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### **Multinational enterprises, development and globalisation: Some clarifications and a research agenda**

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# ***Multinational enterprises, development and globalisation: Some clarifications and a research agenda***

Rajneesh Narula and John H. Dunning<sup>1</sup>

## **Abstract**

This paper revisits an earlier contribution (Narula and Dunning 2000) and considers how economic globalisation has changed the nature of the MNE, MNE motivations, the MNE subsidiary and the modalities by which they interact with domestic economic actors. Most developing countries, however, have responded reactively. We discuss how the opportunities and challenges for developing countries in following an MNE-assisted development strategy have changed over the last decade.

The growing share of industrial activity owned and controlled by MNEs does not always result in a proportional increase in development effects, because individual MNE establishments have different potential for externalities. Concatenation is important: when stage-inappropriate MNE activities are established, crowding-out or regulatory capture is a likely outcome. We highlight the need for systematically linking MNE and industrial policies, but differently than in the import-substitution era. Attracting the ‘rights kind’ of MNE activity remains important, but the greater heterogeneity requires more customisation of policy tools. Lastly, we warn of the dangers of underestimating the social and political costs of structural adjustment and rapid institutional change associated with globalization.

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<sup>1</sup>Professor Dunning passed away on January 29<sup>th</sup> 2009. The final version of this paper was written after Professor Dunning’s demise, based on his comments on a previous draft. While I have tried to stay within the bounds of what he might have agreed with, I take full and sole responsibility for all errors and omissions. RN.



## ***Multinational enterprises, development and globalisation: Some clarifications and a research agenda***

### **1. Introduction**

In an earlier article published in *Oxford Development Studies* (Narula and Dunning 2000) we examined the changing realities associated with globalisation, and how these changes affected the limitations and opportunities for developing countries in a global economy where MNEs played an increasingly important role as catalysts, participants and instigators in development. We felt that the relationship between host country governments and MNEs in this new economic milieu remained an uneasy one, and that, by and large, less developed countries were in a weaker position vis-à-vis MNEs when (and if) they sought to implement an FDI-assisted development strategy. We also emphasised that the kinds of FDI a country received was at least as important as the quantity of FDI, and that the motivation of FDI was of crucial significance.

Over the last 10 years, globalisation has led to a rapid growth in MNE activity. MNEs have proactively sought to reorganise their activities, whether inter-firm or intra-firm; intra-border or cross-border, exploiting the opportunities that globalisation has made available. Host governments in the developing countries, on the other hand, can be said to have responded to this ‘new world’ in a more reactive fashion, if at all.

As with our earlier contribution, our aim is not to summarise or highlight trends in current affairs, which form – now as then - a background to our discussion. We use our earlier article as a lens with which to limit the span of our commentary; reviewing and addressing lacunae to our earlier arguments, and suggest a variety of avenues where further research will help advance the understanding of MNE-assisted development.

Utilising the investment development path (IDP) as a framework, we will revisit our discussion of the ‘right kinds of FDI’, and the role of policy. We will consider how economic globalisation has changed the nature of the MNE, the MNE subsidiary and the modalities by which they interact with economic actors and affect development. Our intention is to return to the issue at the heart of the matter – that of development, and the opportunities and challenges less developed countries may face in following an MNE-assisted development strategy. We seek to advance the understanding of the interaction between MNEs and development, and push the

research agenda to focus on the points of inflection in the growth trajectory of countries, and the role MNEs can play in this. We examine how policy in developing countries has evolved, and highlight how institutional inertia has meant that MNE policies and industrial policies still reflect the import substitution era, and how this needs to evolve if MNE assisted development needs to be promoted.

Section 2 revisits the theoretical basis for our discussion, and highlights how globalisation may have changed the nature of the IDP. Section 3 revisits the importance of policy in the IDP, a factor we neglected to cover in detail in our earlier paper. Section 4 discusses how MNE activity has become heterogeneous, while section 5 revisits the subject of motivation of MNE activity. Section 6 brings the discussion on the interactive aspects of MNE activity and development into focus. Section 7 discusses some conclusions and policy implications.

## **2. Revisiting the Investment Development Path**

The framework for our discussion is the investment development path (IDP) (see Narula and Dunning 2000, Dunning and Narula 1996, Narula 1996). The basic principles of the IDP can be summarised as follows:

- There is a systematic relationship between the structure, extent and nature of the FDI activities associated with a given location, and the economic structure of that location, which in turn, reflects its level of economic development;
- There is an interactive effect between three groups of advantages: The O advantages of domestic firms, the O advantages of MNEs and the L advantages of countries. This three-way dynamic interaction is the essence of MNE-assisted development;
- This relationship can be usefully analysed by categorising their evolution through five stages, and that *ceteris paribus* this stage wise progression can be observed in all countries, although the rate of change and points of inflection are unique to every country.

**\*\*\* FIGURE 1 about HERE\*\*\***

We will differentiate between two ‘versions’ of the IDP. These versions reflect to different modes of applicability, rather than a variation in its fundamental nature. The first ‘version’ is the graphical IDP (Figure 1). This was originally intended as an illustrative mechanism to emphasise

the systematic nature of the relationship between FDI and development, but has itself become the subject of empirical studies which utilise both time series of individual countries and cross-sectional analyses. The latter was intended *as a proxy* for the former, for a given country<sup>2</sup>. These analyses presume that the IDP provides a theoretical basis for predicting the optimum or appropriate levels of FDI for a given level of GDP. Studies that compare countries ignore the idiosyncratic nature of individual countries. Their economic structure and industrial and technological specialisation reflect exogenously determined characteristics such as size, population, geographic location, natural resource endowments and so forth. Each country follows a unique and individual IDP, and the stages through which it passes through are also unique and specific to itself, and to its IDP. Cross-country comparisons are only to be undertaken advisedly, providing little in the way of development implications as the stages are indicative rather categorical.

