Foreign Direct Investment in Emerging Economies

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Executive Briefing

This paper summarizes the pertinent literature on FDI in emerging economies. It focuses on the impact of FDI on host economies, and on policy and managerial implications arising from this (potential) impact. This executive briefing summarizes my reading of the literature in form of propositions.

Why do multinational firms invest in emerging economies?

Foreign direct investment in emerging economies is booming after a temporary setback in 2001-04. Foreign investors seek local markets and export platforms based on local resources such as low cost labour or natural resources. Most investors pursue market-seeking objectives, yet resource-seeking investors account for many large projects, given them a large weight in many measures of FDI. Initially, many investors may be motivated by only one of the objectives, but most investors over time develop a range of activities and serve both domestic and export markets.

How does FDI affect host economies?

The impact of FDI on host economies is complex as foreign investors interact with, and thus influence, many local individuals, firms and institutions. However, on average the effect may well be close to nil.

Local firms benefit potentially in many ways: learning from example, labour mobility, export market access, improved supply bases, or direct relations as suppliers or customers. However, these effects with the characteristics of the FDI project, in particular its development of local supply networks, its investment in human capital, employee mobility, and the value added in local operations.

The impact of FDI varies moreover with the ability of local stakeholders to take advantage of the potential benefits of FDI. In particular, the local regulatory framework has to provide for competitive conditions that are conducive to local entrepreneurship, while avoiding undue market power of the foreign investment firm. Moreover, local individuals and firms need to have the ability to learn from foreign partners – discussed in the literature as *'absorptive capacity'*.

What can governments do (better)?

MNEs undertake FDI if and when it suits their global strategy, and they will invest in the type of project they need to achieve their strategic objectives. Government policy towards inward or outward FDI has a negligible effect these corporate strategies. Government policy may thus focus on attracting firms that plan to locate attractive projects, rather than try to convince them to do change what they are doing.

Specific incentives schemes designed to attract FDI, such as tax breaks or subsidies, may affect location decisions at the margin, especially between neighbouring regions, and especially for footloose projects that do not require specific linkages to the local economy. Yet these are also the least attractive projects in terms of expected local benefits. Moreover, the competition between regions for specific FDI projects entails the danger of a “winner’s curse” as the investor may able to internalize most of the social benefits.

A conducive business climate may be more important for both MNEs seeking investment locations, and for local firms and entrepreneurs seeking to benefit from the presence of MNEs.

What can MNEs do (better)?

Societies at large, especially outside Anglo-American countries, increasingly expect MNEs to assume social responsibilities that go beyond maximizing shareholder value. This view is supported by a recent UN resolution.

This responsibility may extend beyond the boundaries of the firm, for instance to workers employed by subcontractors in distant locations, to emissions into the natural environment, and to corrupt business practices by business associates.

In raising ‘corporate social responsibility’ defining standards is the easy part. The main challenges concern the implementation and monitoring of these standards both within the firm and among its business partners.

Foreign Direct Investment in Emerging Economies

1. Introduction: Why do multinational firms invest in emerging economies?

Foreign direct investment (FDI) is a major source of capital and technology in emerging economies, and continues to accelerate in economic significance. FDI flows have recovered from a downturn in recent years and with US$ 233 billion in 2004 almost reached the 2001 peak of US$ 253 billion (in developing countries, excluding Eastern Europe). This recovery stands in contrast to FDI in developed economies, which fell to US$ 390 billion in 2004, about a third of the 2000 level, mainly due to fewer large mergers and acquisitions in Europe. However, FDI in emerging economies very unequally distributed with China accounting for US$ 61 billion, followed by Hong Kong (34), Brazil (18), Mexico (16) and Singapore (16). Substantial amounts are also received by several other countries in East/South-East Asia and in Latin America. Yet others receive little. India increased it FDI inflows to the highest level ever, yet US$ 5 billion is little for the second largest population of the work. Similar scarce is FDI in Africa. The entire continent attracted US$ 18 billion, which are distributed very unequally (all data: UN 2005).

In view of these numbers, it is not surprising that the role of multinational enterprises (MNEs) in emerging economies has become a key aspect of contemporary disputes over the merits of globalization (Moran, 2002; Bhagwati, 2004). Adversaries of globalization see MNEs as the culprits of many of the failures of the global economy, from persistent inequality, to sweatshop working conditions and to environmental degradation. Proponents of MNEs, on the other hand, point to many benefits that global economic exchange and foreign investment may bring, from lower

prices to consumers, to knowledge transfer to emerging economies, and the spread of modern values and management practices.

Before examining these claims, I briefly introduce MNEs, their motives, and the types of projects they may undertake in emerging economies. Broadly, foreign investors in emerging economies pursue one or both of two objectives,

- access to local markets through local production and/or sale of imported products
- export-oriented production on the basis of local resources such as low cost labour, natural resources, or (less common) human capital.

Globalisation has led to the opening of many markets and thus increased competition not only in emerging markets, but also in developed countries. In consequence, rather than building a strong position in several markets in their home country, more and more companies pursue a global strategy that is focused on one particular industry. In recent years, many MNEs have gone through a process of 'globalfocusing', as they have shed peripheral product lines and expanded their core businesses, often by acquisition (Meyer 2006). As industry-specialists, they aim for global leadership positions in their chosen segment.

