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Foreign Ownership and Market Entry

When a firm wishes to sell in a foreign market, it can do so either by exporting to that market or by investing in a local production unit. The latter mode of servicing a foreign market is referred to as a foreign direct investment (FDI). International production has increased rapidly during the last two decades, and particularly since the second half of the 1980s. This paper describes the facts, explains why firms choose FDI, and evaluates FDI in terms of impact on host economies. Particular emphasis is placed on firms' choice between the two types of foreign investment; "greenfields", which involves the establishment of a new production facility, and cross-border mergers and acquisitions, which involves taking over an existing production unit in a foreign market. The paper also contains a fairly extensive discussion of the consequences of economic integration on market entry. JEL-codes: F23, L13, O14

One of the most striking signs of globalization is the strong growth in foreign direct investment (FDI) during the last two decades, and particularly since the second half of the 1980s. This trend has also spurred a lot of research on the issue of foreign investment and firms' choice of entry mode in foreign markets in general. Important questions are: What motivates firms to undertake an investment abroad? What kind of investment should it choose; the acquisition of an existing plant or the establishment of a new production facility?

When the alternative mode of servicing a foreign market is exports, how does economic integration in the form of reduced international trade costs affect entry mode? What are the effects of the various forms of market entry on the countries in which the foreign firms operate? In what ways can potential "host" countries attract foreign investment and make the most out of the presence of foreign firms or foreign sales?

The ambition of the present paper is to shed light on these very important questions. We start out by defining FDI and describing

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recent trends. We then ask what motivates firms may have to undertake FDI. In the following section we apply the theory on issues related to FDI, and then move on to host country effects and policy implications. The final section concludes.

Facts

FDI defined

FDI is an investment made to acquire a lasting interest in a foreign enterprise with the purpose of having an effective voice in its management. The OECD and IMF interpret “an effective voice” to involve the possession of ten percent or more of the ordinary shares of a corporate enterprise by one owner. Alternatively, if no single owner has 10 percent or more of the shares, the criterion is that a group of investors controls more than 50 percent of the shares. There is however no international consensus on the minimum equity stake. Partly for this reason, countries differ in their definitions of FDI.¹

Note that in addition to new equity and loans from parent firms, reinvested earnings in the foreign affiliates are also registered as FDI. In addition, foreign affiliates may raise money in the host country or in international capital markets. These modes of expanding foreign affiliates’ activities are however not registered as FDI.

FDI may involve either the establishment of a new production facility, a so-called “greenfield” investment, or a purchase of (shares in) an existing foreign firm, a cross border acquisition, in the statistics often reported under the heading “M&A” for “mergers and acquisitions”. In case a firm acquires more than 50 percent of the shares in the acquired firm, this is a “majority

M&A”, and in case it acquires less, it is a “minority M&A”.

FDI should be contrasted with portfolio investments. By definition, a portfolio investment involves a smaller ownership share in the company in which an investment has been made. The time horizon of a portfolio investment is often short term, which also means that this kind of capital is much more sensitive to short term fluctuations in the host economies than is FDI. Typically, portfolio investors are institutional investors, such as pension funds, trust funds, and life insurance companies. These investors are passive, in the sense that they do not take part in the management of the company they have invested in. FDI on the other hand is generally undertaken by large, multinational enterprises (MNEs) with a clear ambition of using their ownership position to exercise control.

FDI should also be contrasted with strategic partnerships and licensing agreements, non-equity relations that have been growing in importance recently. Technology partnerships have been formed in information technology and pharmaceutical and automobile industries in the 1990s. The purpose of these partnerships has been to reduce both the competitive pressure in the market and the costs and risks associated with R&D. International networks of this kind are not captured by traditional measures of international production, such as FDI. (UNCTAD, 1999a: 8)

Global growth in FDI

During the last two decades, and particularly since the end of the 1980s, we have witnessed a strong increase in foreign direct investment, both in absolute terms and relative to trade.²

1. On international differences in definition of FDI, and a discussion of data on FDI, see Dunning (1993), Ch.1.

Table 1. Growth of FDI

| | Value at current prices | | | Annual growth rate | | | | |
|-----|-------------------------|------|------|--------------------|---------|---------|------|------|
| | 1982 | 1990 | 1999 | 1986--90 | 1991-95 | 1996-99 | 1998 | 1999 |
| FDI | 58 | 209 | 865 | 24 | 20 | 32 | 44 | 27 |
| M&A | .. | 151 | 720 | 26 | 23 | 47 | 74 | 35 |

Source: UNCTAD (2000) Table 4, page 5.

Note: Values in billion dollars. Growth rates in percentages. Data on cross-border M&A available from 1987 onwards.

In fact, the growth in FDI, at a yearly average of 23 percent since 1986, has been twice that of trade. Today, 25 percent of global value added takes place in multinational enterprises. And one third of the MNEs value added is created in foreign affiliates. In Canada and Ireland foreign affiliates account for over 50 percent of manufacturing production (OECD, 1998: 21).

Sales from the foreign affiliates (\$11 trillion in 1998) exceed that of global exports (\$7 trillion in 1998), implying that international production is a more important means of delivering goods and services to foreign markets than is trade. Moreover, intra-firm trade, i.e., international trade between various units within the same MNE, constitutes a substantial share (30 percent) of world trade.

Multinationals tend to be important in knowledge-intensive sectors, characterized by high levels of R&D relative to sales, a large share of highly skilled workers, new and/or technically complex products, and high levels of product differentiation and advertising. Examples of such industries include electronics, automotive, computers, and chemi-

icals. Major MNEs in these industries include General Electric (the largest MNE in the world), Ford Motor Company (the second largest), IMB (the seventh largest), and Hoechst AG (the 13th largest).³

FDI growth has been particularly strong in the service sector. Today, nearly half of the world's FDI stock is in services. Growth in FDI in services has been mainly in the form of mergers and acquisitions, notably in sectors such as banking, insurance, and telecommunications. In fact, more than half of all cross-border mergers and acquisitions during the period 1991-1998 took place in service industries. In manufacturing, accounting for 40% of cross-border mergers and acquisitions, industries such as petroleum, chemicals, pharmaceuticals, and automotive have also seen some major mergers. Recent examples include British Petroleum-Amoco in the petroleum industry, Daimler-Benz-Chrysler in the automotive industry, and Astra AB-Zeneca Group Plc in pharmaceuticals (Kang and Johansson, 2000: 20).