However, perhaps most importantly, to imply a predictive aspect to the IDP would be to presume a causal relationship between FDI and GDP, and as any student of econometrics will affirm, correlations do not imply causality. It is not entirely clear that there is a *direct* causality between FDI and development<sup>3</sup>. Indeed, we would go so far as saying that while a relationship exists between MNEs and development, this relationship ‘hides’ a very large ‘black box’ of intervening mechanisms and processes. Unless these intervening mechanisms between MNE activity and development are properly understood, all that can be said with certainty is that *the determinants of FDI are also the determinants of development*<sup>4</sup> (Narula 1996).

Indeed FDI is not essential for growth: Korea, Japan and (and to a lesser extent) Taiwan relied extensively on licensing, technology transfer agreements, imitation and other non-FDI

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<sup>2</sup> Although these analyses serve to illustrate important issues, the use of cross-sectional analysis and specific proxies (such as net outward investment (NOI), and GDP) that are used to test the IDP raise several methodological and measurement challenges. This misunderstanding derives from the error of focusing on the empirical demonstration of the IDP, the now-well-known graphical representation of the relationship between MNEs and development, using NOI and GDP as proxies. Variables such as NOI represents an aggregation of inward and outward FDI, which are themselves also aggregate variable across a variety of sectors and industries, both of which seek to proxy the intensity of MNE activity. Furthermore, all values in such analyses – with almost no exception – have utilised nominal values of FDI and GDP, and in the case of FDI, variously utilising stocks, flows, sum-of-flows, and average flows as substitutes, a practice for which very little empirical evidence exists. Much the same can be said about the dangers of GDP as a proxy for development.

<sup>3</sup> See e.g., Chowdhury and Mavrotas (2006), Hansen and Rand (2006)

<sup>4</sup> One might even suggest that multinational activity is merely concatenated with host country growth, rather than being responsible for such growth. In other words, multinational activity may represent a placebo effect, indicative of improving domestic activity rather than being the most important cause of it. However, it is not our intention to investigate this possibility.

based modalities to catch-up, the common element being the use of foreign knowledge sources (which may be tied to MNEs in general), rather than FDI. Large amounts of FDI to resource-rich economies have not always resulted in much more than marginal industrial development<sup>5</sup>, nor do high levels of FDI sustain industrial development equally efficiently in different stages. We propose later in this paper that it is more relevant to move to MNE activities as the unit of analysis.

However, we want to make clear that we are not postulating that FDI (or MNE) activity *per se* does not play a role in development. We are simply emphasizing that MNE (or FDI) activity is not a *conditio sine qua non* for development (Lall and Narula 2004). Instead the link between MNEs and development is an indirect one: Where inward MNE activity results in positive externalities, and *when* domestic firms have the capacity to usefully internalize these externalities, and *if* the non-firm sector supports domestic capacity building, there will be industrial development. The alleged growth of outward MNE activity from developing countries also raises similar concerns: outward MNE activity does not necessarily imply reverse knowledge transfer between (or indeed systematic links with) the foreign operations and the home country, or indeed that these knowledge flows will have a non-negligible effect on the home country.

The more normative aspects of our earlier contribution addressed the quality and extent of the externalities due to these activities, and we postulated that this depends on the motivation of MNE activity, which is itself dependent on the kinds of L advantages available to them. Even where the ‘right kinds’ of MNE activity are located in the host country, the O advantages of domestic firms need to have the necessary absorptive capability to benefit from them.

The second ‘version’ of the IDP provides a framework within which to analyse development and the MNE<sup>6</sup>: the interactive relationship between the O advantages of firms and the L advantages of countries and how each provides the potential to instigate changes in the other, whether seen at a country, industry or firm level. This approach is succinctly summarised in Table 1. It provides the background within which we can ask: what forces and interactions determine the turning points of a country’s investment development path? Why do some countries demonstrate a positive cumulative causation between MNEs and development in

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<sup>5</sup> Although there may be growth in GDP, such growth does not imply industrial development.

<sup>6</sup> See e.g. Barry et al (2003), Liu et al (2005), Galan et al (2007).



certain industries, yet fail in this regard in others? The considerable empirical evidence on the role of MNE in fostering growth does not offer any firm guide on these mechanisms. Some of these gaps in our understanding – for instance, the extent to which FDI spillovers are internalized by domestic firms – may well reflect methodological weaknesses, *inter alia*, to do with the use of the total factor productivity and the production function model, as well as the problems in measuring technology, knowledge and learning with some of the popular proxies used (Rasiah 2008). Others may derive from the difficulties of aggregating effects on the level of the firm and industry, since spillovers may accrue to actors external to formally organized firms and sectors. Furthermore, economies may also have peculiar inter-industry relationships and interdependencies, some of which may lie in the informal sector.

**\*\*\*TABLE 1 ABOUT HERE\*\*\***

The MNEs and development literature has matured to the point that there are some clear certainties. We know that fostering appropriate domestic capabilities in an appropriate sequence can create the conditions to benefit from knowledge flows within an economy, and between economies. Such knowledge flows can be engendered in MNE activity, or with arms-length actors or quasi-hierarchical mechanisms such as alliances. Growth in earlier stages depends upon the assimilation and adaptation of more mature knowledge assets in sectors where absorptive capacities have been concurrently developed, and that the technology gap not be too large. Establishing the conditions for adaptation and assimilation of these knowledge flows which may be embodied in human capital, equipment (or indeed organisations), requires systematic coordination through industrial policy. The level and nature of industrial policy intervention varies both by the stage of the IDP, as well as the kinds of MNE-related development strategies that the country may have focused on. The strength or weakness of institutions shape the ability of domestic firms to exploit MNE-generated externalities efficiently. Some take a systems perspective to an economy, which subsumes the institutions view - that the efficiency of economic actors depends on how much and how efficiently they interact amongst themselves. (Fagerberg and Srohlec 2007, Criscuolo and Narula 2008). Others have directed their attention to understanding the concept of absorptive capacity as a basis to explain the success or failure of MNE-assisted development.