FDI in emerging economies can serve this objective by extending the market reach or by providing a global supply base. For companies aiming to become global leaders in their market segment, competitive interaction with global rivals may induce early entry in emerging economies in view of first-mover or fast-second advantages. Global competitive pressures may also induce MNE to find new ways to reduce production costs. These pressures lead to outsourcing to low cost suppliers and

investing to exploit location specific assets, for example, natural resources (see also the companion paper by Mari Sako).

Our surveys in India, Vietnam, Egypt and South Africa (Estrin and Meyer, 2004) and in Hungary, Poland and Lithuania (Meyer et al., 2004) illustrate some interesting patterns of FDI:

- About three quarters of FDI aims at supplying the domestic market in the host country - except in Vietnam where the proportion is around 50:50.
- Export-oriented investors account for many large projects, giving them a large weight in many measures of FDI. Initially, investors appear to be motivated by one of the objectives, but most investors over time develop a range of activities focused on both domestic and export markets.
- Most FDI projects are small; at the time of formation the median number of employees was 40 in Egypt, 30 in India, 76 in South Africa and 85 in Vietnam, although some have subsequently grown significantly.
- Mergers and acquisitions between MNE on a global or local stage affect their emerging market operations. Some MNEs divest selected operations as part of a global restructuring, while others may acquire such affiliates.
- A large and increasing share of FDI is in service sectors and construction, notably in telecommunications and financial services.
- Many investors originate within the same region; and regional trade and integration policies, as well as global ones, often influence location decisions. Thus FDI generates regional rather than global exports, especially in Eastern Europe, East Asia, or the Middle East.

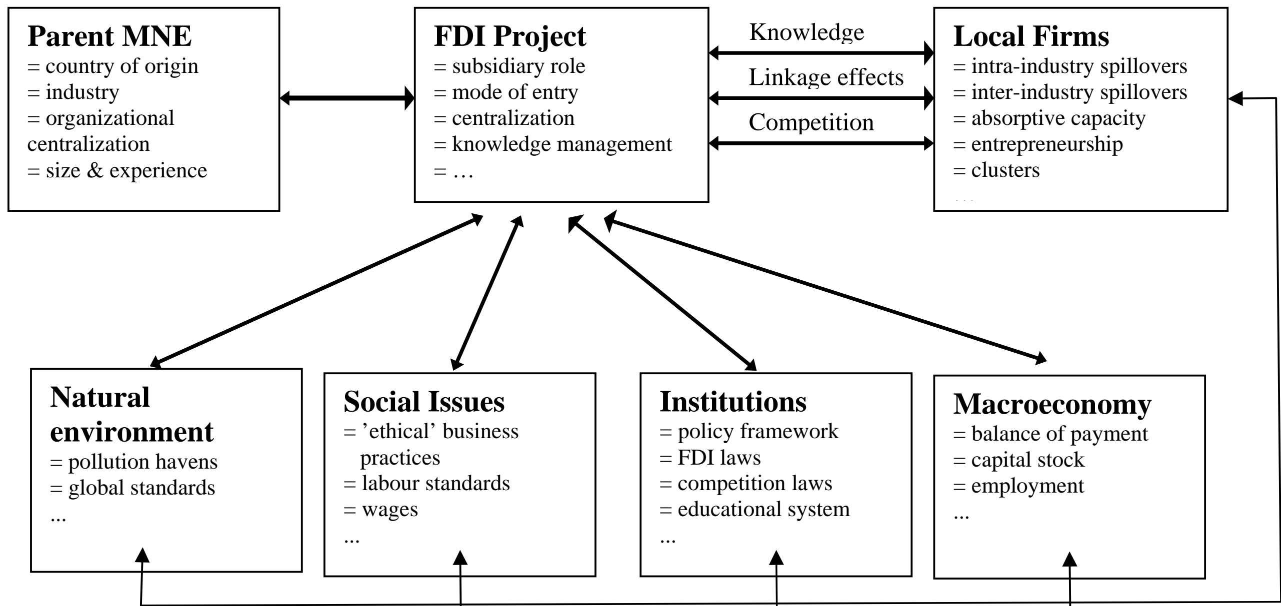
Policymakers may therefore want to think carefully about how to develop their FDI strategies in the context of regional trade policies. Moreover, expected benefits in telecommunications or banking compared would be different than those in the more frequently analyzed manufacturing sectors.

2. How does FDI affect host economies?

The impact of FDI on host economies is complex as foreign investors interact with, and thus influence, many local individuals, firms and institutions. However, on average, the *net* effect may well be close to nil. Figure 1 outlines various channels of impact that I will discuss in this section. The foreign invested firm, or FDI project, is closely interacting with local businesses; most of the impact on the host economy is transmitted trough this interaction. Beyond this, FDI also impacts on other aspects, including macroeconomic variables, the host economy's institutional framework as ass as the natural and social environment.

Most of these interactions are bilateral. On the one hand, foreign investors adapt to the local institutional, social and natural environment in designing their strategies. On the other hand, they would – intentionally or not – influence the environment through for instance political lobbying, setting good examples of labour standards, or polluting the environment. The FDI project in turn is designed by an MNE located outside the country. The structure and strategies of this MNE thus shape the project and its interactions with the local environment.

