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Multinational Enterprises on Host Economies

Editor: Klaus E Meyer

Editor's Introduction:

Multinational Enterprises and Host Economies[1]

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Multinational enterprises (MNEs) invest in a variety of host economies, and closely interact with local businesses and with society at large. This role has become the focus of policy debates of all sorts, as MNEs are seen as a primary conduit of globalization, thus spreading both its benefits and its negative side effects. Yet, MNE are also active and powerful players in the process of globalisation as many of them are indeed very large – with annual turnover exceeding the GDP of many developing countries.

The ambiguity and inconsistency of public attitude toward MNE has been beautifully illustrated on a cover of *The Economist* in January 2000 that I have used ever since to stimulating class discussions. It depicts the cycles of public opinion vis-à-vis MNEs, as public opinion oscillates from 'I am doomed' in the 1970s, to 'he is doomed' in the 1980's, to 'we have boomed' in the 1990's and back to 'I am doomed' now (i.e. in 2000). This journalistic illustration in its over-simplification shows two features of this important debate: policy debates are highly instable and often based on very thin

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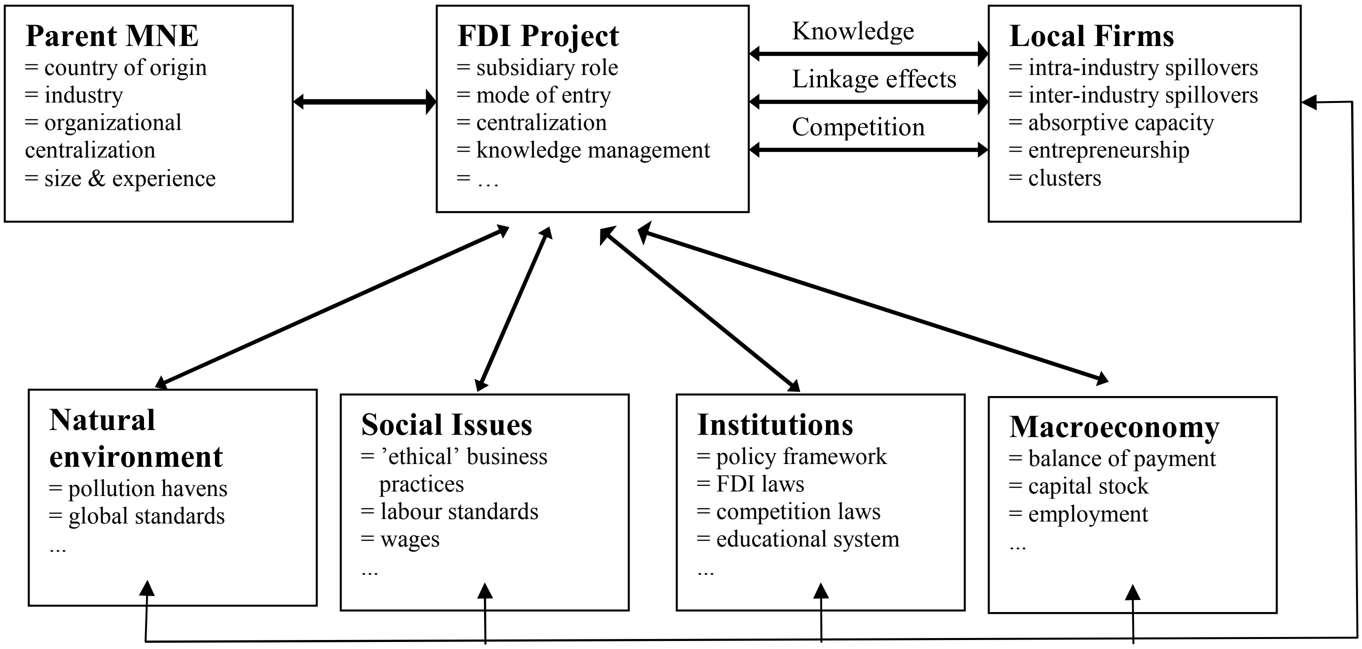
[1] Articles included in this volume are marked by a star (*) and not listed in the list of references at the end of this introduction.