Considerably less is known about the points of inflection. Much of the research points to important threshold levels (of absorptive capacities/human capital/infrastructure, etc) without which countries fail to ‘take off’. It is an essential aspect of the IDP, since it consists of an interaction between development and outward MNE activity, and between development and inward MNE activity, two separate but concatenated processes that themselves have associations. The IDP thus has many such points which need to be more clearly identified and their implications understood. It is unclear (for instance) what threshold level of L advantages is necessary to begin to attract the right kinds of FDI that promote growth in stage 1 countries. Or why Malaysia has thus far failed to progress towards being home to significant outward MNE activity, despite high growth rates, high levels of inward FDI activity and a vibrant domestic sector. It is in the search to provide more detail of these processes, or at the very least, to provide greater richness to the framework to understand these turning points that forms part of the motivation behind the current paper.

It is important to highlight that while much of the work on the IDP focuses on the country level, learning and absorption take place at the firm level. However, the success or failure of individual firms occurs in orchestration with an entire “system”. Innovation and learning involve complex interactions between a firm and its environment. The environment consists firstly of interactions between firms especially between a firm and its network of customers and suppliers. Secondly, the environment involves broader factors shaping the behaviour of firms: the social and perhaps cultural context; the institutional and organizational framework; infrastructures; the processes which create and distribute scientific knowledge, and so on. Thus, the appropriate level of analysis to understand the effects of MNEs on development may not necessarily be that of the country, but the industry. Aggregation to a national level can lead to obfuscation of important trends (see Duran and Ubeda 2001, Bellak 2001, who undertake an analysis of the IDP at the industry level).

## **2.1 Supra-national regions, countries or regions within countries?**

The IDP is not just restricted to understanding MNEs and development and a country level, but also regions within countries: indeed, it may be more relevant at a disaggregated level<sup>7</sup>. Large

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<sup>7</sup> See e.g., Zhang and Bulcke (1996)

differences exist in the developmental levels of regions within given countries, and this disparity is naturally reflected in the quality of L advantages on offer to MNEs. China provides an excellent illustration of this. The distribution of FDI inflows to its three macro-regions remains very uneven with the highest concentration on the coastal region, with the vast central (both in terms of land area and population) and western regions having only lured a small amount of FDI<sup>8</sup>. The coastal region has essentially been converging with the world economy, while the central region and western region have been diverging in relative terms<sup>9</sup>.

Thus, despite close geographical proximity, sub-regions within a country can therefore exhibit vastly different L advantages. It is therefore not inconceivable that a given nation state can exhibit industrial development patterns, MNE activities and policies reminiscent of *inter alia* both a stage 1 location and a stage 3 location simultaneously and evolve in parallel, but independently so. Situations such as this may explain why (as some commentators have suggested) countries are seen to ‘jump’ stages (Mathews 2006), and leapfrog, enjoying the advantages of being newcomers and latecomers, engaged in labour intensive, Smithian industries as well as Schumpeterian sectors. Many developing countries demonstrate a dual (or even multiple) economy, and *inter alia*, help explain why attention has been drawn to the cases of China and India where pockets of world-class competence in extremely advanced knowledge-intensive sectors have grown rather rapidly, cheek-by-jowl with agrarian and labour intensive sectors, more typical of a developing country in stage 1 or 2. Globalisation has made markets for technologies more efficient (albeit those that are some distance away from the technological frontier). Thus where regions or countries possess the relevant absorptive capacities, sector-specific industrial catch-up is potentially possible. However, such strategies require considerable complementary investments and large amounts of capital and planning – and are by no means always successful.

Another feature of globalisation has been the increasing interdependence between nation states and the fuzziness of borders. Nation states experience increasingly ‘fuzzy’ policy boundaries because policy space is limited by other non-national economic actors (whether other countries, or by international and supranational organisations). Obviously, there is considerable variation in the extent to which countries are so affected, and roughly speaking, the stage of the

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<sup>8</sup> Among the all registered FDI by the end of 2004, the coastal region had 87.8%, the central region had 8.3% and the western region 3.9%.

<sup>9</sup> On a GDP per capita basis, Shanghai was US\$ 5280, 10 times greater than that of Guizhou Province in 2004.

IDP reflects the extent to which they are integrated into the world economy, and to which non-national institutions, and knowledge sources affect them. To some extent, the extent to which countries are peripheral to the core is reflected in their stage of the IDP. Peripheral economies (such as stage 1 countries) are those which play an insignificant role as either host or home to MNEs; engage in relatively little trade in intermediate and manufactured goods; contribute relatively little to innovation and scientific progress; that are weakly linked or accessible physically to the core; do not play a significant role in decision making within supranational organizations; and do not share a significant number of formal institutions with the core countries (Benito and Narula 2008). Globalization implies *de facto* economic, political and social integration, thereby creating a longer term interdependence between countries and firms that are so interconnected, but interdependence implies reciprocity. Countries for whom reciprocity is 'unequal' demonstrate fewer cross-border effects of globalisation on policy.

Regional integration is an important accessorial development to globalisation, and has a similar effect on limiting policy space, as well as potentially improving its L advantages. Regional integration schemes also represent an opportunity to redress the inequities of multilateral agreements, and to increase their autonomy from outside forces. Both regional integration and globalisation are processes closely associated with cross-border economic activity, although globalisation is more a consequence of increased cross-border activity, while regional integration is intended to *cause* it (Dunning and Narula 2004).

Regional integration can also play a significant role in changing the milieu for learning, MNE linkages, and general cross-border knowledge flows. The effect of regional integration can strengthen the L advantages of countries and can be crucial in determining the efficiency with which knowledge is acquired, created, diffused and utilised. In deeper integration schemes, rules established at the supranational level can supersede national regulatory frameworks, and membership itself becomes a significant L advantage. They can also act to constrain policy space: international treaties such as WTO agreements also shape policy tools available to countries.

