

Economics 404W

lecture 27

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Announcements: Final writing assignment posted; due May 1

Multinationals: An overview

- What are multinationals?
 - Own a significant equity share of a company operating in another country (“subsidiary” or “affiliate”)
- Two types of multinational investment:
 - Horizontal FDI: This occurs when firms essentially replicate abroad some of the activities that it continues to pursue at home.
 - Vertical FDI: This occurs when firms shift a stage of its production process abroad.

Why horizontal FDI instead of licensing or exports?

The OLI conditions

1. Ownership advantage The parent firm must have a product or process to which other firms don't have access.
1. Location advantage It must be more profitable to produce the product abroad than at home.
2. Internalization advantage There must be some reason that the rents from proprietary assets (private expertise or brand) are better extracted by maintaining direct control of the production.

Why horizontal FDI instead of licensing or exports?

3. Internalization advantage

- Potential licensees may not sign up unless they know the details of what they're getting. Once you tell them, however, they don't need a license to produce your product
- Even if a licensing agreement is reached, turnover among skilled workers, technicians, etc., may diffuse your proprietary knowledge to competitors.
- A Licensee may debase the company reputation in order to earn short run profits.

Why horizontal FDI instead of licensing or exports?

3. Internalization advantage (continued)

- The “hold-up problem:” It is not possible to draw up contracts with suppliers that cover all contingencies. So:
 - Once the supplier has invested in producing the input, the U.S. firm could hold up payment, “saying that some contingencies uncovered by the contract have occurred.
 - The contract then has to be renegotiated, and if the investment is specific to the relationship (i.e., has no other use), the supplier’s bargaining position will be weak.”
 - Suppliers anticipate this, and under-invest in the project. Subsidiaries don’t pose this problem

Why *vertical* FDI instead of licensing or exports?

1. Again, there must be an Ownership advantage that gives the firm some proprietary product or process that others don’t have access to.
2. Location Advantage: Cheaper to do some stages of production abroad:
 - Shipping is *cheap*
 - *Low* trade barriers
 - Low cost of disintegrating the production process
3. Internalization Advantage As with licensing, outsourcing can lead to contract enforcement problems or unwanted tech. diffusion.

Summary: costs and benefits of FDI from a firm's perspective

	Horizontal	Vertical
Costs	<ul style="list-style-type: none"> • Plant-level returns to scale foregone • Disintegration costs 	<ul style="list-style-type: none"> • Disintegration costs
Benefits	<ul style="list-style-type: none"> • Market access <ul style="list-style-type: none"> ○ Saving trade costs ○ Interact with clients 	<ul style="list-style-type: none"> • Factor cost savings

What patterns of FDI are observed?

Share of Foreign Subsidiaries in Total Employment (above-average shares are highlighted)

	France	Germany	UK	USA
Chemicals	44.7	10.3	35.8	37.0
Transport equipment	20.6	7.3	45.6	19.4
Food, beverages	--	4.8	10.6	11.6
Paper and printing	26.8	2.5	--	5.6
Rubber and plastic	29.4	4.7	27.7	13.8
Electrical equipment	35.4	8.8	41.1	--
Textiles and clothing	14.2	3.4	--	4.7
Wood products	17.7	2.7	--	1.3
All industries	27.8	6.0	27.3	13.4

Source: Barba-Navaretti and Venables (2005)

Average firm and plant size of US manufacturing firms, 1987

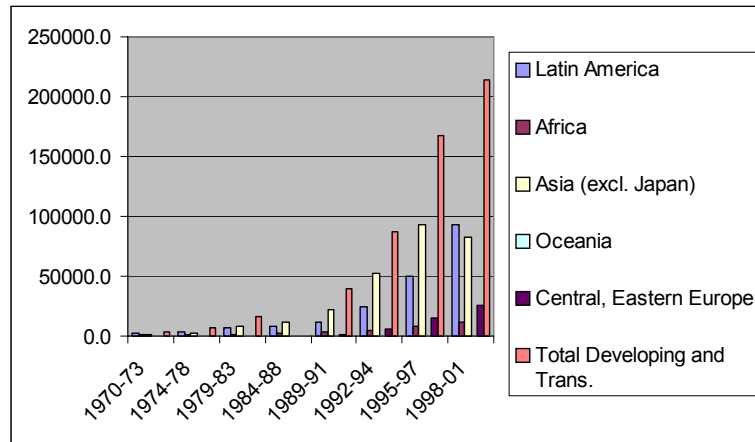
	Plant size (A)	Firm size (B)	Plants per firm (B/A)
Chemicals	132	1120	9.1
Transport equipment	663	4190	6.7
Food, beverages	157	832	5.5
Paper and printing	125	610	5
Rubber and plastic	130	507	4
Electrical equipment	293	1123	3.8
Textiles	279	1056	3.8
Furniture	182	659	3.7
Machinery	172	615	3.7
Apparel	175	526	3
Misc. Manufactures	120	264	2.2
Leather	178	340	1.9
All industries	177	852	5