[2] I thank my colleagues for helpful suggestions and discussions, in particular Steve Brammer, Mark Casson, Björn Jindra, Holger Görg, and Evis Sinani.

empirical evidence. Moreover, the public policy debate surrounding MNE is often lacking logical rigour and empirical evidence. This collection of scholarly research aims to raise the intellectual level of this debate.

What does the scholarly community in economics and business studies have to contribute to this debate? A rich body of both theoretical and empirical research can inform the debate. Most scholarly attention has focused on the interaction of subsidiaries of MNEs with local businesses. However, foreign direct investment (FDI) affect the host society also in various more indirect ways, including the institutional framework, social and labour welfare conditions, and the natural environment (Figure 1).

This volume brings together key research contributions on MNEs and host economies in an interdisciplinary perspective. Economics provides important theoretical foundations, yet some of the more subtle and complex forms of impact are hard to analyse using economics methodologies. A range of other disciplines such as management, sociology and ethics contribute to the discussion of these wider issues. Yet, many research questions remain open due to the complexity of the issues and the challenges of measuring key impact variables. In the remainder of this introduction, I outline the structure of this volume with a few remarks on why I selected the papers included in this collection. I abstain from offering my own views as they are presented in Meyer (2004*).



Source: Meyer (2004)

Introducing the Issues

Various authors have reviewed the vast literature on how local firms may benefit from the presence of FDI, vary in their starting points, and offer different angles on the phenomenon. Blomström and Kokko (1998*) focus in particular on the economics literature on technology spillovers, while Görg and Greenaway (2004*) review literature on a broader range of impact channels, and possible policies to enhance them.

In Meyer (2004*), I focus on issue of concerns to business scholars, and thus discuss in particular how the characteristics of both multinational investors and local potential beneficiaries may affect the extent of spillovers. This paper thus outlines how integration of the international business literature may further advance our understanding of how MNEs affect their host environment. Dunning (2006*) integrates the literature on the impact of FDI with his work on the determinants of FDI, notably the OLI paradigm.

He offers an eclectic framework of the role of FDI in emerging economies that offeres many points of departure for future research.

Theoretical Analysis

Albert Hirschman challenged the economics profession with his book *The Strategy of Economic Development* (1958*). Departing from general equilibrium driven theories *en vogue* at the time, he develops a theory of 'unbalanced growth' which became very influential in the field of development economics. Hirschman argues that poor countries would benefit from pursuing unbalanced industrial growth promoting in particular the development of industries with strong backward and forward linkages. His book thus contains an early theoretical analysis of the benefits that foreign investors would create, and introducing the concepts of 'backward linkage effects' and 'forward linkage effects' to the scholarly discourse.

In the 1980's, a theoretical debate ranged about the 'flying geese pattern' of economic development observed in East Asia. Japanese scholars Ozawa (1979) and Kojima (1985) suggest that vertical FDI seeking natural resources or relocating labour intensive production processes would be more beneficial for economic development than horizontal FDI because of its trade creating effects. Thus, this FDI would help host economies to better exploit their comparative advantages, and transfer technologies that are more closely aligned with the needs of the hosts. In Kojima and Ozawa (1984*) they synthesize their arguments, while Buckley (1985*) provides a counter-point.

Findlay (1978*) offers an early formal model of the spillovers created by FDI. His model suggests that spillovers would increase with the distance in levels of economic development between a country and its inward foreign investors because learning opportunities are a function of this technological gap. Moreover, spillovers would emerge faster the more the foreign investor develops upstream and downstream networks. Further formal economic models employ principles of industrial organization economics. Wang and Blomström (1992*) present a model of a duopoly with differentiated goods, where a multinational enterprise transfers technology to its subsidiary; yet this allows the local firm to learn from the new technologies if it invests in learning from the foreign competitor. Rodriguez-Clair (1996*) analyzes spillovers in a two country setting, and develops a spillover coefficient that measures the effects of MNEs on a host economy. It is increasing with complexity of the goods produced, communication costs between headquarters and the subsidiary, and similarity of the intermediates produced in both countries.