Figure 1: Channels of Impact of FDI



Source: Meyer (2004)

On a macroeconomic level, FDI influences key variables of concern to policy makers: balance of payment, employment, gross domestic investment, and international trade. FDI is commonly believed to have a positive effect on each of these variables, yet theoretical considerations suggest also countervailing effects. However, these effects are often indirect and thus heard to measure empirically (Dunning 1993, chap 14). In consequence the *net* effect of FDI on key macroeconomic variables is often hard to establish empirically:

- FDI imports capital, but at a later stage capital is repatriated through profit remittance or project discontinuation – and in this way, the host country pays for the costs of capital. However, FDI capital is appreciated by hosts because it tends to be less volatile then other forms of capital inflow (UN 1999, chap 6).

- FDI creates employment, especially if it is invested in Greenfield operations. Moreover, additional jobs may be created in local suppliers. Yet FDI may also crowd out local firms that use more labour-intensive methods of production and thus more employment. The policy-relevant *net*-employment effect is thus hard to assert (Dunning 1993, chap 13, UN 1999, chap 9). In the case of acquisitions, the employment effect is even harder to assert because it requires an analysis of *what* would have happened to the local firm *if* it had not been taken over by the foreign investor (Estrin and Meyer 2004).
- FDI increases gross domestic investment, yet part of it may be domestically funded or the capital inflow may increase the exchange rate and thus costs of international borrowing; both effects can lead to crowding out of local investment.
- FDI generates exports. Yet FDI also generates imports, especially in the case of market-seeking FDI and in the case of outsourcing operations that process imported components. MNE are typically more internationally oriented, but this affects both sales and procurement. Thus, the *net* effect of the trade balance may be much smaller than data on exports by FDI may suggest (UN 1999, chap 8).

Dunning concluded in 1993 (p. 413) that *" the question .. is not weather MNE activity is trade promoting or trade replacing, but whether it is an efficient instrument for the reorganization of the cross-border allocation of economic activity in a way that is conducive to both national and international economic welfare"*. This conclusion holds even more true in 2005 as transactions have grown in complexity. Moreover, I would like to extend it to other macroeconomic policy targets, namely capital import, employment and gross domestic investment.

Overall, the effect on macroeconomic variables varies greatly with the specific features of an FDI project, such that evidence on macroeconomic relationships may not be transferable from one context to another, and thus provides little guidance for policy makers. Rather, we need to understand the microeconomic effects of FDI to identify which FDI and under what circumstances benefits the host economy.

2.1. Horizontal and vertical spillover effects to local firms

Many countries aim to attract inward FDI to accelerate the development of technological capabilities, and MNE are often considered a suitable transfer vehicle. Through interaction with local firms, MNEs may generate spillovers that enhance the productivity of local firms. The literature points to different channels (Blomstrom and Kokko, 2002, Meyer, 2004):

- **Demonstration effects** work through the direct contact between local agents and MNEs operating at different levels of technology. After observing an innovation adapted to local conditions, local entrepreneurs may recognize their feasibility, and thus strive to imitate them. As local businesses observe existing users, information about new technologies and business practices is diffused, uncertainty is reduced, and imitation increases.
- FDI contributes to human capital formation, especially through training and **labour mobility**. Trained local employees may move to locally owned firms or set-up own entrepreneurial businesses. MNEs typically pay salaries above local standards to discourage highly trained employees from leaving, yet they may not oppose such movements if the new firms become business partners. Many successful local firms trace their origins to entrepreneurs or top managers that had prior links to MNEs (Altenburg, 2000). Even where few

employees move, those that move may make a substantive contribution to local business.

- FDI may help local firms to access **export markets.** MNEs are more likely to share general trade knowledge, as it is less industry-specific and not part of their core capabilities and its diffusion to local businesses does not endanger their own competitive advantage. Moreover, foreign investors may help building trade channels and a country of origin reputation that local followers may use for their exports (Altenburg, 2000).
- Foreign investors may support local supplier industries and **markets for specialized inputs**, such as labor and materials. Beyond the quality of physical products this may enhance in particular the quality of services provided by suppliers, such as just-in-time delivery and low default rates. With these improved inputs, local firms in turn may enhance their productivity.
- Local firms may benefit from **vertical linkages** in a supply chain, benefiting from knowledge transfers to suppliers and customers. MNEs may make a deliberate effort to improve the quality of local suppliers, especially for components that cannot be cost-efficiently imported due to high transportation costs or where the local industry has a natural cost advantage (e.g. for labour intensive components). These effects benefit also firms in other industries, for instance providers of business services, such as accounting or legal services. Similar, they may support their customers, for instance by providing training in sales and marketing.

However, negative spillovers on local firms are also possible, notably through **crowding out effects**. Foreign investors may gain market share at the expense of local