As is evident from Table 1, the growth in cross-border mergers and acquisitions has been very strong in the second half of the

2. For an historic overview of the development of MNEs, see Dunning (1993), chapter 5. Unless otherwise indicated, the information in this section is gathered from UNCTAD's World Investment Report, various years.

3. UNCTAD's World Investment Report ranks the world's 50 largest non-financial MNEs.

Table 2. Regional distribution of FDI

| | Inflows | | | | | Outflows | | | | |
|----------------------|---------|------|------|------|------|----------|------|------|------|------|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 1995 | 1996 | 1997 | 1998 | 1999 |
| Developed countries | 63 | 59 | 59 | 72 | 74 | 85 | 84 | 86 | 92 | 91 |
| Western Europe | 37 | 3 | 30 | 37 | 35 | 49 | 54 | 51 | 63 | 64 |
| United States | 18 | 21 | 24 | 30 | 32 | 26 | 20 | 23 | 21 | 19 |
| Japan | - | 0 | 1 | 1 | 2 | 6 | 6 | 6 | 4 | 3 |
| Developing countries | 32 | 38 | 37 | 26 | 24 | 15 | 16 | 14 | 8 | 8 |
| Africa | 1 | 2 | 2 | 1 | 1 | 0 | - | 0 | 0 | 0 |
| Latin America | 10 | 13 | 15 | 11 | 12 | 2 | 2 | 3 | 2 | 3 |
| Asia | 21 | 23 | 20 | 13 | 11 | 12 | 14 | 10 | 6 | 5 |

Source: UNCTAD (1998) Table 4, UNCTAD (1999a) Table 8, UNCTAD (2000), Annex Tables B.1 and B.2.

Note: Numbers as percentage of global FDI flows.

1990s. In 1999, mergers accounted for more than 80 percent of global FDI.⁴ This means that the addition to international production capacity is far less than that implied by the value of annual FDI flows.

Developed countries accounted for about 90 percent of the worldwide majority-owned acquisitions. In developing countries, FDI inflows are mainly in the form of greenfield investments. The lesser importance of acquisitions in LDCs is partly due to the fact that poor countries typically offer fewer suitable firms to acquire, and partly because of a more restrictive take-over legislation compared to OECD countries, particularly with respect to majority take-overs.

Note that the large share of mergers and acquisitions in total FDI in the late 1990s is not unprecedented. In the late 1980s this share was also well above 60 percent. In absolute numbers, however, both mergers and acquisitions and FDI in general were much larger at the end of the 1990s than a decade earlier. Moreover, while the cross-border

mergers and acquisitions of the 1980s often crossed industry borders, most of the recent mergers are concentrated in the same or related industries; the business philosophy has changed from conglomerate building to one emphasizing the need to focus on core activities.

Regional distribution of FDI

The majority of FDI takes place between major OECD countries, notably between the EU and the USA. The EU is the largest source of FDI, with an outflow of \$510 billion in 1999, nearly two thirds of world outflows. With foreign investments of \$199 billion, the UK in 1999 replaced the US as the world's largest foreign investor for the first time since 1988. EU's share of FDI-inflows was 35 percent, and the corresponding share for the US was 32 percent.

LDCs' share of FDI-inflows has been growing in the 1990s, at least up till the financial crisis in Asia which started in the fall of 1997. In 1990, this share was 20

4. UNCTAD's World Investment Report 2000, subtitled "Cross-border mergers and acquisitions and development", contains an in depth discussion of M&As.

percent, reaching 37 percent in 1997. The majority of these investments are hosted by the Southeast Asian countries (19 percent in 1997) and Latin America (15 percent in 1997), with Africa's share being a modest 1.6 percent. China alone represented one third of non-OECD inflows in the period 1990-96. Indeed, during this period China was second only to the US in terms of FDI inflows.

As evident from Table 2, the share of global FDI destined for LDCs fell due to the Asian crisis in 1997, to 24 percent in 1999, South-East Asia losing 10 percent and Latin America 3 percent relative to 1996. Similarly, the share of FDI outflows from LDCs dropped from 14 percent in 1997 to 8 percent in 1999. It is however important to note that although the crisis led to a decline in Asia's and Latin America's share of global FDI, in absolute terms, the drop in FDI was much less dramatic. In fact, FDI inflows to Latin America were five percent *higher* in 1998 than in 1997, even though this continent registered a 4 percent reduction relative to global FDI in the same period. The relatively modest response of FDI flows to most Asian countries in a period of deep financial and economic crisis, is evidence of the long-term nature of this kind of capital flows relative to portfolio investment.⁵

Even if LDCs receive less FDI than the more developed parts of the world do, the importance of these capital flows for developing countries is arguably greater. For one, FDI is likely to be relatively more important in less advanced countries as a source of capital and technology due to limited access to international capital markets and small amount of domestic R&D. Moreover, the size of LDC economies is

generally smaller than that of developed economies. In fact, the FDI/GDP ratio is higher in developing countries than in OECD countries (UNCTAD, 1999a: 19).

Explanation

In recent years we have witnessed large-scale privatization and extensive liberalization of international investment rules in most parts of the world. Such policy changes are obviously important in explaining the great rise in global FDI: It gives multinational companies the *opportunity* to invest abroad. But in order to understand the rise in global FDI, we must also understand why multinationals find it profitable to use this opportunity: We must search for factors that *motivate* FDI. In short, we need a theory. Such a theory must answer the following three questions: 1) What makes a firm competitive in foreign markets? 2) Why would a firm choose to produce abroad? 3) Why would a firm choose to own the foreign production unit?

