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International Trade

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Theories of Foreign Direct Investment:
Why are there Multinational Enterprises?

These notes constitute what I have to say (in brief) about multinational enterprises (MNEs) and foreign direct investment (FDI).

INTRODUCTION

There are essentially two types of private international capital flows. The first (and by far the larger) type is portfolio investment, or financial capital moving in search of higher returns. Such capital moves, in theory, until risk-adjusted dollar returns are equalized. The issues that matter for attracting such investment include: 1. nominal after-tax interest returns (interest, dividends) and/or expected change in equity values; 2. expected change in the exchange rate; 3. exchange rate volatility, business risk, and political stability; 4. ability of investors to repatriate capital incomes freely, requiring the absence of capital controls and the existence of convertible currency. Such flows can be quite "footloose," shifting among national markets rapidly. They are a big factor in rapid growth in new equity markets in developing countries, suggesting that financial liberalization can attract significant amounts of capital. Their abrupt reversal can play a role in currency crises, such as those in Mexico, Argentina, East Asia and Russia.

The second type is foreign direct investment by MNEs. FDI consists of investments that attain some degree of management control over real producing assets, such as firms, farms, resorts, buildings, and so on. These are undertaken for reasons of profit-maximizing corporate strategy that takes advantage of differences in market sizes and features. FDI is the focus of this paper.

CHARACTERISTICS OF FDI

FDI is an investment in which the investor acquires a substantial controlling interest in a foreign firm or builds a subsidiary in a foreign country. Most FDI involves acquiring existing facilities. An obvious question is "How much FDI confers management control?" Countries have different standards on this issue. The U.S. standard is ten percent or more purchased by one foreign entity (note this means that a U.S. firm could be both an affiliate of a foreign MNE and an MNE itself, with affiliates in foreign countries). In practice, the bulk of available equity is purchased in a takeover, averaging 80% in the U.S., though this depends on government regulations (for example, the U.S. only allows foreign firms to own 25% of any major U.S. airline; it is still very common in developing countries to limit foreign equity in many sectors to 49%).

It is interesting to note that most financing for building and expanding affiliates is raised on local capital markets, suggesting that FDI does not really constitute a transfer of capital abroad. Further, since FDI involves real management decisions, it is not very footloose; rather MNEs tend to retain their local operations for a long time once they have been located. Thus, FDI is quite different from portfolio investment. FDI is far more strategic in nature.

The extent of FDI differs markedly by industry. It is greatest in banking, finance, tourism services, mining, and manufacturing sectors in which knowledge capital (innovations, product quality, technology) are important. The last fact supports the view that, in large part, MNEs are means for transferring knowledge abroad. There is also much FDI in consumer products in which consistent and high quality is important. That is why, believe it or not, major American MNEs include McDonald's, Kentucky Fried Chicken, TCBY, Disney, and Levis.

The U.S. was utterly dominant as a source (provider) of FDI in the 1950s through the early 1970s. Since then MNEs headquartered in other developed nations have become increasingly important sources of FDI, though the U.S. remains the largest single source. The U.S. is also the biggest host (recipient) of FDI in the world. Following are figures on stocks of FDI for some major countries at the end of 1997 (source: UNCTAD):

<u>Country</u>	<u>Source (\$b)</u>	<u>Host (\$b)</u>	<u>Host FDI/GDP</u>
U.S.	907.5	720.8	8.3%
Japan	284.6	33.2	0.7%
Germany	326.0	137.7	5.9%

U.K.	413.2	274.4	20.5%
Canada	137.7	137.1	22.0%
Netherlands	213.2	127.9	30.4%
Switzerland	156.7	56.5	18.0%
France	226.8	174.2	10.1%
Italy	125.1	78.5	7.4%
Australia	52.4	126.3	29.7%
R. of Korea	18.0	14.8	2.6%
Thailand	3.8	23.1	11.6%
China	20.4	217.3	24.7%
Taiwan	34.2	19.8	7.3%
India	0.6	11.2	2.6%
Mexico	3.3	86.8	22.3%

Some notes on growth of inward FDI in 1990s in developing countries. China's inward stock rose from 4.8% of GDP in 1990 to 24.7% in 1997. India's rose from 0.5% to 2.6%. Thailand's rose from 9.3% to 11.6%. Mexico's rose from 13.2% to 22.3%. Most of the rise in Mexico came in the period from just before NAFTA was passed to now and the growth has not much slowed down over that period. Unfortunately there is virtually no FDI in sub-Saharan Africa.