Perez (1997*) offers an evolutionary model of technology spillovers that depend on the absorptive capacity of local firms and are inversely related to the technological gap; yet received spillovers influence the market share dynamics between local and foreign competitors. He thus suggests that strong local firms would benefit from competition from foreign investors, while weak firms are likely to be crowded out completely. Markusen and Venebles (1999*) analyse the relationship between the number of foreign-owned firms and the number of domestic firms under a range of assumptions and scenarios. They argue that, under certain conditions, entry of foreign investors would trigger entry of new domestic firms in vertically related industries.

Criscuolo and Narula (2002*) approach the issue from the host country's perspective and conceptualize national absorptive capacity as aggregate of the attributes of the economic system and its member firms, especially its human capital.

Macroeconomic Evidence

At the country level, scholars have attempted to relate the inflow of FDI to macroeconomic growth in terms of GDP on the basis of 'endogenous growth models' (Romer 1990; Barro and Sala-i-Martin, 1995). Probably, the most comprehensive such study has been presented by by Borensztein, Gregorio and Lee (1998*). They find a complementary effect of countries' absorptive capacity, measured by proxies for human capital, which positively moderates the relationship between FDI inflows and GDP growth. In particular, a minimum threshold level of human capital is required to benefit from inward FDI. Balasubramanyan, Salisu and Sapsford (1996*) differentiate countries by their trade openness, and find that FDI has a more positive effect on economic growth countries with export-oriented trade regime compared to countries with import-substitution type trade regimes.

More recently, Li and Liu (2005*) examine the macroeconomic relationship taking account of the endogeneity of FDI, that is foreign investors are likely to seek locations with higher economic growth as well as contribute to this growth. Their empirical study shows that such an endogenous relationship has increased over the time period of their study from 1970 to 1999. This endogeneity reinforces the complementary relationship between FDI and local human capital in promoting economic growth. Lai, Peng and Bao (2006*) test a similar model on regional data from China and find that FDI interacts with both trade openness and with human capital endowment.

Productivity Spillovers: Horizontal

The research question that has probably attracted most empirical research is horizontal spillovers, in particular the productivity benefits that local firms attract from foreign investment in their industry. This literature bypasses the fact that knowledge flows are not measurable directly by estimating local firms' productivity as a function of, among other factors, the presence of foreign investors in the industry.

This literature has evolved in several stages, notably to employ more complex datasets and more sophisticated analytical techniques, and to incorporate moderating variables that may influence this relationship. Caves (1974*) initiated this stream of research with a cross-sectional analysis of firm productivity in Australia and Canada. Swedish scholars such as Blomström and Persson (1983*), Kokko (1996) and Sjöholm (1999) extended this research to a variety of developing and emerging economies, often finding statistically significant positive effects.

This research stream made important steps forward when empirical techniques, and IT processing capacities, became available to analyse panel data (Haddad and Harrison, 1993*; Aitken and Harrison, 1999*). This allows the introduction of time lags to control for possible reverse causality as foreign investors are likely to invest in industries with higher productivity, rather than higher productivity being caused by the foreign presence. Görg and Strobl (2001*) review this literature using a Meta-analysis of 21 studies and find that these methodological issues substantially affect the results, such that early cross-sectional studies may have overstated the actual effects of FDI. Moreover, they point to important variations of spillovers across countries; both results were confirmed in a similar we conducted recently on a larger set of studies (Meyer and Sinani, 2005).