Dunning's OLI-theory

In his widely acclaimed OLI-theory, Dunning (1993) provides a synthesis of the answers proposed by the literature to the three questions raised above.⁶ Three conditions, namely ownership advantages (O), location advantages (L), and internalization advantages (I), all have to be satisfied for a firm to undertake FDI.

Ownership advantages

A firm selling in a foreign market has certain disadvantages relative to its local competitors. The disadvantages could be related to langu-

5. For a more detailed discussion of FDI inflows to Southeast Asia, see Thomsen (1999).

6. See also Markusen (1995) for an overview and a discussion of the OLI framework.

age and cultural barriers, limited knowledge about local tastes and institutions, etc. The hypothesis is that given these disadvantages, the firm operating in the foreign environment must possess some advantage over local firms in order for foreign production, or indeed international sales of any kind, to be profitable. This advantage could be in the form of a more cost efficient production process, a unique product, better access to international capital market, international marketing facilities, etc.

Location advantages

A location may offer various kinds of benefits to firms. First, it may be home to *natural resources*, such as oil, minerals, or trees, which attract firms involved in the extraction of these resources. This is sometimes called resource-seeking FDI.

Second, countries may be endowed with a low cost, and perhaps highly qualified, *labor force*. Firms seeking to reduce labor costs or perhaps gain access to ideas and technology may be attracted to such a location. This kind of FDI is referred to as “vertical” or “efficiency seeking” FDI. It is called vertical, since it involves a geographical decentralization of the firm’s production chain, where the affiliates typically produce labor intensive intermediates that are shipped back to high-wage countries, often to the parent company itself. The name efficiency seeking stems from the fact that the main aim of the investment is greater cost efficiency in production. For instance, Japanese companies involved in labor intensive manufacturing industries such as electronics components, chemicals, electrical appliances, and textiles have invested heavily in neighboring countries in order to reduce labor costs. FDI aimed at accessing highly qualified labor in a certain area, such as the IT-expertise in California’s Silicon Valley, is sometimes referred to as “technology

sourcing” FDI.

Third, a location offers proximity to *local customers*. This is sometimes referred to as “market seeking”, or “horizontal”, FDI; “market seeking” since the aim of the investment is to supply local markets, and “horizontal”, since the affiliate basically does the same thing as the parent firm. By locating in a specific area, firms save on trade costs, such as tariffs. This rationale for FDI is therefore sometimes referred to as the tariff-jumping argument. If plant specific costs are not too high relative to the foreign market size, it may be more profitable to service foreign markets through FDI rather than exports.

For instance, the high tariff barriers protecting Latin American markets from international trade in automobiles have contributed to a large amount of FDI in this sector, notably in Argentina and Brazil. Similarly, Japanese car producers have invested in both Europe and the US in order to service local markets. For certain kinds of non-tradable services, such as real estate, hotels, retail trade, telecommunication, and part of the banking and financial sectors, there is no tradeoff between trade and FDI at all; market entry simply requires FDI.

Most of the global FDI is horizontal. Brainard (1997) reports that only 13 percent of the overseas production of U.S. owned foreign affiliates is shipped to the United States, while only 2 percent of the output produced by foreign affiliates located in the U.S. is shipped to their parents. Not surprisingly, vertical FDI is relatively more important when hosted by LDCs.

Fourth, there may be a *strategic incentive* to invest abroad. We may call this “monopoly seeking” FDI. Particularly when the investment is in the form of an acquisition, the market power, and therefore the profit of the investing firm, is likely to increase (since the number of competitors goes down). But

also greenfield investments may have a strategic motivation. Firms may wish to have production plants in several locations because such a presence may deter entry by potential newcomers (Ganslandt, 1998).

Finally, low wages and a large local market are not sufficient conditions for attracting FDI. The *public sector* supplies public goods and services and defines and implements economic policies and all these public sector activities affect the profitability of an investment project, whether domestic or foreign. As an example, 16 leading MNEs operating in India named regulatory control, bureaucratic intervention, and the lack of adequate infrastructure, particularly telecommunications and transportation as major difficulties in operating in that country.⁷

In relation to this last point, note that firms not only seek business-friendly policies at a specific point in time. More importantly, since an investment in a particular country involves a long-term exposure to the economic and political conditions in that country, firms typically look for some commitment to these policies. They need to be assured that their investment is safe from expropriation, that profits can be transferred out of the country, and that potential disputes between the host government and the multinational firm will be solved in a fair and efficient way. Countries with a record of economic, political and social stability are likely to be attractive to foreign investment. For instance, multinationals investing in Central and Eastern Europe listed macro-economic stability as key to realizing the potential of their investment (UNCTAD, 1998). Signing international trade and investment agreements may serve to commit to a set of policies and to signal this commitment to the

rest of the world. Fernandez and Portes (1998: 214) argue that for Mexico, NAFTA serves mainly as a commitment and signaling device:

Mexico joined NAFTA on rather unfavourable terms, securing very little in concrete tariff reductions or other concessions from the United States. Although this was not perceived as an insurance premium by U.S. policymakers, Mexican policymakers may have perceived it as such. Again, this is particularly relevant in the context of foreign investment. To persuade U.S. investors to take advantage of Mexico's low labor costs by investing in Mexico, it was necessary to reassure them not only that tariffs for Mexican exports to the United States were low but also that they would stay low and that contingent protection would be less likely to be imposed.

A similar argument has been offered by Blomström and Kokko (1997b).

Internalization advantages

In order for the MNE to choose FDI rather than an arms-length agreement, such as licensing or strategic partnerships, there must exist some advantage of conducting the business internally within the firm. These advantages include greater control over the technology and quality of the product. In addition to problems tied to control of arms-length operations, negotiating such deals may be difficult and costly, as emphasized by Blomström and Kokko (1997a: 8):

Markets for technology are typically imperfect, which makes the transaction costs for sales to outsiders high. For

7. Cited in UNCTAD (1994), page 83.

instance, it is difficult to judge the value of any specific technology and agree about prices and licensing costs that are acceptable to both parties. Consequently, MNEs often prefer direct investment before licensing, and the preference for FDI may be particularly strong when the newest and most profitable technologies (or those that are very close to the MNEs principal line of business) are exploited.