(Note these figures are for stocks of FDI at current cost, not at market value. Stocks refer to the total value of accumulated FDI, rather than the annual flows of FDI, which represent additions to stocks.)

From these figures some conclusions may be drawn. The U.S. still owns considerably more foreign production facilities than foreigners own here, but it is the biggest player on both sides of the story. The U.S. is quite open to FDI; there are very few restrictions on investment and acquisitions here. You may be interested to know that the largest national sources of FDI in the U.S. include (in order) the U.K., Japan, the Netherlands, and Canada (Department of Commerce, 1994; Graham and Krugman). Also quite open are Canada, the U.K., Australia, and the smaller European nations (Netherlands and Switzerland), as indicated by the ratios of FDI to GDP. Germany also has relatively few formal restrictions on FDI, so that its low ratio is puzzling, given that it is a smaller economy than the U.S. However, there is some evidence that Germany's tolerance of cartels discourages foreign entry.

Japan has become the second largest source of FDI, which is unsurprising in light of its large size, its need for raw materials, and the sophisticated technological basis of its manufacturing. An interesting feature of Japan's FDI is that an unusually large share of it is in distribution activities (buying wholesale and retail distribution networks abroad and providing finance through banking and insurance), indicating that the remarkable growth in Japan's exports over the last 30 years has been accompanied by rising FDI to service that trade. The nature of Japan's FDI abroad has shifted recently from acquiring firms and real estate in the industrial nations to investing in manufacturing facilities in developing nations in Asia, a trend that has become the object of concern in Japan about "hollowing out" the Japanese economy (the same idea as American concerns about FDI moving jobs to poor countries). To economists, the truly unusual feature of Japan's economy is the tiny amount of FDI that has entered Japan (\$16.9 billion by 1993), a ridiculously small amount. Japan has a great many formal (that is, laws and regulations) and informal (business cartels, interlocking financial systems, expensive land) that have made penetration by foreign MNEs quite difficult. This has been a source of tension between the U.S. and Japan and is now serving as a drag on the efficiency of the Japanese economy. This system is likely to change markedly over the next ten years.

Not many developing countries report data on stocks of FDI. Korea's case is most interesting, however. In the last 5 years it has become a significant source and host of FDI, with most of its MNEs investing in Asian developing economies. The growth of FDI in Thailand in recent years has been spectacular (largely from Japan).

Despite all the concern expressed in academic circles about MNEs dominating developing countries, the vast bulk of FDI takes place among industrial nations. Approximately 85% of the stock, and continuing flow, of FDI consists of transactions of MNEs in which the host and the source are both developed economies (Greenaway, 1993).

However, conventional wisdom is correct in at least one respect. Most MNEs are absolutely huge corporations, with global sales in the tens of billions of dollars. It appears that a key characteristic of MNEs is that to be one, you'd better be big.

TYPES OF INTEGRATION

An MNE is a firm with productive activities located in at least two different nations. These activities could include management, R&D, technical services, and production (extraction of minerals, assembly of products). Thus, MNEs are firms that integrate activities across borders and must, therefore, take advantage of opportunities that are not available for non-integrated firms. Firms may be integrated horizontally, vertically, or both.

Horizontal integration means producing similar goods, such as cars, at different locations, such as the U.S., France, and India. In principle, it is no different from doing so within a single country (eg, General Motors produces cars at many U.S. plants), except for the existence of more regulations and uncertainty covering transborder production.

Vertical integration means producing goods at different stages of an overall production process, within a single firm. Thus, an MNE might extract iron ore in one location, produce steel in another, and assemble cars in a third location; or it might perform R&D for developing computers in one place and assemble them in another place.