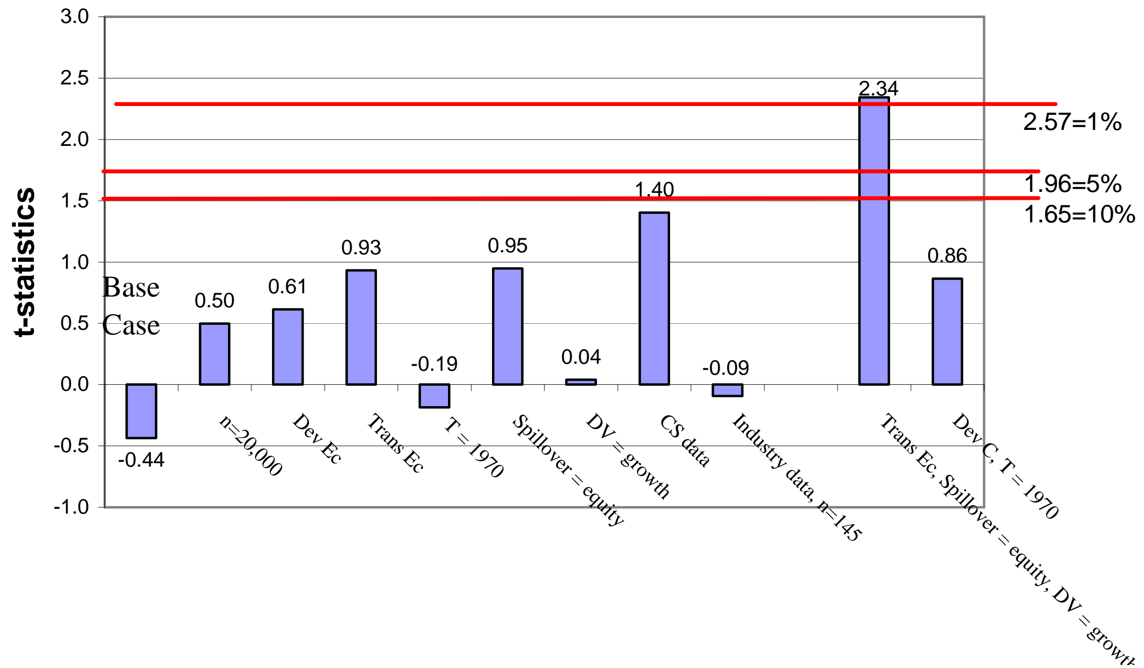
firms. This would leave the local firms, at least in the short run, with excess production capacity and thus low productivity and low profitability. Moreover, foreign investment may source internationally and thus weaken the local industry's domestic supplier base.

Empirical research has focused on horizontal spillovers, i.e. benefits attracted by local firm in the same industry. We have recently conducted a Meta-analysis of this literature (Sinani and Meyer, 2005), that is a study that aggregates the findings of several studies using special empirical techniques. We found that on average these studies do *not* find statistically significant spillovers benefiting local firms.

These studies regress FDI presence in the same industry on the productivity of local firms. To infer a statistically significant positive impact, a study would have to find a positive t-statistic of at least 1,96 (5% significance level) of the coefficient of FDI-presence. However, some studies find negative effects. Figure 2 summarizes the findings of the Meta analysis. We estimate the t-statistic as a function of characteristics of the study, and report predicted values for the t-statistic (Figure 2). On average, we find that on average the effect is negative for industrialized countries, and positive but small for developing and transition economies. Changes in the study design have only small effects on the predicted outcome. The significant positive effects found in many early studies (and thus policy advice) can be attributed to the use of cross sectional (CS) data, a technique that has now been shown to create upward biases. Thus, the argument of horizontal spillovers does *not* justify policy intervention.

Figure 2: Meta-analysis of horizontal spillovers:

Predicted t-statistics by characteristics of the study



Notes:
Base Case: Developed Country, 1995 data, firm level panel data, N=3425 (=median value for studies that are firm-level panel data).
Interpretation: Predicted values are for a bases case, and variations of explanatory variables over the base case. Note that for industry level studies, the median number of observations in these studies (n=145) was used.
Source: Sinani and Meyer (2005).

On the other hand, empirical research on *vertical* spillovers provides more favourable evidence of the existence of spillovers, albeit such research is difficult to conduct (it requires detailed industry-level input-output data). A positive effect is plausible as MNE may have an interest to help their local business partners to improve their business practices, yet they would not have an interest in helping their (potential) competitors. Yet, it is less clear who accrues the benefits of improved productivity especially in case of unequal bargaining power.

2.2. Variation of impact across MNE

MNEs vary in their internal operations, including for instance the centralization of decision making, organizational cultures, and human resource management practices. Consequently, subsidiaries in emerging economies would vary in their interactions with other business units of the parent's network. This in turn affects interactions with local businesses, for instance, the development of local supply networks, investment in human capital, employee mobility, and the stages of the value chain located in the host economy.

Some of these variations are due to *industry-specific features* (Grosse 2005). Infrastructure FDI for instance in transport or telecommunication can greatly enhance productivity in other sectors of the economy, yet at the risk of foreign control – possibly even monopoly – if the sector is not appropriately regulated. Similar benefits and risk arise from financial sector investment. Services such information technology operate in more competitive markets and may benefit a wide range of other business. In manufacturing, major variations arise from the need or opportunity to produce close to the market due to high transportation costs or low scale economies.

An aspect of particular relevance for MNE spillovers is *intra-firm knowledge transfer*. Knowledge sharing within the MNE is a precondition for knowledge spillovers. Typically investors would transfer 'know 'how' to their affiliates to enhance efficiency and productivity. Yet they would keep tighter control over their 'know why', because such knowledge could – if diffused to other firms – threaten the international market position of the firm. Knowledge spillovers would also rise with higher value added activities, such as complex manufacturing processes, such as customized machinery, rather than mass assembly of for example garments or shoes.

In particular, *research and development* (R&D) is commonly believed to generate positive spillovers. Traditionally, MNE would keep their R&D activities close to their home base, or locate it in leading edge clusters such as Silicon Valley. However recent data show that R&D is increasingly located in countries such as China, India, Singapore and Brazil (UN 2005). This potentially boosts the technology flows between MNEs and local suppliers or local institutions, such as universities.