Limiting the spread of technology may be particularly difficult in many LDCs, due to weak patent protection systems. This fact may induce firms to avoid arms-length agreements and choose FDI in these countries. As an example, India banned direct investment by Coca-Cola hoping that the company instead would choose to license the production of its soft drink to a local producer. The weakness of Indian property right protection, however, discouraged the American company from entering into a licensing agreement, and the company instead decided to leave the market (Vishwasrao, 1994). In Indonesia and the Philippines, foreign investors are required to phase down their participation in a company over time. Rather than adding to domestic capabilities, the result has been a reduction in investments and technology transfer from the parent firm. Generally speaking, empirical research indicates that restrictions on FDI have not been successful in increasing technology transfers to the host economy (OECD, 1998a: 61-62).

Applications

In this section we discuss three issues in light of the theoretical overview presented above. The first issue deals with the fact that FDI is particularly prevalent in knowledge-intensive sectors. Can the OLI-theory explain this fact? The second issue concerns the rise in

acquisitions. When do firms choose this form of market entry, and can we explain its recent rise? Finally, we focus on economic integration and market entry. What are the likely effects of increased market integration on FDI? This last question has received a lot of attention in the literature, and is also the issue that will receive the most attention here.

R&D, FDI, and OLI

Multinationals are often found in industries in which products and production processes are unique to firms, typically the result of large investments in R&D and a large employment of highly skilled labor. The OLI-framework may shed light on this observation. First, knowledge is often firm specific, for instance in the form of patented products and production processes. Knowledge is an ownership advantage that may make the firm competitive in world markets. Second, knowledge can easily be transferred between countries at little extra cost. If the firm derives its ownership advantage from firm specific knowledge, the costs of establishing a foreign affiliate are probably modest, compared to a situation where the ownership advantage is embodied in a particular kind of machinery. Third, it may be preferable for an R&D intensive firm to internalize its foreign operations by choosing FDI, rather than to enter into a licensing agreement, in order to keep a tight control over its technology.

In sum, the ownership, location, and internalization advantages are all highly relevant for R&D intensive industries. The observed importance of FDI in these industries is therefore in line with the predictions of the theory.

Entry mode: Greenfield versus acquisition

We have already discussed a firm's choice between FDI and alternative modes of servicing foreign markets, such as exports. In

what now follows, we shall dig deeper and study a firm's choice between different forms of FDI, notably the choice between greenfield investment and acquisition.⁸

For the investing firm, an important advantage with acquisition relative to greenfield is that an acquisition reduces the competitive pressure in the market. This is likely to increase profits through a higher price on the firm's output and perhaps a lower price on its inputs. We would therefore expect acquisitions to increase in importance in markets where the competitive pressure increases, for instance due to international economic integration. The entry costs may also be lower under acquisition than greenfield. It is costly for a new firm not only to set up a new production site, but also to hire a new staff, to establish distribution networks, and to acquire manufacturing skills adapted to local conditions; a type of infrastructure and information that an existing firm is likely to have. Yet another feature of acquisitions is that this mode of entry allows quicker entry into a market relative to greenfield. If, for strategic or other reasons, the investing firm seeks a quick entry, an acquisition may be the right choice.

The most important advantage with a greenfield investment is that it gives the investing firm a higher degree of flexibility. Acquiring another firm to a large extent also means acquiring its technology, its staff, and its organizational structure. Quite likely, therefore, ownership advantages are easier to transfer to a new venture. The greater technological and organizational flexibility of greenfield investments may also translate into lower production costs. It is also possible that a firm would be less inclined to transfer technology

and know-how to an acquired firm, since the possibility of controlling the use of such knowledge may be weaker in this case compared to the case of a production unit built from scratch. If internalization of knowledge is important to a firm, it may favor greenfield over acquisition.

From this discussion, we would expect greenfield to be relatively more important for a firm with a technological edge over its competitors. There may be three reasons for this. First, a firm which possesses a strong technological advantage over its competitors may not be too worried about the competition, and therefore less inclined to choose acquisition in order to reduce the competitive pressure in the market. Second, a highly efficient firm would tend to choose greenfield in order to implement its technology in an efficient manner. Third, greenfield may also be chosen in order to protect its technology.

Empirical evidence from OECD supports this prediction. Greenfield is generally preferred to acquisitions in countries and sectors where the investing firm has a technological and competitive advantage. For example, Japanese MNEs entering Europe have relied on greenfield in semiconductors and transport in the UK, a sector where Japanese firms have a technological edge over their UK-counterparts. When entering the European market for chemicals, on the other hand, Japanese firms have chosen to acquire existing firms in Germany and the Netherlands. One likely reason for this preference of acquisition over greenfield is the fact that technologically, the European firms in this sector are more on par with their Japanese competitors, and therefore that the need to internalize knowledge is less

8. For an analysis of a firm's choice of entry mode, including the option of acquisition, see Bjorvatn (2000a) and Norbäck and Persson (2000).

important (Kang and Johansson, 2000).

Earlier in this section we noted that an important advantage with acquisitions is that it is likely to reduce the competitive pressure in the market. A reduction in the competitive pressure is of course an advantage not only to the acquiring firm but also to the other firms in the market not involved in the acquisition. In fact, theoretically speaking, it is typically the case that “it is more profitable to be outside a merger than to be a participant”, to quote the influential article by Stigler (1950). In other words, there may be a free-rider problem associated with mergers and acquisitions: While a merger is likely to increase aggregate profits in an industry, no individual firm has an incentive to take part in the merger. The theory therefore predicts that mergers are not likely to take place, at least not if we assume that firms are profit maximizers.

The reason why it may be more profitable to be an outside firm relative to the merger, can be explained as follows. Following the merger, the merged firm uses its increased market power to raise the price on its output. The other firms respond to this price increase by capturing market shares from the merged firm. The outside firms therefore benefit both from a higher price and larger market shares, and are therefore better off than the merged firm. Salant et al. (1983) demonstrate that in the case of Cournot oligopoly with linear costs and demand, a merger involving less than 80 percent of the industry will not be viable.