### **3. Revisiting policy orientation as a force in development**

It is necessary to distinguish between policy orientations in somewhat greater detail in understanding the IDP, particularly with regards to developing and upgrading domestic

competitiveness, and this needs to be done in a historical context. Previous policy orientations will have shaped the way in which economic activity is organised, and there is considerable consequent inertia and path dependence in economic structure, which often limits the efficacy of current policy. Despite an ostensibly greater openness to inward FDI, countries that had hitherto restricted inward FDI flows continue to show attenuated inward MNE activity, such as Japan, Korea, and India. Our earlier work distinguished amongst economies using a dichotomy of an outward-oriented, export-oriented policy orientation (OL-EO), or an inward-looking, import-substituting orientation (IL-IS), which in hindsight seemed an oversimplification. Policy orientation plays a significant role in hindering or promoting MNE activity. This dichotomy also presumed no explicit strategy towards MNEs, but emphasised trade policies.

We propose that there is both a considerably greater overlap in how policy has historically been implemented, reflecting the fact that most countries' policies derived at some level from the more generic import-substitution model. At the same time, important variations in the political, sociological and economic milieu have affected MNE and development strategies, and continues to affect trajectories today.

At the risk of oversimplifying a complex set of developments<sup>10</sup>, import substitution (IS) was intended to capture the rents that derived to the developed economies from value adding to the primary commodities imported from the south. The implementation of IS generally involved a high degree of central planning, combined with protection. Protection was undertaken through tariffs, exchange rate manipulation, quotas and exchange controls. Although one of the main objectives was to decrease manufactured imports, the net effect was also to discourage exports, in both manufacturing and agriculture, *inter alia*, because of overvalued exchange rates. Domestic industry was to be developed by seeking capital and technology from abroad, since it was largely accepted at the time that physical capital and know-how could be transferred relatively easily through the flow of aid, turn-key projects and the provision of technical experts from the north to the south.

The role of MNEs was seen as a means to actualise the process of technology transfer. Investments in most countries were permitted in targeted sectors with the explicit understanding that control, ownership and technology would gradually transfer to the domestic sector. In

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<sup>10</sup> See Bruton (1998) for a thorough overview.

addition, intermediate inputs were to be phased out as domestic suppliers acquired the competence to meet the (graduated and increasing) local content stipulations that were generally included in the investment agreements. FDI was largely undertaken with the intention of supplying the local market. Captive markets meant that MNEs were able to pass on the costs of producing at an inefficient scale. A considerable share of productive assets was in state ownership, either as a part of the belief in central planning, or to support large capital intensive and scale-intensive projects which the private sector could not afford.

IS policies led to economic growth in most developing countries although the anticipated growth of domestic manufacturing did not go quite as planned. This in part reflected the application of broadly similar IS programmes, despite the considerable differences in the initial economic structure and industrial development. IS schemes sought to duplicate the same breadth of industrial sectors regardless of their initial specialisation and resource endowment.

Although it is often assumed that the East Asian economies pursued a OL-EO approach, the majority of East Asian economies also implemented similar infant industry programs in the 1950s, discouraging foreign ownership when possible, and encouraging the development of domestic enterprise in much the same way as had Latin American, African and South Asian countries. While maintaining the basic objective of building up domestic manufacturing capacity, Taiwan modified its import substituting regime in the late 1950s, and Korea followed suit in the mid-1960s, seeking to encourage exports *alongside the primary goal of building domestic industrial capacity*. These included establishing a realistic exchange rate, and creating incentives to export (including subsidies, credit allocation, trade restrictions, and reduced or duty free access for imported inputs). Singapore went much further, dropping IS policies almost completely around the same time. Later, Malaysia, Thailand, began to move toward a greater export orientation and friendliness towards FDI from the late 1970s onwards, although still maintaining a strong orientation towards building domestic capacity. They were later followed by Indonesia, Philippines, China, India and eventually most of Asia, Africa and Latin America. The point here is that all these countries pursued industrial policies that maintained significant elements of IS regimes until (and in some cases, beyond) the 1990s.

Thus, while it is possible to say that the East Asian countries adopted a *more* outward-looking, export-oriented policy orientation at a much earlier period in time. Almost all actively sought to intervene to support the growth and competitiveness of their domestic sector, alongside

their export-orientation<sup>11</sup>. This was done through a variety of means, both by promoting domestic sectors as well as restricting imports. East Asia can therefore be said to have been both *export oriented and import-substituting (EO-IS) at the same time*.

Applying Lall's (1992, 1996) taxonomy, three distinct approaches towards MNEs can be discerned. The first is the *EO-IS Autonomous strategy*, where selective restrictions on FDI, and the use of technology imports (in the case of Korea) was used as a means to promote domestic development. China's approach in the 1980s and early 1990s also followed this model, and to some extent, that of Brazil a decade before that. The second is the *OL-EO Strategic FDI dependent strategy*. This strategy is best exemplified by Singapore, as well as new EU member states such as Czech Republic and Slovakia. The goal is not to focus explicitly on promoting a large domestic industrial base, but to attract and embed MNE activity, making strong efforts to upgrade the quality of FDI towards higher value-adding activities. The third is the *OL-EO Passive FDI dependent strategy*. In this model, FDI is also the primary driver, but instead of intervening to encourage upgrading (as with strategic FDI dependent strategy), it relies on market forces to encourage the upgrading process. Although policies to encourage the development of 'generic' location advantages may be implemented (such as infrastructure development, incentives for exports, skilled cheap labour), the development of complementary domestic industrial capacity are not developed in tandem with FDI upgrading.