Another source of variation is the mode of entry. In a *joint venture*, two partners share their resources in return for access to the partner's resources. This can lead to mutual learning, and thus extend linkages and knowledge spillovers in the local business community. Yet MNEs would be more concerned about unwanted technology diffusion and thus be more reluctant to share crucial knowledge with local employees. *Greenfield* projects create new businesses and thus have direct positive effects on employment and domestic value added, and increase competitive pressures on local competitors. *Acquisitions*, on the other hand, are at the time of entry fully operating enterprises. The new owners may or may not continue traditional business relationships, possibly drawing on their existing suppliers, which would strongly impact on local industries. However, based on inherited operations, acquisitions are more likely then Greenfield projects to engage in R&D.

These variations influence the effectiveness of government designing policies aimed to attract FDI. Policies ought to consider explicitly what type of FDI would benefit the host economy, rather than focusing on quantitative targets for FDI. Moreover, evaluation of policies should analyze what types of investors, and with what type of projects would consider the local environment (incl. political institutions) attractive.

2.3. Variation of Impact across local contexts

The impact of FDI varies moreover with the ability of local stakeholders to take advantage of the potential benefits of FDI. Benefits are not obtained quasi-automatically. Firms' own strategies and resource endowment are crucial for benefiting from interaction with foreign investors. In particular, the local regulatory framework has to provide for competitive conditions that are conducive to local entrepreneurship, while avoiding undue market power of the foreign investment firm.

Business scholars have focused on absorptive capacity in the contexts of knowledge transfers within MNEs and within strategic alliances. Zahra and George (2002: 186) define absorptive capacity as "a set of organizational routines and processes by which firms acquire, assimilate, transform, and exploit knowledge to produce a dynamic organizational capability". It encompasses not only human capital but also structural characteristics of the organization that affect its ability to value, assimilate and commercialize new knowledge. This in turn has been associated with structural features of the organization, such as strategic and organizational flexibility. For example, local joint venture partners may improve their capacity to learn by promoting organizational flexibility, and encouraging collaboration and exchange of information within the organization, and giving employees greater latitude to alter activity patterns (Lane et al. 2001).

FDI also can act as a stimulus to innovation and discovery. Entrepreneurial activity by individuals leaving a foreign-owned affiliate to establish their own business generates potentially large spillovers. Studies of successful local firms find that many entrepreneurs or top managers had prior links to MNEs. Moreover, large MNEs may stimulate the evolution of industrial clusters. FDI by a lead firm may draw other network members to the same location, and thus create a larger impact than the

initial investment alone. For small ambitious firms in emerging economies, access to such production networks is of increasing importance.

Government policy thus ought to aim to enable local firms to interact with multinational corporations in ways that benefits both partners. The main consequence of this is that most policies that promote the development of local businesses would also strengthen the abilities of local businesses to make the best out of their interaction with foreign investors, for instance education policy or competition policy.

2.4. Impact on local stakeholders: labour and the environment

Globalization debates take a special interest in the standards in MNE affiliates and their subcontractors in emerging economies. Some observers fear that the strong bargaining power of MNEs vis-à-vis their employees and potential host countries leads to a lowering of labour standards and wages, and may have a detrimental impact on the natural environment. Does competition for FDI trigger a ”race to the bottom” (Spar and Yoffie, 1999), i.e. a lowering of standards for labour and the environment? The literatures on labour and environmental issues are largely separate, but the lines of argument are similar, such that we can discuss them here together.

On the one hand, concerns about global standardization and the firm’s reputation induce many MNE affiliates to pay higher wages and to establish higher labour standards than local firms with respect to e.g. working hours, sick leave, child labour, or unionization compared (Moran, 2002). Since MNEs generally wish to retain their qualified staff, they want to keep them satisfied, unless they are employing unskilled labour with few outside job opportunities. Similarly, the standardization of business practices and technologies across the subsidiaries of an MNE would raise standards above local requirements in countries with less demanding standards. On

the other hand, lower standards and lower wages present opportunities to reduce production costs.[1]

The unease about the ”race to the bottom” is of concern in certain industries, such as textiles, footwear and assembly of electronics. Spar and Yoffie (1999:565) argue that a race to the bottom can occur in industries where

- firms and goods are mobile across borders, i.e. free trade and investment, and
- ”regulation and factor costs are heterogeneous – and the heterogeneity leaves gaps that can be turned into the firm’s competitive advantage”.

Moreover lowering of standards is facilitated by

- Homogeneity of products (or of components at certain stages of the value chain), such that price is a key competitive parameter.
- Regulatory differentials are important for the cost structure of the industry, such as labour law for textiles and footwear.
- MNEs would not incur major transaction costs or sunk costs when relocating a production plant, i.e. location is not sticky.

Businesses are generally not interested in engaging in such a race to the bottom, but they are pushed into it by competitive pressures. Theoretically, if firms were to cooperate and implement common standards, the race would stop. However,

[1] Economists may argue that as long as the contract is entered voluntary, both partners would be better off. Notably, local wages reflect outside earning opportunities, which are typically low in those countries where so-called sweatshops are located. However, this assumes *ex ante* full information and the absence of switching costs. Both conditions are unlikely to be fulfilled in labor markets, especially for migrant workers in developing countries. Moreover, bargaining power and even the ability to price discriminate may allow locally important employers to accrue most of the surplus created.

this would require cartel-like cooperation which, would be are hard to enforce, especially if firms are heterogeneous. But contrary to market cartels, policy makers may support the creation of standards cartels (Spar and Yoffie, 1999).