The theoretical analysis of mergers typically assumes that firms are located in the same market. Cross-border mergers and acquisitions add another dimension to the analysis, since an acquisition is now also a means of market entry. In Bjorvatn (2001) I demonstrate that cross-border mergers are

more likely to be profitable for the merging parties than an intra-market merger.

Economic integration and FDI

A large literature, theoretical and empirical, analyses the effects of economic integration on FDI.⁹ Economic integration can be defined as a reduction in transaction costs between countries, on goods and factors of production, and an international harmonization of national legislation on trade and investment.

A reduction of international transaction costs can be due to political choice (as when tariffs and non-tariff barriers are reduced, international investors are granted national treatment, countries sign international dispute settlement treaties), or by technological change (as improved ways of shipping goods bring down transportation costs and the developments such as the Internet reduce communication costs).

We shall distinguish between “global integration”, for instance due to WTO-agreements, and “regional integration”, as exemplified by regional trade agreements such as the EU and NAFTA.

Global integration

A reduction in international trade costs is likely to increase the profitability of vertical FDI, and reduce the profitability of horizontal FDI. Recall that in the case of vertical FDI, the most important L-advantage was access to cheap and perhaps well-qualified labor, the output mainly being sold on the international market. Cheaper access to the world market through a reduction in trade costs makes such an investment more profitable. In the case of horizontal FDI, on the other hand, the prime L-advantage was proximity to local

9. Two central contributions are Markusen and Venables (1996, 1998).

consumers. As trade costs go down, the world in a sense becomes smaller, and locating close to final demand, i.e., the tariff-jumping argument, becomes less important. Hence, one should expect an increase in trade relative to market-seeking FDI as trade costs go down (at least if the foreign affiliate is not heavily dependent on imported intermediates).

Empirical evidence on the effects of economic integration on FDI is mixed. Brainard (1997) finds that a reduction in trade costs causes a substitution away from FDI and towards trade; i.e., a support of the tariff jumping argument. Other empirical studies suggest that economic integration has had the opposite effect, namely causing an increase in FDI. Feinberg et al. (1998) studies trade liberalization between Canada and USA in the 1980s and early 1990s, and report (on page 771) that “reductions in Canadian tariffs actually *increased* capital and employment in Canada by U.S. multinational companies. Overall, trade liberalization appears to have stimulated growth for the U.S. multinational companies.” Given the open conclusion from theory on the consequences of economic integration on FDI, for instance, as discussed above, depending on whether FDI is horizontal or vertical, the mixed empirical evidence is not surprising.

Regional integration

So far, we have studied economic integration as an overall reduction in international transaction costs. Frequently, economic integration takes place on a regional basis. In this case, the effect on FDI also depends on the response of firms located outside the integrating region.

Almost every country in the world belongs

to, or considers joining, a regional integration arrangement, and 55 to 60 percent of world trade now occurs within such trading blocs.¹⁰ Some of the most important agreements are the European Economic Area, including the EU and EFTA; NAFTA, with United States, Canada and Mexico as participating countries; ASEAN, involving Indonesia, Malaysia, the Philippines, Singapore, Brunei, and Thailand; MERCOSUR, with Argentina, Brazil, Paraguay and Uruguay; and SADC, which involves most countries in southern Africa.

There are at least three reasons why regional integration agreements should increase FDI into the integrating region. First, a reduction in intra-regional transaction costs increases the effective market size of the region, which in turn makes it a more profitable area for foreign investment inflows. Second, regional integration sometimes involves an increase in trade barriers to the outside world. From the tariff-jumping argument, we know that such a policy can be expected to increase investments into the region. Third, many agreements feature explicit dispute resolution mechanisms. If effective, these should stimulate both FDI and trade.

Note that an increase in FDI is not likely to be evenly distributed between the integration countries. Countries with the strongest locational advantages are the ones that are likely to attract FDI.

Regional integration agreements do not necessarily increase extra-regional FDI. Foreign firms that prior to the agreement were already established in many of the integrating countries may choose to rationalize their operations by reducing the number of foreign

10. For an overview over regional integration arrangements over, see Schiff and Winters (1998). For analyses, see Fernandez and Portes (1998) and Blomström and Kokko (1997b).

affiliates in the region. Moreover, higher trade barriers to the outside world would tend to make efficiency seeking investments less profitable. Similarly, if imported intermediates are important in the foreign affiliates' production process, higher trade costs may reduce the attractiveness of FDI.

Empirical research indicates that regional integration on balance is likely to attract more FDI into the region. For instance, there was a considerable inflow of US direct investment into the European Community after its formation. Similarly, there was an upsurge in Japanese investments in Europe as a consequence of the 1992 common market program (Blomström and Kokko, 1997b).

Regional integration may have another effect, which may perhaps be more important in politically less stable developing countries. Integration agreements, by raising reform decisions from national to international levels, may serve as a commitment to a policy of liberalization and a signal to foreign investors about this policy. As argued earlier, this may have been the main benefit of NAFTA for Mexico.

Economic integration and FDI growth:

A puzzle?

From the discussion in Section 1 we know that the majority of FDI is market seeking, at least in the OECD area. At first sight, then, one should, following the tariff-jumping argument, expect economic integration to lead to a reduction in FDI, which is contrary to what we observe. How do we explain the rise in FDI in a period of increasing international economic integration?

One explanation would be that economic integration not only involves a lowering of trade costs. Other features associated with integration may dominate the tariff jumping argument and stimulate more horizontal FDI. For instance, economic integration also

involves a liberalization and harmonization of national rules and regulations on foreign investment. Typically, a number of services, such as banking, insurance and telecommunication, have been shielded from foreign ownership. As a result of national initiatives and international agreements, such as the WTO-agreement on telecommunications services that came into effect in 1998, a number of services have been made accessible for foreign ownership. It is possible that the observed rise in FDI is simply the realization of a potential that has been there for a long time, but a potential which foreign investors were previously prohibited from exploiting.