“Outsourcing” is the choice by a firm to have some tasks done by other unrelated firms. This can be done within a country or by contracting with firms in another country, in which case the activity is called “offshoring”. This has become quite common with respect to labor-intensive services and assembly activities.

WHY ARE THERE MNEs?

This is not a trivial question. The basic question relates to why a firm would undertake international integration, given that there are clear cost disadvantages to doing so. These disadvantages include additional communication and transport costs; language and cultural differences; limited understanding of local markets, tax laws, regulations, and business practices; risks of expropriation (that is, the host government deciding to take over or nationalize your operation) and other forms of policy discrimination, and exchange rate volatility; and the need to pay higher wages to managers to induce them to move abroad. Such problems do not face domestic firms to nearly the same extent. So why would an MNE attempt to overcome these problems?

Seen in this light, a necessary condition for a firm to become an MNE is that it has some compensating advantages over local firms. The standard framework that business economists use to explain these advantages relates to advantages of ownership, location, and internalization (OLI), as set out by Dunning (1981), Caves (1982), Buckley and Casson (1976), and Casson (1987). Following is a brief summary of the OLI framework.

Ownership advantages of the firm refer to some proprietary advantage that a local firm would not have. Overwhelmingly these refer to some technological advantage, including a superior production process, better management, new products, and a reputation for high quality. These advantages provide some monopoly power for the MNE because they may be hard for local firms to imitate. Of course, the market power is enhanced to the extent the advantages are protected by regulations such as patents, trademarks, and copyrights (this helps explain why intellectual property rights are so important in the debate over globalization of markets). Because these advantages allow MNEs to produce at lower cost than local firms or to command market loyalty among consumers in different areas, they provide an incentive to engage in foreign production. Note that one major reason for the emergence of MNEs is the fact that R&D may be performed in one place (or a few places) but the results of the R&D (a blueprint, new technology, new products) may be used in several production locations. In economic terms, R&D is a public input, in that its results are not consumed by one activity but by many without diminishing the value of the R&D. Thus, many MNEs develop new technologies in, say, the headquarters country, then produce in several locations using those technologies. Again, the main function of the MNE is to transfer technology abroad.

Location advantages are features of host countries that make integrated production in those countries more profitable than simply exporting goods to them. Examples include input availability and cost (thus, the largest reason for vertical integration is to get secure access to raw materials and inexpensive labor), market size (a significant factor in attracting FDI to Mexico within NAFTA or Turkey given its proximity to the EU, etc), transport costs, consumer incomes and preferences, policies that encourage or discourage FDI, and, quite importantly, the structure of trade barriers. It is well established that a significant amount of FDI has taken place in order for firms to be able to produce behind trade barriers, which would exclude exports to those countries as an alternative way of servicing markets. “Tariff-jumping” has been an important reason for American FDI in the Common Market in the 1960s and 1970s, Japanese FDI in the U.S. in the 1980s (concern over further protectionism here), and many other cases. This has been especially important in explaining FDI in manufacturing sectors in developing countries that have followed protective input-substitution policies in order to attract manufacturing FDI (Latin America, Africa, some Asian countries). Note, for example, that some American FDI in Mexico in the 1970s and 1980s was undertaken for this purpose; as NAFTA forces Mexico to remove those trade barriers we would expect a fair amount of FDI to return to the U.S. because it is a

more rational place to produce some goods (machinery, autos, chemicals). The point to remember is that FDI attracted and sustained by trade barriers is likely to be inefficient and to use outdated technologies.

Internalization advantages are the most subtle issue, yet perhaps the most important, for MNEs. Ownership and location advantages could explain why a firm would choose FDI over exporting, but they don't really explain why a firm would choose FDI over licensing (selling access to) its technology or products to firms in other countries. Licensing would provide revenues to innovative firm without exposing them to the costs of FDI and foreign production. If markets were perfect, the licensing revenues would be the same (in present value terms) as revenues from FDI and should be more profitable. What's the problem?