Industry self-regulation can achieve part of such regulation by creating common standards and certification. Many initiatives by firms, industry associations and governments aim to raise standards and to reverse the 'race to the bottom'. However, there no clear empirical evidence whether these initiatives would achieve their objectives: are industries with the aforementioned characteristics actually "racing to the bottom"? How effective is industry self-regulation? Are standards cartels, with or without government involvement, moderating races to the bottom?

This involvement of NGOs raises many empirical questions. They have not yet been comprehensively evaluated in terms of for instance stakeholder involvement, rigor of the standards, accountability of the monitoring and complementarity with state regulation. It is not clear how NGO involvement and codes of conduct would influence business standards: Is the system falling short because monitors can't observe all abuses, or is it overshooting as NGOs proclaim higher standards then a social consensus would approve?

Policy makers should moreover focus on long-term implications. Poor working conditions, including child labour, have been common during early stages of industrialization in Europe and North America. Moreover, Asian economies that permitted sweatshops, like Taiwan and South Korea, have substantially improved their standards of living over the past three decades, while countries that resisted "exploitation", like India, continue to suffer for widespread poverty. However, these specific cases do not allow inferring that sweatshops would be a *necessary* step in the process of economic development.

3. What can governments do (better)?

Governments and MNEs live in a complex relationship as they pursue common goals, yet also experience some distinct conflicts of interest. Grosse (2005:4) outlines the ambiguous demands of policy makers towards MNEs. They want:

- *"to achieve economic growth, but they are not as positive about foreign (firms') ownership of parts of the local economy"*
- *"development of technology and skills, but not necessarily dependence on foreign provision of these key underpinnings of competitiveness."*
- *"economic development, but without environmental damage or social conflict that foreign (and local) firms might cause"*
- *"the opportunity for local citizens to enjoy products and services from around the world, but still to maintain a national or local culture and values"*
- *"their sovereignty to pursue national interests, when the increasingly global economy often forces supra-national goals on them".*

These double-edged objectives, together with the diversity of interactions across foreign investors, suggest to fine-tune government policy such as to optimize the received benfits. This however raises two questions. Firstly, how could such a policy be designed? and, is it feasible to implement such a policy in practice?

3.1. Policy Objectives

In general, policy interventions may be justified if a) they increase (static) efficiency of resource allocation in inefficient markets, b) change the distribution of income and

wealth in a politically desirable way, or c) enhance the dynamic and long-term processes of accumulation of resources and capabilities in the national economy.

The *efficiency argument* is rarely used as a pro-FDI argument unless the policies aim to rebalance distortions created by other policy interventions, such as import quotas or tax regimes. The *distribution argument* is naturally subject to widely varying value judgement. However, even if one believes in the merits of redistribution from MNEs (and thus their shareholders) to local citizens, it is doubtful if such policies can be effective vis-à-vis globally mobile MNEs.

The *dynamic capabilities* argument implicitly underlies most contemporary argumentation for positive intervention for FDI. The creation of industrial clusters requires many economic agents to co-specialize their investment decisions, from students choosing subjects at universities to businesses investing in R&D. However, individuals and even firms are inefficient in coordinating their (interdependent) investment decisions concerning the development of new capabilities that often transcend the boundaries of specific firms. Thus, policy intervention aim to overcome a dynamic coordination failure and attract specific FDI projects that may stimulate cluster development (Lall 1996). Government intervention aiming to create internationally competitive clusters of firms would however have to have rare foresight into the future competitiveness of industrial sectors and technologies.

From the perspective of potential foreign investors, the general business environment may be more important than specific incentives. The business environment includes some aspects that can be influenced by government policy such as the bureaucracy handling approval or registration of new businesses, or the efficiency of regulatory institutions (World Bank 2005). Thus, the *first prerogative for policy makers to create an infrastructure*, such that investing firms can, with limited

risk, take up the opportunities offered by the comparative advantage of potential host economies, for example relatively cheap labour or raw materials. A conducive business climate may attract both MNEs seeking investment locations, and local firms and entrepreneurs seeking to benefit from the presence of MNEs.

A generally conducive business environment can be expected to foster both the efficiency of resource allocation, and the dynamic development of capabilities – and arguably also creates benefits for weaker income groups. The question however remains if and how specific policies might create additional benefits.

3.2. Policy Implementation

Even if policy interventions can theoretically be expected to enhance the benefits of foreign direct investment, policy advice first has to analyze whether the policies can actually be implemented. In particular, can the desired positive effects be generated without creating undesirable side effects of activist government policy, such as bureaucracy, corruption, and favourism for politically influential groups? The answer often depends on the general state of political institutions in the country, in particular their efficiency and their independence from interest groups. Interventionalist policies that helped Japan or Singapore may not work elsewhere because they depend on the existent of an efficient and highly respected public sector.

Moreover, policy makers should not overestimate their impact on MNEs. Firms undertake FDI if and when it suits their global strategy, and they invest in the type of project they need to achieve their strategic objectives. Government policy towards inward or outward FDI generally has negligible effects on these corporate strategies. Government policy may thus focus on attracting firms that plan to locate attractive projects, rather than try to convince them to do change what they are doing.

