Foreign capital inflow and its welfare implications in a developing country context

Summary:

The paper utilizes a 3-sector general equilibrium framework to ascertain the welfare implications of foreign capital inflow. The author finds that capital inflow triggers resource reallocation across sectors to the benefit of the agriculture sector and foreign enclave, but to the detriment of the manufacturing sector, which contracts as a result. In addition the paper documents that foreign capital inflow widens the skilled-unskilled wage gap under some conditions.

Comments:

The model assumes a foreign enclave and manufacturing sector with sector-specific capital. Presumably the type of export goods produced by the foreign enclave should matter for how realistic some of the assumptions are. However, the author does not also indicate what kind of good or (tradable) service is being produced by the foreign enclave. Would that matter for the dynamics of the model? Would that weaken a key assumption of the model, i.e. non-substitutability of domestic and foreign capital as well as the extent to which skilled labor substitutes for capital?

A key implication of the model specification is that a rise in rental rate of domestic capital implies a rise in rental rate of foreign capital, and consequently a decline in wage of skilled labor. This dynamics lacks an intuitive foundation and is inconsistent with some other key observations in the paper.

For example, the author asserts that a rise in output of manufacturing leads to excess demand for skilled labor, which raises the wage. It is plausible that such an increase in output of manufacturing is what triggers a rise in rental rate of capital, so how does one reconcile this with the decline in wage of skilled labor under a scenario where there is an increase in demand for both skilled labor and domestic capital?

Moreover, it is unclear how price of domestic capital affects the price of foreign capital. The author appears to establish there is a direct relationship between the two. It would help to provide some intuition behind how the price of domestic capital drives the price of foreign capital, given that domestic capital and foreign capital are neither substitutes nor complements.

Arguably, the rise in rental rate of domestic capital would be demand driven; and if so, it is conceivable that wage of skilled labor would also increase. In other words, the cause of the higher rental rate for domestic capital could determine whether skilled wages are rising or falling. The author would need to address that.

As pertains to the main dynamics of the model, the author suggests that an increase in foreign capital leads to increase in demand for skilled labor, and consequently wage for skilled labor. This draws skilled labor from manufacturing sector, and consequently transfer of capital from manufacturing towards agriculture. The reallocation of skilled labor to the expanding foreign enclave is intuitive. It is unclear, however, why there is movement of capital towards agriculture, and not in the opposite direction to substitute for skilled labor. Arguably, the manufacturing sector should be more productive than agriculture, and hence a preferred destination for domestic capital. Why is cheaper domestic capital not being used to substitute for more expensive skilled labor, as previously suggested in the paper?