Source: Barba-Navaretti and Venables (2005)

Patterns of FDI

- FDI tends to go to large markets.
- The ratio of FDI to exports tends to be high for host markets where the trade costs of exporting are high. Horizontal FDI?
 - Commercial policy-induced barriers (“tariff jumping”)
 - transport costs.
- Among U.S. multinationals, a rapidly growing share of affiliated production is being exported back to the United States. Vertical FDI?
- The role of factor costs is weak/mixed overall, but the investments that generate shipments by subsidiaries back to the U.S. tend to be in host countries with very different factor prices.
- FDI into the developing world has been growing particularly rapidly since 1990.

FDI flows into the developing world (millions of US dollars)



source: Barba Navaretti and Venables (2005), table 1.3

Patterns of FDI

- Net inward investment rises, then falls with the level of development.
 - The very poor countries have small markets and are difficult places to operate business.
 - As the economy grows, markets do, and so does the ease of doing business. Nonetheless, R&D-intensive and advertising-intensive products don't get produced locally. An opportunity to come in.
 - The most developed countries are R&D sources themselves, so they are net outward investors.

Host Country Effects of FDI and fragmentation

Effects on wages

- To the extent that globalization creates extra demand for labor in the developing countries, it is putting upward pressure on wages there.
- This should be true whether the extra demand comes from FDI or from local firms acting as suppliers to northern markets.
- A positive effects of FDI on wages in general have been documented in some cases—e.g., Ireland.
- It is well established that subsidiaries pay more than their local counterparts. Differentials range from 6 to 26 percent in developed countries, and from 10 to 260 percent in developing countries. (Why?)

Host Market Effects of FDI and fragmentation

Sweatshops:

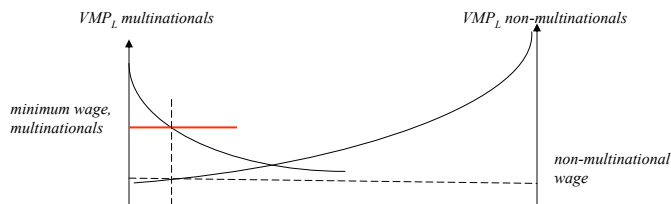
- Although multinationals pay their workers more than their competitors, many people have complained that multinationals exploit their workers in sweatshop conditions, and have demanded that products from these sweatshops be banned from U.S. markets (Brown, Deardorff and Stern, 2004).
- Two major anti-sweatshop organizations have emerged: Fair Labor Association (FLA, 1998) and the Workers Rights Consortium (WRC, 1999).
- FLA is more closely associated with the apparel industry; WRC more closely associated with unions. Both developed codes of conduct and enforcement mechanisms.

Host Market Effects of FDI and fragmentation

Sweatshops, continued

- The two groups differ on wage policy:
 - FLA: employers shall pay employees, as a floor, at least the minimum wage required by local law or the prevailing industry, whichever is higher, . . . “
 - WRC: “licensees shall pay employees, as a floor, wages and benefits which comply with all applicable laws and regulations, and which provide for essential needs and establish a dignified living wage for workers and their families” [A living wage provides the basic needs of an average family unit of employees in the garment manufacturing employment sector of the economy]
- So most subsidiaries satisfy the FLA code, but many do not satisfy the WRC code. If it were to be enforced, what would happen?

Host Market Effects of FDI and fragmentation



Anti-sweatshop minimum wages

- If the multinational does not leave, a minimum wage for multinationals only can lead to heightened inequality and job queuing.
- How are multinational profits affected by the minimum wage?
- Among workers, who benefits, and who is hurt?

Host Market Effects of FDI and fragmentation

Child labor

- Why ban child labor? if you believe that certain minimal standards of human behavior are fundamental, and that children cannot make decisions in their own interest.
- A global ban on child labor would not simply re-direct FDI (as would “living wage” regulations).
- One problem: distinguishing exploitative child labor from children helping out on family farms in non-exploitative ways.
- Another problem: how to enforce such a ban. The International Labor Organization (ILO) has no enforcement powers. The WTO doesn't want to get involved.