The large scale liberalisation of the economies of most developing countries since the mid 1980s saw a massive shift away from import substitution, but at different rates and with varying degrees of enthusiasm. In many cases their prior orientations are still evident in their IDPs. For instance, Latin America did not voluntarily move towards an outward orientation, but was pressured into structural adjustment programmes due to economic crises in the 1980s. The restructuring entailed large-scale privatisation of public sector activities, rapid dismantling of import and FDI restrictions, and the termination or attenuation of state incentives and public goods aimed at enhancing the competitiveness of domestic firms.

Thus, the IS programmes (as originally conceived) shared much in common with the autonomous strategy of Korea and Taiwan, except that in the Asian economies strong state intervention was more clearly targeted and coordinated to enhance domestic technological capabilities and competitiveness, while at the same time emphasising international markets as a

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<sup>11</sup> For a discussion of these policies see Amsden (2001) and Lall (1996).

benchmark. Subsequent restructuring strategies that have taken a largely passive FDI dependent policy went to the other extreme: they emphasised international markets and export competitiveness, *but withdrew the support structure that allowed firms to internalise the positive externalities that derived from international competition.*

Inefficient institutions can retard the efficient accumulation and transfer of knowledge between industrial enterprises and other economic actors within their milieu, influencing growth in general (e.g., Rodrik, et. al. 2004; Lall and Narula 2004; Meyer and Peng, 2005; Asiedu 2006). A fundamental shift from one political and/or economic regime or policy stance can represent a discontinuity or ‘shock’ to the system, and this can play havoc with both formal and informal institutions. There is often a strong institutional inertia which must be overcome, whether this shift is as fundamental as experienced by the former centrally planned economies during their transition, or from an import-substituting stance to a more open, export-oriented one, as experienced by many developing countries, the difference being only one of degree (Neuber 1993, Narula and Jormanainen 2008).

Inertia can be a pervasive phenomenon at the level of a whole economy, because often there is a self-reinforcing interaction between industrial enterprises, the infrastructure and politics which perpetuates the use of specific technologies, production of specific products, and/or through specific processes, and specific customer-supplier associations. Institutional restructuring is not an instantaneous or costless process and results in inefficient outcomes, since actors in the system are obliged to alter their *raison d’etre*. Institutions developed for, or specialised around, a particular economic system are not efficient in responding to the needs of another. In the case of the import-substituting countries, institutional inertia was often associated with selected industries built around national champions.

The sudden exposure of these economies to the vagaries of international competition has not necessarily facilitated their institutional restructuring. Liberalisation in developing countries did not always take place gradually, requiring a multilateral view by governments on hitherto-domestic issues. Institutional inertia in most cases has meant that countries have been quick to see the costs of globalisation (principally the erosion of economic [and political] sovereignty and the sterility of policies and attitudes associated with import substitution) as outweighing the benefits associated with it. Although by the mid-2000s, many countries had largely overcome institutional inertia, it continues to shape the ‘flavour’ of policies. National champions and



interest groups dominant in the IS era continue to hold sway; a suspicion of MNEs continues to limit access in certain sectors.

The policy orientation matters because without a clear industrial policy that is systematically integrated with FDI strategies will result in sub-optimal sustainable industrial growth opportunities. The current OL-EO passive FDI dependent strategy differs from the strategic FDI dependent strategy (as well as the IL-EO autonomous strategy) in several important respects, but especially because it underestimates the costs and the difficulties of internalising technological spillovers. Perhaps most significantly, however, is the failure to implement reciprocal control mechanisms and international competition to target competitiveness against international norms, which export-orientation allowed the East Asian economies to do. Countries such as Brazil that targeted international markets in certain industries, achieved similar levels of technological competitiveness to the Asian countries in certain areas (Amsden 2001). While the 'new' OL-EO model has helped correct many inefficiencies, *inter alia*, improving important macro-economic fundamentals, and reduced the excessive role of the state in domestic industrial activity, it has also led to a rapid and overzealous reduction in the state's involvement in the provision of public and quasi public goods which are necessary conditions for industrial development (Katz 2001).

## **4. Heterogeneity in MNE activity**

### **4.1 Moving away from FDI and towards MNEs**

Although there is a tendency to associate the control and coordination of an MNE's international operations with majority owned foreign affiliates (which is undertaken through FDI), both control and coordination may be achieved through a minority ownership, and in some cases through non-equity means. Historically, FDI and MNE activity have been synonymous, partly a reflection of the way in which most international and national agencies that maintain and collect data on MNE activity. Although FDI remains one of the main modes by which MNEs engage in cross-border value adding activities, the MNE may also control and engage in value adding activities through non-equity means, such as through cooperative agreements and outsourcing, sometimes without *de jure* ownership of the productive assets, but *de facto* controlling the

operations of the non-affiliated operation. Therefore, the use of the term ‘MNE’ as a synonym for FDI is increasingly inaccurate (Wilkins 2001).

The nature, structure and organization of the MNE has changed markedly over the last 40 years, and especially so over the last decade. A more current definition of an MNE is a firm requires the emphasis on the nature of the interdependencies between the various operations in different locations, their active coordination and control across borders, and away from the ownership structure. As we shall discuss in later sections, this has significant implications for development.

We have noted elsewhere the importance of alliance capitalism, which implies that the favoured modes of cross-border value adding activity have begun to shift away from an emphasis on hierarchies towards a richer variety of organizational modes (Dunning and Lundan 2008). This has occurred along with a systematic shift in certain sectors and a variety of industries away from the vertically integrated firm. The improved enforceability of contracts and declining transaction and monitoring costs resulting from developments associated with globalisation have made it easier for firms of all sizes to monitor, identify and establish collaborative ventures than previously had been the case (Narula 2003). In other words, hierarchical control and full internalisation is no longer always a first-best option to MNEs. Even where this is so, full internalisation may simply not be a choice available to the MNE (Dunning and Narula 2004). This has implications for our understanding of the potential for non-internalised means of MNE activity to affect industrial development, a matter we shall be taking up in greater detail in a later section of this paper.