Another feature of economic integration is that international communication costs have also gone down, particularly with the possibility of transmitting electronic information via Internet. Lower costs of communication makes coordination of decentralized production easier, and may therefore stimulate FDI. Economic integration may also lead to higher world income and therefore larger markets, which tends to increase market-seeking FDI.

Also factors not directly linked to integration could make FDI more attractive to firms. For instance, technological improvements that reduce marginal production costs tend to make other variable costs, such as trade costs, relatively more important. Hence, even though trade costs in absolute terms have gone down, their relative importance in total sales costs may have gone up, making it more important for firms to locate closer to final demand.

It is also possible to argue that a reduction in trade costs *as such* may trigger an increase in FDI. For instance, if the foreign affiliate is highly dependent on imported intermediates, a reduction in trade costs increases the profitability of foreign production. This effect may dominate the tariff-jumping argument,

i.e., the argument that a reduction in trade costs increases the profitability of trade relative to FDI. Yet another argument is that for strategic reasons, a reduction in trade costs may trigger FDI. The reason is that a reduction in trade costs, by making world markets more accessible, also increases the profitability of entry in a market. It may be in the interest of incumbent firms to block such entry in order to keep competition at a minimum. One way of doing this is to invest abroad, thereby reducing marginal sales costs. If the potential entrant observes that the established firm has low sales costs, it knows that competition in case of entry will be tough. The response of the potential entrant may therefore be *not* to enter, and the incumbent firm has achieved what it set out to do. Hence, the optimal strategy for the incumbent firm as a response to lower trade costs may be FDI (Ganslandt, 1998).

It may also be true that a reduction in trade cost increases the host country benefits of FDI. If this is the case, one might expect countries to become more positive towards hosting multinationals, and stimulate increased FDI by implementing FDI-friendly policies. The reason is basically as follows. In markets of imperfect competition, it may be beneficial for a country to grant its industry some degree of protection from foreign competitors in order to avoid too much profit ending up in the pockets of foreign owners. High trade costs may provide exactly this kind of protection when the foreign firm is an exporter. A lowering of trade costs increases the competitiveness of a foreign exporter, thereby weakening the protectionist argument for keeping the foreign firm at a distance from the local market. The host country

benefits of FDI, including increased consumer surplus and technological spillover effects, may then dominate the protectionist argument for dealing with the foreign firm as an exporter. The result may be a change in attitude towards FDI on the part of host countries, which may lead to more FDI taking place (Bjorvatn, 2000).

We also know that most of the recent surge in FDI has been in the form of acquisitions. Reduced international trade costs offers one explanation to this development. By intensifying international competition, lower trade costs may force companies to act in order to maintain the profitability of the firm. Focusing on core activities by selling out peripheral operations and purchasing operations closer to the main line of operations may cut costs. In addition, as argued above, acquiring international competitors may increase profits by reducing the competitive pressure in the market. Hence, pressure on profits caused by reduced trade barriers may stimulate cross-border mergers and acquisitions.

Evaluation

Theoretical studies have typically been concerned with the positive question; why do firms choose FDI rather than alternative modes of servicing foreign markets, such as exports? Host country effects of FDI and policy implications have received less attention.¹¹ One possible reason for this relative neglect may be the consensus that appears to prevail today that FDI is good for host economies, and that the challenge for host economies is simply to attract more of it.

Even in less developed countries, where

11. Exceptions include Ono (1990), Richardson (1998), Horstmann and Markusen (1992), Bjorvatn (2000) and Reis (2001).

the skepticism against multinational companies and FDI has traditionally been widespread, the general attitude now seems to be far more positive. For instance, UNCTAD (1999b) reports that: "Foreign direct investment is welcomed and, indeed, actively sought by virtually all African countries." While it may well be true that FDI on balance is beneficial to host economies, the picture is not so clear from a theoretical viewpoint at least. Particularly when host countries are less advanced, the impact of FDI can be expected to be great, and not necessarily positive.

Positive effects

Foreign entry may increase competition in the domestic product market and benefit domestic consumers by lowering prices and by adding new product varieties to the market. In the factor market, increased competition is likely to increase wages and reduce unemployment. A foreign firm is likely to possess ideas and knowledge that differ from those of local firms, and can therefore be expected to add more to competition than entry by a domestic firm. Similarly, foreign firms are not likely to be part of local, informal business networks aimed at sustaining a situation of "gentlemanly competition." Foreign entry may therefore create more turbulence than domestic entry and thus have a stronger pro-competitive effect (Caves, 1971).

Job creation may take place not only in the foreign affiliates. Local suppliers of intermediate goods may enter the market and existing ones expand their output and employment in the face of increased demand for such products from the foreign entrant.

In less developed host countries, MNEs may also provide valuable services in assisting local firms to reach OECD markets with their products. Services include design, packaging, distribution, and financial services.

FDI may generate tax revenues to host governments, at least if the MNEs are not offered extensive tax holidays, and bring added supply of foreign currency, given that the foreign affiliates produce for international markets. In this way, FDI may reduce the "twin deficits" plaguing many countries in the world, namely the budget deficit and current account deficit. FDI may also stimulate economic growth by adding capital to the economy. Particularly in poor countries that may not have easy access to international credit markets, FDI may be an important source of capital accumulation.

The positive effect of FDI that has received the most attention in the literature is the potential for technological spillover effects. For most economies, MNEs are an important source of technology. Even though MNEs through FDI keep a stronger control over its technology, relative to say licensing agreements, there may be significant spillovers from MNE to local firms.

Spillovers may lead to a reduction in the home firms' production costs over time. Exactly how foreign entry affects local firm production costs is of course an empirical question, and a very difficult one to answer. Spillovers may be channeled via the labor market, as local workers are trained in the foreign firm and later take their acquired knowledge to domestic firms. For instance, there are several case studies demonstrating that MNEs train workers and managers who are later employed by local firms. In this case, FDI, i.e., the local presence of foreign production, may be a precondition for local learning.