More recently, this line of work has been extended to understand the conditions that may facilitate the emergence of positive spillovers. Thus, scholars have analysed how the characteristics of the potential recipient firms influence their received benefits. Early discussions on FDI spillovers have focused the technological gap hypothesis suggested in Findlay's (1978*) model, which suggest that developing countries can benefit more the further they are from the technological frontier. However, several studies point out that local firms' benefits crucially depend on their own ability to utilize received technologies. Following Cohen and Levinthal (1990), this work has in particular focused on the concept of absorptive capacity (e.g. Sinani and Meyer 2004*). Combining the technological gap hypothesis and the notion of absorptive capacity, a non-linear U-shaped relationship has been established between the gap between foreign and local firm and the benefits attracted of local firms (Liu, Siler, Wang and Wei, 2000*).

Spillovers are also predicted to vary across different types of foreign investors and FDI projects (Meyer, 2004*), yet such evidence is harder to establish because of data-availability constraints. However, foreign investors have been shown to vary in their impact on local productivity based on their level of ownership (Javorcik and Spatareneau, 2007) and their investment motivations (Driffield and Love, 2007*). Moreover, if foreign investors dominate a local industry, this may have detrimental effect on local firms such that the spillover coefficient itself is inverse-U shaped (Wang and Yu, 2007*).

Productivity Spillovers: Vertical

Theoretical considerations suggest that vertical spillovers, i.e. benefits that accrue to suppliers or customers, are at least as important as horizontal spillovers. These vertical spillovers do not only rely on externalities but are included the consumer and producer surplus created by market transactions.Yet, we have much less empirical evidence, mainly because the datasets required to analyse vertical interactions along the supply chain are fairly complex and hard to obtain. Lall (1980*) provides the first major study on vertical spillovers. Building on Hirschman (1958*), Lall develops the theoretical arguments on why backward linkages would emerge, and he provides probably the first systematic empirical evidence.

An innovative approach to study vertical linkages has been used by Belderbos, Capannelli and Fukao (2001*). They analyze local content ratios of Japanese overseas manufacturing affiliates across 14 countries to identify project and country-specific determinants of the extent of interaction with local suppliers. They find that more linkages exist for older affiliates, acquisitions and joint ventures, and in less developed countries also by less-R&D intensive foreign investors. Moreover, local content requirements appear to have a positive effect while FDI established to jump tariff barriers has less local content. Thompson (2001*) asks foreign investors directly, and finds that those located in industrial clusters report on average more positive developments in their local supplier industry than those located at dispersed locations.

Javorcik (2004*) employs industry-level input-output data from Lithuania, and finds that higher productivity in supplier industries to industries with high foreign presence. This productivity effect is larger when the foreign investors are domestic market oriented rather than export oriented. At the same time, she finds no evidence of spillovers within the same industry. Driffield, Munday and Roberts (2002*) use similar data from the U.K. and investigate both forward and backward linkages. They find that domestic firms purchasing from foreign investors would benefit, while those supplying foreign investors would not. They suggest that, perhaps, foreign investors are able to appropriate any gains from productivity increases of their suppliers.

Spillovers to Local Firms: Beyond Productivity

Foreign investors affect local businesses not only through productivity effects, but in a variety of other ways. Two interesting lines of research have emerged. Firstly, scholars have investigated market access benefits as foreign investors directly or indirectly help local firms develop their exports (Aitken, Hanson and Harrison, 1997*; Greenaway, Sousa and Wakelin, 2004*). The rationale of this literature is that MNEs would share knowledge on how to operate in international markets, build trade channels, and enhance the country-of-origin reputation.

Another important channel of spillovers is the training of employees who subsequently move to local firms or establish their own business. Gerschenberg (1987*) provides evidence on employee movements in Kenya, yet there have been no major studies deepening this analysis, or investigating movements of MNE employees in other contexts. In my view, a particular interesting channel of spillovers are people who have worked in an MNE and thus acquired modern business knowledge, and who subsequently become entrepreneurs setting up their own business. There may not be many people pursuing such a career path, yet those who do potentially have a major impact on the host economy. Patibandla and Petersen (2002*) explore this issue as part of a case study of foreign investors on the evolution of an IT cluster in India. Görg and Strobl (2002*) approach the issue from a different angle, and investigate, motivated by Markusen and Venebles (1999*), to what extent foreign investors contribute the creation of new domestic firms. This area certainly merits further research; I would in particular be interested to better understand the impact of inward FDI on the creation and growth of domestic entrepreneurial firms.