The benefits that might accrue are primarily associated with the linkages between the MNE affiliate and domestic actors that provide knowledge spillovers. These may be domestic linkages (with knowledge flows between the affiliate and other actors in the domestic economy, depending upon the extent to which the affiliate is embedded), or they may be linkages between foreign sources of knowledge and affiliate. Although the FDI literature also addresses channels for knowledge spillovers, when the discussion to the level of the MNE, a richer variety of channels presents itself, although not all of which may benefit the host milieu.

\*\*\*\*FIGURE 2 ABOUT HERE\*\*\*\*

Figure 2 illustrates a two-country scenario of a joint venture between an MNE and a domestic firm. With FDI as the unit of analysis, only the organisations linked with the block arrows matter, as these involve equity relationships. However, with the MNE as the unit of analysis, a variety of other means to engage in knowledge exchange can be included. For instance, technology may be licensed or purchased by the MNE affiliate from unaffiliated public research organisations either abroad or based locally. A second set of linkages are active two-way collaborations (indicated in figure 2 by the dashed lines which may involve a large array of actors, both domestic and foreign. Such agreements represent a higher level of knowledge exchange, and may be undertaken with a variety of partners. In general, these non-equity linkages present considerable potential to increase knowledge flows and the potential technological competitiveness of domestic firms, as it creates important new sources of demand for commercially driven economic units engaged in R&D. Of course, as we discuss later, MNEs are reluctant to develop knowledge-intensive linkages with new and untested partners, but they point to the *potential* for important knowledge flows, assuming the local milieu possesses the appropriate quality of location-specific advantages in terms of infrastructure, human capital and public-sector actors.

It is worth mentioning that knowledge flows and linkages can also be associated with second and even third level suppliers to an MNE, as well as helping these firms with establishing partnerships with other non-related economic actors. Yeung et al (2006) point to important network effects for firms not directly related to the lead MNE in a cluster, and its role in creating non-cluster external economies for its suppliers.

## **4.2 Refocusing analysis on the role of subsidiaries**

It has largely been assumed that the nature of the MNE affiliate and its potential for spillovers and the creation of domestic linkages is somehow reflected in the nature of the parent firm's operation as a whole, both in terms of its industry-specific characteristics, as well as the kinds of ownership advantages it possesses and the nature of location advantages it seeks to utilise in conjunction with these O advantages.

Different kinds of subsidiaries will provide different kinds of potential linkage and spillover effects (Cantwell and Mudambi 2000, Marin and Bell 2006, Jindra et al 2009). There are at least two reasons for this. First, because the O advantages of a subsidiary are not necessarily a subset of its parent (Birkinshaw 1996). In addition to the transfer of assets from the

parent to the subsidiary, the subsidiary also evolves its own set of managerial and technological capabilities which may either be as a response to location specific characteristics (such as peculiarities in supply conditions, or location specific demand), or because the subsidiary has evolved independently of the parent firm (either because the subsidiary is an acquisition, or because the MNE's strategy is based on a 'federal' model of freestanding and largely autonomous country affiliates, as may also be expected with a firm that engages in a multi-domestic strategy). As a result, such multinationals tend to be organised as a loosely coupled network of relatively autonomous subsidiaries, each with its own strategic goals and activities (Astley and Zajac 1990, Birkinshaw 2002). Even where the MNE operates as a tightly coupled organization with a high degree of interdependence and coordination between subsidiaries (Astley and Zajac 1991), the affiliate in question may possess affiliate-specific O advantages. Each affiliate can evolve its own profile of capabilities, which may overlap with that of the headquarters, but the extent of the overlap is a function of country- and subsidiary- specific path dependency (Birkinshaw and Hood 1998). In other words, the subsidiary itself may provide unique, subsidiary-specific spillovers to the domestic economy, and for this reason its strategic decisions in terms of sourcing and linkages may differ from that of a sister subsidiary in another host location, not just that of its headquarters.

Second, the decision to interface with the local economy is not entirely a subsidiary level decision, particularly with more tightly coupled organisations. Thus, there are dangers of taking a purely subsidiary-level view when drawing policy decisions, without taking into account the manner in which the subsidiary's strategy interfaces with that of the overall parent MNE strategy (Papanastassiou and Pearce 2009). The extent to which strategic decision making resides with the subsidiary relative to the headquarters is an important one. There are competing forces that require national responsiveness of subsidiaries and those that require subsidiaries' global integration with the umbrella of the MNE's overall structure. When national responsiveness of a subsidiary is important because local market or industry-specific conditions require greater response to individual host country circumstances, they exert more decision-making autonomy within the overall MNE setup. When there are considerable gains in terms of cross-border coordination, and industry-specific characteristics allow for greater standardisation, subsidiaries are afforded limited autonomy.

The two forces here – the extent to which subsidiaries possess unique and potentially valuable subsidiary-specific ownership advantages, and the extent to which the subsidiary is autonomous in its decision making - are of course closely linked. The subsidiary's bargaining power vis-à-vis the HQ are greatly enhanced where a given subsidiary is a net contributor towards the MNEs overall knowledge capabilities, and is therefore able to exert not just greater autonomy on its own activities in its host location<sup>12</sup>, but also upon the entire MNE.

One might argue that the 'ideal' situation would be to host subsidiaries that are both deeply integrated within the MNE network (and thus of signal importance to the MNE as a whole) as well as deeply integrated into the host milieu (which implies considerable linkages with the host economy) (Young and Tavares 2004, Costa and Phillipov 2008).