Moreover, empirical evidence suggests that the spillover intensity from FDI may depend negatively on the technology gap between local and foreign firms (Blomström, 1986, Cantwell, 1989, Kokko et al., 1996). In order to learn from foreign firm technology, the

technology employed by the foreign firm must, so to speak, be within the reach of local firms. As an example, Kokko (1994) shows that there are few signs of spillovers in Mexican industries where the foreign affiliates have much higher productivity and larger market shares than local firms.

Finally, being exposed to (foreign) competition may force the domestic firm, which in the pre-liberalization enjoyed a protected monopoly position, to reduce organizational and technological inefficiencies, so-called X-inefficiencies. On the basis of a study of industry in six developing countries, Bergsman (1974) argues that internal inefficiency is several times as important as “external” inefficiencies caused by monopolistic pricing in the output market.

Negative effects

While FDI may increase competition in the host market, this is not necessarily the case. Moreover, increased competition need not be a positive thing for the host country. Regarding the first point, whether or not FDI leads to increased competition, we should note that the mode of entry is likely to be important. Entry in the form of an acquisition may simply be a change in ownership, for instance replacing one domestic monopolist with a foreign one. Clearly, consumers need not be affected by this kind of FDI. Indeed, if the foreign firm prior to the acquisition supplied the market through exports, the acquisition reduces the degree of competition in the host market and probably harms consumers.

Regarding the second point, namely that increased competition not necessarily is a good thing for the host country, note that any improvement in consumer surplus must be weighed against reduced profits for locally owned firms. Since MNEs generally operate in oligopolistic markets, there may be a

substantial potential for profit shifting due to foreign entry. Theoretically, at least, the loss in domestic profits may well dominate the gain for domestic consumers. In the extreme case of profit-shifting, the foreign entrant may act as a predator, eliminating local producers from the market.

Looking at the effects of MNEs on concentration in 46 Malaysian industries, Lall (1979) concluded that the presence of foreign firms tended to increase concentration. Similar results have been reported in Mexico (Kokko, 1994). The evidence therefore suggests that there is a larger risk that MNCs crowd out local firms in LDCs than in developed countries.

The danger that foreign firms may replace weak domestic firms is however, relevant also in the more developed parts of the world. It has been suggested that the entry of US firms in European markets has increased competition in the industries where local firms had some traditional technological strength, whereas local firms in other industries – and especially in countries where markets were too small to allow both kinds of firms to operate at efficient scale – were forced out of business or pushed to market segments that were ignored by the foreign MNEs (Cantwell, 1989).

There is also a danger that a foreign takeover will lead to a closing down of the local headquarters and R&D operations, concentrating these activities in the country of the parent firm. Such a move took place in connection with foreign takeovers in the Brazilian car industry (UNCTAD, 1999a: 40). The effect on the host economy may be negative, since R&D may have important spillovers to the rest of the economy.

Policy implications

What kind of FDI should a country try to attract, and what can the country do in order

to attract it? As we have seen above, FDI may generate both static and dynamic gains for the host economies. The static benefits of FDI include a reduction in macroeconomic imbalances such as unemployment, government budget deficits, and current account deficits, and improved resource allocation through increased competition in local markets. FDI may also generate long-run growth effects, by adding to the capital stock in the host economy, and in particular by adding to its stock of technology and know-how through spillovers.

The effect on competition is likely to be larger if the investment is in the form of a greenfield rather than acquisition, and if it is horizontal rather than vertical. The effect on job creation and the twin deficits is likely to be stronger if the foreign affiliate purchases a significant share of its intermediates locally, rather than through imports. Significant government income is conditioned on the MNEs not being granted generous tax holidays.

Technological spillovers are likely to be stronger if the foreign affiliate uses a technology that is somewhat more advanced than that of local firms, but where the technology gap is not too large. Spillovers are also likely to be more important the stronger are the linkages to the local economy. Linkages are likely to be more important the larger is the share of locally supplied intermediates, the larger is the share of skilled workers employed locally, and the closer geographically the foreign affiliates are to local firms.

Potential host country governments face a dilemma. In order to get the most out of a foreign affiliate, they may wish to place a number of conditions on FDI, including local joint venture partners, local content require-

ments, limits on expatriate personnel, compulsory licensing and other forms of mandatory technology transfers. Such restrictions on firms intended to encourage technology transfer may however backfire. Firms may simply choose not to invest in a country with numerous conditionalities tied to the investment, as the above mentioned case of Coca-Cola in India shows.

In practice, the bargaining power of host economies may be fairly limited. Given that MNEs can choose between a number of countries in which to invest, potential host countries may find themselves involved in an international tax competition situation, where countries overbid each other in terms of incentives to attract FDI. The result of such a “race to the bottom” may be that host countries gain very little from FDI. International investment agreements are probably required in order to reduce such problems.¹²

Perhaps the most important asset for a country, not only for attracting FDI but also for increasing the potential for economic growth, is a highly skilled and highly motivated labor force. Such an asset is attractive for firms irrespective of whether the aim of the investment is to supply the local market or international markets. Moreover, education policies may enhance the capacity to absorb foreign technologies once an investment has been made, thereby increasing the spillover effects to the local economy.

Regional integration provides foreign investors with access to a larger market and may service as a commitment to a set of liberal and business-friendly policies. This may spur increased investment from abroad. It should however be noted that regional integration also increases the attractiveness of neighboring countries that are also members of the

12. See for instance Oman (2000).

integration agreement. A lowering of trade costs between countries may lead to a relocation of industries, possibly resulting in a core-periphery outcome in which the core-countries attract both intra-regional and extra-regional investment, the periphery-countries ending up as losers from the integration process.

An important location advantage for a country in terms of attracting FDI (and, of course, for stimulating business in general), is a well-developed infrastructure. Good infrastructure, widely defined to include both physical infrastructure such as roads, ports, international airports, as well as institutional infrastructure including a well functioning and honest bureaucracy, reduces transaction costs and therefore increases the profitability of doing business in the country.