Licensing across borders involves difficult problems in defining and enforcing contracts. First, it is hard to establish a market price for the license up-front, because the firm receiving the license ("licensee") doesn't know how much it's willing to pay before it knows how valuable the product is, while the firm selling the license ("licensor") won't reveal the value of its product without a license. If it did reveal its product or technology, the licensee could copy it without paying market value for the license. Second, suppose a license is provided. Without well-defined and enforceable contracts, the licensee may choose to produce low-quality versions of the product (diminishing the licensor's reputation for quality), it may invade markets of other licensees (reducing those license fees), and it might sell the product or technology to other users. These problems are significant especially for knowledge-based assets that have been licensed, such as new technologies, and consumer products.

For reasons of this kind, MNEs often find it more advantageous to engage in FDI, which gives them far more control over local operations than does licensing. Moreover, it provides an incentive for MNEs to use well-trained managers (often from their headquarters) to run the overseas facilities and to safeguard their technological advantages. Over time MNEs tend to train more managers from recipient countries and to make management more localized.

POTENTIAL BENEFITS OF FDI

The gains from FDI, from the recipient country's view, include the following. First and foremost, FDI carries with it the transfer of superior technology. Access to modern international technologies is, it now appears, the key factor in determining the growth rates of developing countries. Second, FDI expands intra-firm trade, allowing greater specialization. Third, FDI increases competition for local firms and generates dynamic gains from trade and investment. Fourth, there are spillover benefits from training technical managers and expanding employment in the formal sector. Fifth, MNEs tend to pay higher wages than competing local firms, at least in developing countries (though this seems also to be true in developed countries). Fifth, there is the possibility of targeting FDI for social policy reasons, such as regional employment.

POTENTIAL COSTS OF FDI

MNEs have long been harshly criticized for their operations in developing countries. Given that MNEs are large firms and that they are looking for profit increases, which may come from exploitation of local resources, their operations could be harmful. Such has long been the conventional wisdom among many development economists and sociologists. What are the potential costs? First, there is the possibility of monopolization by foreign firms that could extract resources and charge high prices without providing much value (tax payments, extraction fees, training, quality) in return. This problem is more likely to exist in small countries with limited abilities to regulate MNEs or to extract resources themselves. Second, MNEs are likely to repatriate their profits to shareholders in other countries. In itself, this is no problem because MNEs wouldn't invest if they couldn't earn some return. However, they may do so through the process of "transfer pricing," in which artificial within-firm prices are set in order to minimize global tax liabilities. An example would be a firm that charges itself a high price for an input in a high-tax economy in order to make low profits (or even losses) on paper there, incurring a low tax liability. Such practices are inefficient and presumably cost countries some sovereignty in terms of setting independent tax policies. Third, MNEs might transfer "inappropriate technologies," meaning older or excessively capital-intensive technologies, to poor nations. In fact, there is little evidence that this is true, and to the extent it is true it is caused by incentives arising from protectionist import policies in the host nations. Finally, monopoly practices by MNEs are often thought to worsen income distribution and aggravate rural-urban migration problems in developing countries. Again, economists would argue that the real problems here are related to poor regulations by host governments that provide incentives for this behavior. If trade barriers permit MNEs to monopolize a local market, for example, the real problems are the trade barriers and an inability to regulate the MNEs through anti-trust policies.

WHAT DOES THE EVIDENCE SAY?

It's a mixed bag; there are elements of truth to both stories. Monopolization is surely a greater problem in small, poor countries, but then incentives for MNEs to invest in those nations are not very high, except in resource extraction. Such countries are well justified in levying strict extraction fees on their minerals and agricultural outputs. In larger countries monopolization by MNEs is largely a substitute for monopolization by domestic firms, both of which activities tend to be protected by trade restrictions. The better policy stance is to liberalize trade barriers and work for free entry (effective competition) among domestic and foreign firms. Finally, in countries that are interested in joining the globalization process in order to secure significant economic growth, there seems little alternative to opening up to FDI. This view has become widespread among developing nations and will dominate their policy-making for the foreseeable future.

Additional Readings:

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