Incentives schemes for FDI, such as tax breaks or subsidies, may influence location decisions *at the margin*, especially between neighbouring regions, and especially for footloose projects that do not require specific linkages to the local economy (and thus may create fewer spillovers). However, the competition between regions for specific FDI projects entails the danger of a "winner's curse" as the investor may able to internalize most of the social benefits. On the one hand, competition among potential hosts for FDI is *good* because FDI reacts primarily to 'fundamentals' such as political & economic stability, market access & growth, skilled workforce and infrastructure. Investment in 'fundamentals' is good for both domestic and foreign firms, such that even if no FDI materializes, this may benefit the host economy. On the other hand, competition among potential hosts may be *bad* because governments face a "prisoner's dilemma". They have a collective interest to refrain from bidding wars, but have individual incentives to offer potential investors some fiscal or financial inducements. Hence, the aggregate level of inducements may be too high (Oman 2000).

Thus, policy makers proposing a specific policy to attract FDI should ask themselves two questions: Do we have appropriate public sector institutions in place to implement the policy? And, do the direct and indirect costs of the policy for society stand in an appropriate relation to the expected benefits? These issues may be of less concern to policies improving the general business climate than for policies that specifically aim to attract a specific investor.

3.3. Policy as Bargaining

Economic analysis often presumes policy issues to be a matter of governments setting the rules, and investors adjusting. In practice, however, the relationship is much more

complex as governments and businesses engage in various form of direct and indirect bargaining. Traditionally, business-government relationships were often seen as adversary, especially in developing countries. However the recent literature has outlined that this relationship can and should be collaborative. The relative bargaining positions and the potential for a collaborative relationship however greatly vary with the specific nature of the project (Grosse 2005).

Governments aiming to attract foreign investors by selling a strong local firm, such as an incumbent telecom operator, have a valuable assets and thus often a strong bargaining position. It is weaker if they seek a partner for a loss-making firm in a declining industry such as steel. To attract Greenfield investors, countries offering distinct locational advantages such as an industrial cluster or human capital have stronger negotiation positions then those offering only financial incentives. On the other hand, foreign investors pursuing Greenfield entry have more degrees of freedom with respect to their intra-country location choices. This gives them high bargaining power vis-á-vis local municipalities, and the opportunity to take advantage of special incentives in SEZs and industrial parks.

The relative bargaining position however changes over time, which has long been a major concern to business scholars analyzing government-MNE relationships. After foreign investors have 'sunk' their capital investment, governments may change the policy framework a little but not as much as to trigger divestment. This 'obsolescing bargain' thus weakens the position of MNEs over time. It may be of declining concern as many policy variables are agreed in multilateral agreements such as the rules of the WTO, and governments are concerned about their reputation in the wider investor communities. However, for certain types of capital intensive projects in

sectors that are highly sensitive to regulation – such as telecommunication or energy – the concerns about obsolescing bargain still exist (Grosse 2005).

4. What can MNEs do (better)?

4.1. Moral viewpoints

The question how FDI contributes to host economies can hardly be separated from ethical questions concerning how MNEs *should* treat their local environment and their local stakeholders. Societies at large, especially outside Anglo-American countries, increasingly expect MNEs to assume social responsibilities that go beyond maximizing shareholder value. This view is supported by a 2003 UN resolution:

> *"Recognizing that even though states have the primary responsibility to promote, secure the fulfillment of, respect, ensure respect of, and protect human rights, transnational corporations and other business enterprises, as organs of society, are also responsible for promoting and securing the human rights set forth in the Universal Declaration of Human Rights…" (United National Social and Economic Council, 2003: 1).*

Authors on these issues can be broadly distinguished between those taking a normative view and those taking an instrumental view. The **normative view** believes that MNEs have a moral responsibility to their stakeholders, and thus reject the primacy of shareholders over other stakeholders. Thus, managers' primary moral obligation may be to their shareholders. Yet they also have other obligations, such as respect for the law and respect for core moral norms. Managers thus would have to balance their obligations to the shareholders with equally legitimate obligations to

other stakeholders (e.g., Hartman et al. 2003). This view is also implicit in the above cited UN declaration.

On some issues, such as child labour or slavery, a broad international consensus supports certain moral standards, known as ‘hypernorms’. Yet on other issues such as CO_2 pollution or employees’ right to annual leave, standards vary greatly between and within countries. Certain ethical principles are considered appropriate for some but not all cultures, which creates a ‘moral free space’ (Donaldson and Dunfee, 1999). In global but organizationally disaggregated supply chains, the responsibility of consumers and upstream distributors for their product chain has increasingly captured the minds of the interested public. MNEs are under pressure to increase the labour, health and environmental standards in their operations abroad. However, no clear guidance exists for well-meaning managers what constitutes good labour practice and how it should be implemented. In particular, there is no consensus how far moral responsibility would extend beyond the (legal) boundaries of the firm, for instance to workers employed by subcontractors in distant locations, to emissions into the natural environment, and to corrupt business practices by business associates.

Proponents of the **instrumental view** argue, somewhat simplified, that firms should pursue high labour or environmental standards *if* this benefits their own profitability. Such positive effect may arise in different ways:

- Raising standards may raise productivity if environmental standards reduce wastage, or labour standards increase work motivation. Empirical evidence shows that such benefits can be substantial. For example, Frenkel and Scott (2002) compare two similar subcontractors of sports-shoe manufacturer adidas in China

and found that the firm that took a collaborative approach to introducing a new corporate code of conduct achieved better performance in terms of for example reject rates or employee turnover.