Macroeconomic stability is clearly an important factor determining a country's attractiveness for foreign investors. Blomström and Kokko (1997b: 38) conclude that for the MERCOSUR area, at least, "macro-economic stability appears to be a more important determinant of FDI inflows than is regional integration." Argentina, which is a much smaller economy than that of Brazil, experienced large inflows of FDI even before the effective implementation of the MERCOSUR agreement, largely due to macroeconomic reforms that brought down inflation and interest rates, and secured the convertibility of the local currency. Similarly, in Europe, while membership in the EU (then; EC) brought large increases of FDI to Spain and Portugal, Greece was marginalized in terms of FDI inflows, basically because its macroeconomic policies proved unattractive to foreign investors.

Many countries discriminate between vertical and horizontal FDI, promoting the former and discouraging the latter. Malaysia, for instance, has been very successful in

attracting firms to its Export Processing Zones. Such zones grant firms a number of advantages, including tax holidays, zero or low tariffs on imported intermediates, property rights over land, streamlined application procedures, etc. The country is however much more restrictive when it comes to allowing entry of multinationals wishing to service the local Malaysian market. For instance, there are local participation rules attached to market-seeking investments, including minimum domestic ownership shares and local management requirements.

Restrictions on horizontal FDI are understandable and can in certain cases be defended on economic grounds by reference to the problem of profit shifting, for instance in the form of the infant industry argument. But the implementation of such policies requires a great deal of knowledge about supply and demand in specific markets, knowledge that governments are not likely to have, and which can perhaps be obtained only at great cost. Moreover, given that market characteristics change over time, for instance due to technological progress, policies must change as well. This requires a degree of political autonomy and flexibility that governments typically do not have. For instance, the infant industry argument is an argument for a temporary protection of an industry. But given that such a policy has been introduced, special interest groups are likely to form to secure the continuation of the policy. The result could be a permanent protection of the industry, which might well reduce rather than increase the competitiveness of local firms.

Foreign firms in export processing zones typically have few links with the local economy, and the potential spillover effects may therefore be limited. Export-oriented investors are often less willing to establish links with local companies because of the need

for high quality inputs at competitive prices in order to compete in world markets.

This tendency is exacerbated by the fact that the host governments often promote sectors such as electronics in which there are no pre-existing indigenous capabilities and hence no potential local suppliers. In addition, of course, given the tax and tariff exemptions, there may be little tax revenues to collect from these MNEs. Thomsen (1999: 27), analyzing the case of the ASEAN4 countries, namely Indonesia, Malaysia, the Philippines, and Thailand, argues that the emphasis of host countries on export promotion is unwise:

Not only have exports been limited to a small number of products, usually intermediate ones, and sectors, the export sectors have also tended to be virtual foreign enclaves within host countries. They have often been characterized by low value-added (principally from labour-intensive assembly operations) and a poor record of technology transfers. Many of the most successful export sectors in the ASEAN4 are highly import dependent, and this has limited the impact of massive devaluations in these economies on exports. In some sectors, imports represent 80-90 percent of the value of exports. The high import dependence for MNE-related exports is symptomatic of the poor linkages between foreign affiliates and the local economy more generally. Poor linkages reduce the scope for technology transfers through FDI which could assist in local industrial upgrading. Arguably, the failure to upgrade production in light of greater competition in labour-intensive activities from China and Vietnam is one of the underlying structural problems which served to undermine confidence in the years preceding the crisis.

Concluding remarks

During the last two decades we have witnessed a radical increase in FDI. Most FDI flows take place between countries in the OECD area, but increasingly countries outside this area are hosting foreign owned production. Factors such as the size of the local market, the quality and price of local labor, the quality of physical and social infrastructure, and macroeconomic stability are important location advantages that may attract FDI.

It is evident that FDI may contribute greatly to the host economy. In Taiwan and Singapore, where educational standards and infrastructure are well developed, foreign investment has spawned many local suppliers, competitors and service firms, including independent indigenous enterprises that are highly successful in world markets and that have, in some cases, become multinationals themselves.

Foreign ownership is however not a precondition for economic growth. South Korea experienced rapid economic growth during the 1980s and until the financial crisis in the late 1990s, relying largely on domestic technology and domestic ownership. Korean entrepreneurs were encouraged to unbundle foreign packages of technology and adapt them to local conditions, a process known as reverse engineering. Moreover, Korean firms were guided by their foreign customers on designs and production and management techniques. Evidently, learning can take place through local R&D and contact with demanding customers, and does not require the local presence of multinational firms (Rhee et al, 1984).

Still, other countries relying on local capabilities, such as India, have not been as successful as South Korea in generating long term growth. The reason may be that successful implementation of protectionist policies requires a degree of political

autonomy and flexibility that most governments do not have. Policies that at the time of implementation may well have been sensible become locked in through the pressure of special interest groups, and over time become incompatible with economic growth and development.

Although the general attitude towards FDI today is very positive, foreign entry is not necessarily a blessing for the host country. Particularly if the host country is a less developed one, the impact of FDI may be great, both positive and negative. Foreign firms may be a lot more effective than local firms. If they compete on the same market, the foreign firm is likely to capture significant market shares from the local firms, possibly eliminating local firms altogether. Certainly, foreign firms may be a valuable source of technology to less advanced countries. But empirical research suggests that if the technological gap is too great, the ability of the local firms to learn much from its foreign competitor is limited. Following this reasoning, it may be beneficial for less advanced countries to expose their markets to firms which are not radically more advanced than themselves, which could be interpreted as an argument in favor of South-South integration.

Given the general wish to attract FDI, countries may start competing against each other in order to do so. Such competition need of course not be wasteful. For instance, improvements in infrastructure and educational programs that strengthen a country's locational advantages are productive investments. Other forms of competition are not productive, however. Tax competition may lead to a race to the bottom and undermine the governments' ability to perform important functions, such as the provision of health care and redistribution of income. There may be a need for international agreements on FDI

in order to avoid such tax competition, and to ensure that the benefits of FDI are shared fairly between the MNE and the host country.

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