Few developing countries are in such a position. They are often host to the most truncated affiliates possible with very little value-adding, and besides their governments do not have the bargaining power vis-à-vis MNEs to demand such concessions<sup>13</sup>. There are exceptional circumstances where this may be the case. For instance, in the case of affiliates acquired to internalize specific proprietary assets, and whose O advantages were location-bound to some extent (and therefore hard to duplicate or relocate elsewhere). Also, where affiliates have a long history in a given location and are therefore highly embedded. The cost of realigning its supplier base may greatly outweigh the benefits of integrating it more closely to the rest of the MNE. There are also subsidiaries in sectors where natural barriers to trade require a multi-domestic strategy. In other cases, tariff and non-tariff barriers in the past may have induced such a stance. Lastly, and in relatively few instances, there may be government intervention, where embeddedness has been a condition for their establishment (as in the case of e.g., China).

It is important to note that while the literature on FDI and development focuses largely on spillovers and linkages there are a number of other possible benefits that may be derive from MNE activity. However, in terms of learning potential, these are the most significant. Therefore, attracting MNEs without considering the potential for linkage creation is short-sighted. MNEs seek well-established *existing* location advantages, and the initial scale of entry will tend to be small both in size, the scope and competence levels tend to match the *existing* capacity of the

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<sup>12</sup>Although some research indicates that subsidiaries with greater than average competence levels are able to exert higher levels of autonomy (Pearce, 1999; Taggart & Hood, 1999); others have argued that because of the strategic importance of such a subsidiary, the HQ will attempt to exert tighter control (Martinez & Jarillo 1991).

<sup>13</sup> Indeed, Iguchi (2008) notes that even in country such as Malaysia, linkages are rarely established because of government programmes.

innovation system, and the *existing* potential for backward linkages. This, in the case of most developing countries (and particularly in stage 1 countries) is often modest. The bulk of their higher value adding operations tend to be based in countries with the appropriate non-generic specialised L advantages— usually a handful of advanced Stage 4 and 5 countries, and an even smaller group of stage 3 economies. Attracting more strategic R&D activities to developing economies is especially difficult. MNEs tend to display a strong inertia towards maintaining their R&D activities in a few (carefully selected) locations (Narula 2002). Of course, operations of less strategic significance within the MNE may not be subject to such high levels of inertia, but it is safe to say that the greater the strategic importance of the activities planned in a given location, the greater the cost to the MNE of a ‘wrong’ decision, both from an economic and strategic perspective, and thus the greater the forethought in such investments, and the greater the locational inertia and bias towards proven and existing locations.

Locational inertia works both ways: Just as it is difficult to persuade MNEs to establish operations in a *de novo* location, once a threshold level of activity and embeddedness is achieved, the MNE is less likely to be footloose, and its presence in a given location acts as an important signal to other potential entrants. For instance, Intel’s entry in Cost Rica acted as a signal to other firms, and not just to those firms within the same sector (Mytelka and Barclay 2006).

It is also worth noting that there is considerable path dependence in the type of subsidiary based in a given location. Prior to economic liberalization, MNEs responded to investment opportunities primarily by establishing miniature replicas of their facilities at home, although the extent to which they are truncated varied considerably between countries (Dunning and Narula 2004). Few MNEs still utilise miniature replicas when engaging in greenfield investments. Rationalisation of activities with an efficiency-seeking objective has, in many cases, led to a downgrading of activities from truncated replica to single activity affiliates. MNEs have taken advantage of liberalisation to rationalize production capacity in fewer locations to exploit economies of scale at the plant level, especially where local consumption patterns are not radically different to justify local capacity and where transportation costs are not prohibitive. This has meant that some miniature replicas have been downgraded to sales and marketing affiliates, which can be expected to have fewer opportunities for spillovers. MNE activities has seen a downgrading in terms of both scope and competence, moving towards sales and

marketing operations, although some – rather few – locations (and once again, countries such as India, China, and South Africa) have seen an increase in the scope or competence levels. As MNEs have used complex networks, this has by and large been to the benefit of the MNE, while most host countries with generic location advantages have seen a decline in scale, scope and competence. The benefit from subsidiaries in terms of linkages and spillovers varies considerably and is not always reflective in its sales, employment or flows of FDI. A sales office or an assembly unit may have a high turnover, employ a large staff, but the technological spillovers will be relatively fewer than, a manufacturing facility. Countries that are at an early stage of the IDP, with a very limited domestic sector and a poorly defined innovation system are often host to single-activity subsidiaries, primarily in sales and marketing, as well as natural resource extraction. The most advanced economies with domestic technological capacity have hosted the least truncated subsidiaries, often with R&D departments.

It is only in those sectors where ‘specialized’ location advantages associated with higher value adding exist can host countries benefit significantly from MNE activity in the long run. This requires a considerable amount of government interaction and investment into tangible and intangible infrastructure, and for which there is a certain threshold level of investment in building up absorptive capacities required for ‘take-off’. As countries reach a threshold level of technological capabilities, governments need to provide more active support through macro-organizational policies. This implies developing and fostering specific industries and technological trajectories, such that the location advantages they offer are less ‘generic’ and more specific, highly immobile and such that they encourage mobile investments to be locked into these assets.

In general, government incentives and subsidies have proven to be rarely pivotal in determining the scope and competence of MNEs (which normally imply greater potential for greater technological spillovers). We want to emphasise that even if FDI were attracted through large subsidies it is unlikely to become embedded, or provide significant externalities and spillovers to the host economy without the appropriate domestic absorptive capacity (Criscuolo and Narula 2008). From a growth and learning perspective, externalities only matter if they can be captured by other economic actors in the host economy. For externalities to be optimally

utilised there needs to be an appropriate match between the nature of potential externalities and the absorptive capacities of domestic firms.

It is worth noting that the discussion on MNE-assisted development continues to focus excessively on the attraction of new (initial) MNE affiliate establishments and its associated mode of entry. From a development perspective, this ignores the fact that any given affiliate is itself in the process of its own internal dynamics (as discussed earlier). The nature of its activities also relies on a dynamic between the MNE's value adding operations and the changing L advantages of the host location over time.