- Firms adapting ambitious corporate social responsibility charters aim to build a reputation of an ethical firm. This should increase the perceived value of the products by consumers and by investors. If markets are efficient, and consumers would be willing to pay higher prices for goods produced with higher standards, then meeting these standards would benefit profitability. However, is this mechanism sufficiently efficient to translate consumer preferences into business practices in distant locations? While consumer surveys often suggest that consumer value 'ethical' qualities of the products they buy, it is less clear to what extend this actually increases their willingness. Experimental evidence suggests that consumers would pay a premium for certain features (Auger et al., 2003).
- Higher standards may shield MNEs against negative publicity. Traditionally, many MNEs took the legalistic view that they cannot be held responsible for the labor practices of their foreign suppliers. However, the activism of NGOs and attention of the media put spotlights on incidences of practices considered unethical by these stakeholders, such that "the advantages of lower cost labour or lower cost inputs from more abusive suppliers must be weighted against the crush of negative publicity, the costs of public relations, and the possibility of consumer protests." (Spar 1998). Such systems are expected to link ethical behaviour to profitability: failure to comply to standards that a firm committed to may severely affect the firm's reputation, and thus their sales and their bottom line (Spar, 1998).

- High standards reduce the risk of catastrophic events such as environmental disasters or strikes that would disrupt the production process or even undermine the viability of the firm.

Ultimately, these effects may positively affect financial performance. While individual studies provide opposing results, a recent meta-analysis suggests that corporate virtue in the form of social responsibility is on average likely to pay off (Orlitzky, Schmidt and Rynes, 2003).

4.2. The Feasibility of Higher Standards

Hartman et al. (2003) provide a hands-on approach and tell the story of positive examples of MNEs who aimed to raise the standards in their global supply chain. Their work illustrated that defining standards is the easy part of raising 'corporate social responsibility'. The main challenges concern the implementation and monitoring of these standards both within the firm and among its business partners. Waddock and Bodwell (in Hartman et al. 2003) outline principles of management that may help corporations develop an integrated approach to managing labour issues as well as broader issues of corporate social responsibility. They outline three mutually reinforcing processes that MNEs are suggests to set in motion "(1) *inspiration* or vision setting and leadership commitment processes; (2) *integration* of the vision and values into strategy, human resource, and operating practices; and (3) *innovation* processes, which involve establishing indicators that measure responsibility performance and provide a basis for improvements, remediation where necessary, and learning" (p. 119, emphases in the original). Their case evidence suggests that creating a code of conduct is insufficient and the main challenge is "accepting

responsibility down the chain and introducing all the management systems necessary to make adherence to the code possible" (p. 134).

We have at this stage, however, little systematic and independent evidence on how changed corporate responsibility practices affect workers in the 'sweatshops', local communities, and host economies at large? Especially indirect effect are often overlooked. For instance, changes in child labour regulation may increase the share of children not working, but it may also increase the share working in services rather then manufacturing where law enforcement is more difficult. Such data are difficult to obtain, among other reasons because a lot of child labour takes place in the informal sector.

4.3. More Moral Dilemmas

The global social responsibility debate raises further complex ethical issues. For instance, labour standards in MNE and their suppliers have to be seen in a context where working conditions are typically considerably worse in local firms then in those firms working with or for MNEs. Many children are involved in selling goods on the streets, or in running family businesses such as restaurants. The discussion should thus take a broader perspective including multinational and local firms.

Moreover ethical standards are grounded in culture, and cultures vary. There has been a convergence towards common standards (or "hypernorms") as encoded in international conventions. But these conventions reflect, among other views, the interests of labour unions in North America and Europe wishing to limit competition. It cannot be taken for granted that these standards are also what local ethical standards would demand. It is reasonable to argue that product sold in, for example, the USA should be produced according to minimum standards reflecting a social consensus in

the USA. However, how about products made for local markets, or for third countries such as Japan or Taiwan where labour rights in other countries are much less of a political issue?

This leads to a complex issue that muddles the debate further. Many shoes made in Vietnam are actually produced in Taiwanese and Korean owned firms, that act as subcontractors to well known international brands. Whose standards should apply, the host country's, the foreign investor's, or the customer's. Why should a Taiwanese manager, who experienced sweatshops in his own country three decades ago, take a more generous approach towards labour issues in mainland China?

In conclusion, ethical aspects of business have become a major concern to multinational enterprises. Higher standards may increase the positive effects of MNEs on their host economies, albeit some argue that too fast rises of standards may undermine countries' competitiveness and thus inhibit economic growth. However, defining and monitoring standards raises complex ethical and managerial challenges.

Round-up

As emerging economies integrate into the global economies, international trade and investment will continue to accelerate. MNEs will continue to act as pivotal interface between domestic and international markets, and their relative importance may even increase further.

The extensive and variety interaction of MNEs with their host societies may tempt policy makers to micro-manage inwards foreign investment and to target their instruments at attracting very specific types of projects. Yet, the potential impact is hard to evaluate ex ante (or even ex post) and it is not clear if policy instruments

would be effective in attractive specifically the investors that would generate the desired impact.

In my view, the first priority should be on enhancing the general institutional framework such as to enhance the efficiency of markets, the effectiveness of the public sector administration and the availability of infrastructure. On that basis, then, carefully designed but flexible schemes of promoting new industries may further enhance the chances of developing internationally competitive business clusters.

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