Host Market Effects of FDI and fragmentation

Child labor, continued

- Does globalization encourage child labor? Not obviously:
 - Vietnamese experiences went the other way—increased income among rural households led to more schooling and less child labor among rural children.
 - Edmunds and Pacvnik (2005) “find a negative but statistically insignificant association between openness and child labor conditional on cross-country income . . .”

Host Market Effects of FDI and fragmentation

International technology diffusion

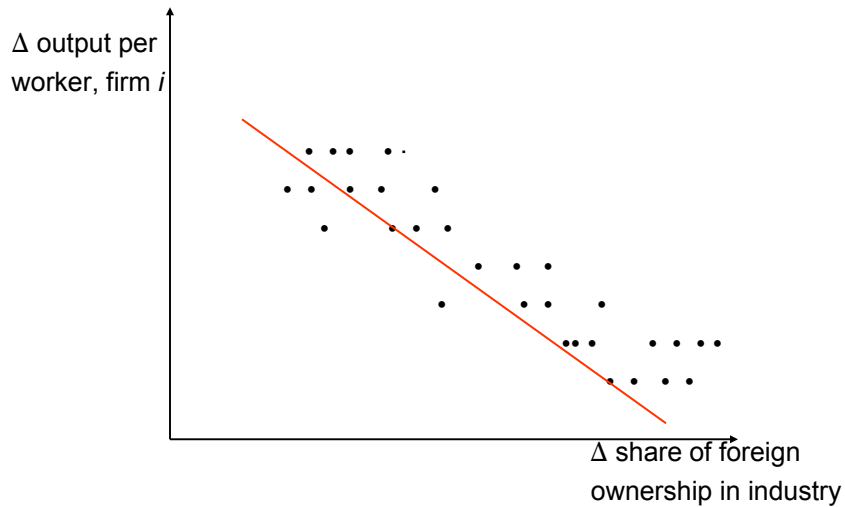
- A large fraction of the R&D and innovation in the world comes from multinationals.
- Multinationals generally try to protect their technological advantage rather than let it diffuse. But some of the expertise embodied in the multinational is likely to spill over to domestic firms:
 - As employees turn over.
 - Through shared domestic suppliers.
 - Through demonstration effects
 - Through competitive pressures (?)

Host Market Effects of FDI and fragmentation

International technology diffusion: the evidence

- Case studies document instances where upstream suppliers learn from subsidiaries, and their domestically-owned clients benefit.
- Similarly, there are instances where labor turnover has led to learning spillovers.
- It's difficult to say how pervasive these phenomena are, however. Econometric studies generally don't pick up strong systematic effects.
- In the short run, they sometimes find negative association between FDI and domestic firms' performance.

Evidence on International technology diffusion



FDI policies in host countries

- Many countries want to attract FDI, and pursue policies to do so. Some policies are sensible in their own right:
 - Stable, sustainable macro policies translate into relatively steady growth, with few crises. When they do, the country is relatively attractive.
 - An effective legal system and protection of property rights are also important from the multinational's perspective.
 - Informational, marketing efforts to educate potential investors.

FDI policies in host countries

- Some countries go beyond these policies:
 - Trade barriers to encourage domestic production.
 - Tax breaks
 - Exclusive rights to the domestic market
 - Complementary services, including infrastructure

FDI policies in host countries

- Countries have also tried to ensure that spillovers take place, once the subsidiary is there:
 - Local content requirements ensure upstream suppliers are part of the action.
 - Local R&D requirements are an effort to prevent multinationals from simply outsourcing the low skill, labor intensive stages of production rather than bringing sophisticated processes to the host country.
 - Local hiring requirements for managerial and skilled personnel, to develop an indigenous stock of expertise.

FDI policies in host countries

- Have these policies attracted investment?
 - Regression analyses have shown that many of the policies described above do induce FDI.
 - But when captive markets are created for multinationals, the effect can actually be to reduce the value of GDP at world prices. Case studies suggest that this has happened in a significant minority of cases.
 - When FDI reduces national income, it's not because the multinationals are losing money. It's because there are large discrepancies between domestic and world prices.

FDI policies in host countries

- Are the payoffs worth it?
 - The subsidiaries do often bring newer technologies in, and they typically pay above-market wages to their employees.
 - But as already noted, the magnitude of the spillover effects is debatable, and sweetheart deals are often not welfare-improving for the country as a whole.