because it reduces the profitability and the number of multinational firms and then reduces the range of differentiated goods available to the local variety-lover consumer thereby increasing the range of imported goods which are subject to trade costs. This positive effect on the price index translates into a negative effect on real income and then on consumer welfare. As one would expect, the first (positive) effect dominates the second (negative) - and then integration is good for welfare - only when a country owns a sufficiently large share of profits i.e. when is "rich" while the opposite happens otherwise.

As far as trade costs are concerned, our paper predicts the existence of a U-shaped relationship between economic integration and welfare both at the national and at the aggregate level: when trade integration is sufficiently low, a further increase in the degree of trade integration reduces welfare but when the degree of trade integration is sufficiently high then integration turns out to be good for welfare.
In other words, our model predicts the existence of a welfare-minimizing degree of integration. Reducing trade costs can then have completely different effect according to whether the economy is located at the left or at the right of this welfare-minimizing degree of integration. More precisely, a marginal increase of the degree of integration might be harmful (both at the country and at the aggregate level) when countries are not sufficiently well integrated while a sufficiently strong improvement in economic integration is always good both at the country and at the aggregate level.

Opening for between countries asymmetries in capital holdings leads to some new interesting interactions between firms' ownership and trade integration. In particular, when the distribution of global profits is uneven, liberalization policies always increase welfare inequality.

Moreover, since this welfare-minimizing degree of integration is lower for "rich" countries, there is an entire range of intermediate trade costs such that liberalization leads to opposite welfare effect in the two countries: positive in the "rich" country and negative in the "poor" one.