Referee Report on the paper

"Foreign Capital Inflow and its welfare implications in a developing country context."

This paper proposes a theoretical analysis of the welfare effects of foreign capital inflows using a 3-sector, 4-factor, perfectly competitive model of international trade for a small open economy. The four factors are skilled and unskilled labor, domestic capital and foreign capital. The three sectors are Agriculture (the *numeraire*, using unskilled labor and domestic capital), Manufacturing (using skilled labor and domestic capital) and an Export-Processing Zone (obscurely named "Foreign Enclave", using foreign capital and skilled labor). The main results are three: i) the skilled-unskilled wage gap is widened by an increase in foreign capital; ii) an inflows of foreign capital increase the output of EPZ and agriculture, but lowers manufacturing output; iii) Foreign capital inflows increases domestic welfare.

I find the topic of the paper very relevant. However, I do have some concerns about the paper.

Here my main concerns:

1. First, these results are somewhat directly linked to the assumptions about the production structure of the economy. So a first order question is why this should be the most appropriate or reasonable way to describe production processes? For instance, one might argue that in much of the Chinese export processing zones, the relevant combination of input is foreign capital with unskilled labor. I suspect that result number 2 would be affected by this alternative assumption about the production technology. This calls both for a more detailed discussion of the modeling choices and possibly to the need for some motivating evidence supporting the modelling choices made by the author. It seems that this sort of "chained, double specific factor model" is just the base of everything, but we have no idea about the plausibility of these assumptions relative to different ones, with potential different implications.

2. Second, why should we think about foreign capital only flowing into the EPZ? Again, more discussion and evidence is needed. Results would be widely different if there was just a capital aggregating both domestic and a foreign component.

3. Third, one main comparison the author(s) make(s) is between the welfare result in this paper and the one obtained by Beladi and Marjit (1992, CJE), whose model featured both a tariff and a different structure of production (3-sector 3-factors model of trade). Where is the difference in the results stemming from? The tariff or the production structure?

Moreover, I’d suggest to the author(s):

i) to update the references (see for instance also: Reis, A.B. “On the Welfare Effects of Foreign investments”, 2001, *Journal of International Economics*, and references therein);

ii) to link more results 1 and 2 to the literature on the Stolper-Samuelson and Rzybicinzki effects;

iii) to ship to the appendix also the equations (9) and subsequent [by the way, I noticed some mistakes in numbering];

iv) to review the writing style of the paper, which is not easily readable, at least in some parts.