Wages and Labour Standards

The issue of labour and multinational enterprises is of high political sensitivity and often discussed rather emotionally. This complex discussion involves positive and normative dimensions, i.e. not only do scholars debate how MNEs affect local labour force, but also how they *ought* to behave vis-à-vis their local employees. Similar issues arise with respect to the environment, discussed in the next section. My selection of papers aims to provide analytical insights that may facilitate systematic discussions.

The economics literature has explored the effect of MNEs on local wages, both in terms of wages paid to those working in the MNE subsidiaries (Aitken, Harrison and Lipsey, 1997*, Lipsey and Sjöholm 2004; Hayman, Sjöholm and Tingvall, 2007) and in terms of possible wage spillovers to local firms in the same region (Driffield and Girma, 2003*). Studies in emerging economies, such as Aitken, Harrison and Lipsey (1997*), suggests that MNEs typically pay higher wages than local firms, last not least to retain their trained workforce. However, the higher wages paid by foreign investors may bid up wages that local firms have to pay their employees. Thus, Driffield and Girma (2003*) find increases of wages paid by local firm, yet they are confined to the immediate region where the FDI is located.

A different line of work analyses the antecedents and consequences of MNEs introducing labour standards on themselves and their suppliers. Lee (1997*) reviews the literature on labour standards at a time when expectations towards MNEs were shifting, and research efforts intensified. The pressures for introducing labour charters arise from a variety of sources, including legal requirements, industry self-regulation and informal pressures from non-governmental organizations (NGOs). Spar and Yoffie (1999*) explores the nature of the pressures that may induce firms to competitively lower standards – also known as 'the race to the bottom' – and the countervailing pressures from consumer organizations that may induce MNEs to maintain high standards to avoid the 'spotlight' of media and NGOs.

Frenkel and Scott (2002*) provide empirical evidence how a new code of conduct for suppliers has led to rising standards and rising productivity in one supplier firm, while reluctant adoption of the code in another supplier firm led to inferior economic performance. However other studies, such as Egels-Zandén (2007), find suppliers failing to meet standards and systematically misleading monitoring teams who are to assess their performance.

The Natural Environment

The discussion on the impact of MNEs on the natural environment is similarly political and emotional, with hard evidence being even harder to establish. The theoretical discussion focuses on two lines of argument. The first argument contents that MNEs are likely to adopt more stringent standards than local firms because they are more closely monitored by various stakeholders in their home and host economies. Moreover, they may gain scale advantages from implementing common standards across operations in different countries, which would be higher than the local requirements at any specific location. Moreover, firms exposed to higher environmental regulations may become early movers into new technologies, which may translate into long-term competitive advantages when other countries follow in upgrading their standards (Porter 1990, Porter and Linde 1995).

The second line of argument, generally known as 'pollution haven hypothesis', contends that MNEs use their ability to relocate production to move towards locations with less stringent regulations, or they might use the threat of such relocation to pressure politicians not to raise their standards. This concern about pollution havens has been expressed by several environmental interests groups, such as Mabey and McNally (1998*). Zarsky (1999*) reviews the arguments and the empirical evidence on both effects.

The response of multinational enterprises to these pressures, and their likely adoption of higher environmental standard has probably first been analysed by Gladwin and Walter (1976*). Rugman and Verbeke (1998*) discuss how multinational enterprises react to environmental regulation that varies across countries, and under which conditions they would develop environmental capabilities. Christman (2004*) provides empirical evidence for the standardization argument; analysing how external pressures may influence standardization. She finds that governmental pressures lead to harmonisation of performance standards, industry pressures lead to standardisation of processes, while consumer pressures mainly affect firms' communications.

Early econometric studies on the pollution haven hypothesis found only weak evidence at best (Eskeland and Harrison, 2003; Javorcik and Wei, 2004*), though some recent studies find a significant but small effect (Hoffmann, Lee, Ramasamy and Yeung (2005). He (2006*) employs a simultaneous equation model and identifies both direct and indirect effects of FDI on SO_2 emissions in China, and finds a positive effect via economic growth and a negative effect of tighter enforcement regulation balancing each other. FDI seeks less regulated provinces, yet this effect is small.

Normative Issues

The discussion on the impact of multinational enterprises on host economies has a positive and a normative dimension. Most studies in these two volumes focus on the positive impact, i.e. they aim to establish the actual observed impact. However, the discussion of these issues is closely intertwined with normative issues. While the economics literature often avoids normative issues, scholars in other social sciences find it intellectually difficult to separate how MNEs act, and how they ought to act. These issues have been discussed primarily under the theme of 'corporate social responsibility', and the final section of this volume provides a few key contributions in this debate.

A benchmark for the normative discussion is provided by the Libertarian view of Milton Friedman in his book Capitalism and Freedom, summarized in Friedman (1970*). In the decades since this book was written, most analysts recognize that this view makes implicit assumptions about the efficiency of markets that do not hold in practice.

Proponents of this view often argue that, if consumers really care, it would help profitability to produce goods to high social and environmental standards. A crucial element of this argument is whether ‘doing good’ is actually good for firms’ financial performance, a question that has been investigated in a number of empirical studies. Orlitzky, Schmidt and Reyes (2003*) synthesize this literature and find a positive effect.

Since many of th markets concerned are not as efficient as assumed by, e.g., Friedman, it is often suggested that some form of regulation, involvement of NGOs, or social responsibility codes by MNEs themselves is appropriate. Scherer and Smid (2000*) present a moral view grounded in Continental European value systems, and argue that MNEs ought to take a proactive stance.

Hartman, Shaw and Stevenson (2003*) draw on integrated social contracts theory and Donaldson and Dunfee’s (1999) concept of ‘hypernorms’ to analyze what standards would be appropriate to expect of MNEs employing workers in different locations around the world. Arnold (2005*) reviews the debate on ethics and labour standards, considering both instrumental and normative views with regards to corporate social responsibility.

However, foreign investors may also influence the local institutional environment as local policy makers accommodate the interests of foreign investors, or the business community as a whole, why designing new laws. Such influences may arise from competition for foreign investors but also from direct actions taken by foreign investors, for instance in the form of lobbying. This is a relatively new stream of literature, from which I selected Kwok and Tadesse (2006*), who focus on the role of MNEs as a change agent influencing patterns of corruption.

A broader question is whether initiatives taken by firms aimed to deliberately create positive spillovers actually create the desired effects. Despite many positive examples, some recent studies provide more sobering evidence. Bird, Raufflet and Smucker (2004) provide compelling case evidence on the effects of CSR on in a variety of developing countries, pointing in particular to the need to consider the local context when designing standards and processes. From their study, I selected Khan (2004*), who studies the long-term implications of the campaign to abolish child labour in the manufacture of footballs in the Sialkot district of Pakistan. He finds that the campaign benefited MNEs and NGOs, yet many poor women and children are worse off as they no longer have access to work. Frynas (2005*) analyses cases where firms took deliberate action to make a positive contribution on the wider community, and he finds that they make many mistakes that governmental aid agencies made decades ago, leading to low impact of their contributions.

Concluding remarks

These two volumes bring together key contributions of a complex and growing literature that is developing in different lines of social science research. I had to make difficult choices when selecting papers for inclusion in this volume; unavoidably, many readers may miss their particular favourite. In bringing together contributions from different disciplinary perspectives, I hope to encourage dialogue between often rather distinct scholarly communities, as well as to provide an overview of the state-of-the art in research on the relationship between MNEs and their host societies.

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