There is a considerable literature on the individual MNE's choice of mode of entry (see Meyer et al 2009). We know that MNEs may be more likely to transfer sophisticated technologies and management techniques to their wholly owned subsidiaries than to partially owned affiliates (Javorcik and Saggi 2004). Nonetheless, the extent of the spillovers and linkages are not always determined *ex ante*. It is largely accepted that the benefits of MNE activities accrue most often where the affiliate is embedded in the local milieu, and *ceteris paribus*, initial greenfield investments – no matter how large the initial investment might have been – does not become immediately deeply embedded into the host economy, but becomes develops linkages slowly, and over time<sup>14</sup>. Increased embeddedness implies increased linkages, and thus sequential investments strongly suggest greater potential for development. The initial investment represents a tentative 'bet' by the MNE on the quality of a host's L advantages. The nature of inertia is such that it is easier to persuade those that already have sunk costs in facilities to expand them (assuming positive returns<sup>15</sup> to the MNE and constant or improving L advantages), than to seek to attract a new Greenfield investment. Thus, investments that take place several years after the initial investment may be more beneficial in terms of spillovers and linkages (Filippov and Costa 2008).

## 5. Revisiting the motivation of MNE activity

Table 2 lists how motives of FDI have evolved between the 1970s and the early 2000s. Cross-border organization structures were simple, and motivations for specific subsidiaries tended to be overwhelmingly resource seeking or market-seeking, with a minority of MNEs engaged in

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<sup>14</sup> This bias is reflected in the inordinate attention given to FDI flows, rather than FDI stocks by the financial press as well as policymakers, the underlying assumption perhaps being that capital formation is about capital *per se*.

<sup>15</sup> Iguchi (2008) finds that subsidiaries' are more likely to create backward linkages with the host economy when the affiliate is seen to yield positive returns.



efficiency-seeking or strategic asset-seeking activities. The emphasis has shifted considerably over the last 30 years, in that MNEs have become increasingly sophisticated in managing and integrating activities across borders, and even relatively new and smaller MNEs are organized to maximize cross-border efficiencies and take advantages of the economies that derive from multinationality. MNE operations increasingly tend to involve multiple motivations simultaneously (Criscuolo et al 2005). One can, nonetheless, speak of certain host locations providing L advantages that are especially suited for specific activities, relative to other activities. One would not expect significant strategic asset-seeking activities in stage 1 countries, where L advantages would be ideally suited to resource-seeking activities. At the same time, a single country might be host to several subsidiaries of the same MNE, each motivated differently, or in different parts of the same country. Given our earlier discussion about sub-national regions and differences within countries, it should come as no surprise that such multiple L advantages attract MNE activity simultaneously motivated by such vastly different intentions.

**\*\*\*TABLE 2 ABOUT HERE\*\*\***

Given the multiple motivations any given MNE establishment might engage in a given location, understanding the potential for industrial development by focusing largely on attracting MNE activity with specific motives is increasingly difficult. Nonetheless, the discussion on the motives remains important, because motivations are indicative of the potential consequences of their activities, and changing motivations over time reflect on how L advantages are perceived to have evolved by MNEs. However, by themselves, motives cover a multitude of sins, not least because there is considerable overlap between the motives. In addition, MNE motives and strategies are interrelated. Domestic market oriented affiliates generally purchase more locally than export-oriented firms because of lower quality requirements and technical specifications. MNEs create more linkages when they use intermediate goods intensively, communication costs between parent and affiliate are high, and the home and host markets are relatively similar in terms of intermediate goods. Affiliates established by M&As are likely to have stronger links with domestic suppliers than those established by greenfield investment, since the former may find established linkages that are likely to retain if they are efficient. Linkages vary significantly

by industry. In the primary sector, the scope for vertical linkages is often limited, due to the use of continuous production processes and the capital intensity of operations. Investments in the primary sector continue to provide limited avenues for upgrading unless carefully shepherded. In manufacturing the potential for vertical linkages are broader, depending on the extent of intermediate inputs to total production and the type of production processes.

From an outward FDI perspective, it is worth noting that UNCTAD 2005 reports that even relatively new MNEs from developing countries are increasingly engaging in strategic asset-seeking investments. However, it is not entirely clear whether such firms are able to internalise and efficiently utilise such knowledge acquired to generate sustainable O advantages that can be exploited elsewhere, particularly where they do not possess the necessary complementary assets to do so. It is worth noting that a distinction needs to be drawn between ‘strategic investments’ and ‘strategic asset-seeking investments’. Firms may make strategic investments that may provide no discernible economic contribution to the MNE, but which may affect their long-term market positioning, for instance, through M&A. Asset-seeking activities imply the active augmentation of existing ownership advantages through, *inter alia*, R&D, although the literature has tended to blur the difference between the two.

Different motivations of outward FDI by developing country MNEs, likewise, require different O advantages of MNEs, and seek specific types of L advantages. Not all types of outward MNE activity necessarily imply significant learning opportunities for the home-based operations of the MNE. In the case of natural resource-seeking investments for instance, but they rarely represent channels for reverse technology transfer. It is worth noting that there is not inconsiderable FDI in sectors where firms by necessity require a foreign presence, particularly in service based industries. Some of these investments are ‘strategic’ – banks and insurance companies need to maintain overseas operations in strategic financial centers such as New York and London. Yet others require a physical presence since the nature of their activity requires proximity to clients. Such investments are both market-seeking and resource-seeking and while knowledge acquired from such operations helps improve best practice, the extent to which they benefit home-country operations depends upon the extent to which the MNE itself seeks to evolve into a global integrated enterprise, or maintain its foreign operations as *de facto* free-standing enterprises with weak links to the parent company. Lastly, outward FDI may also be a

means to exit institutional constraints at home (Witt and Lewin 2007), or may be seeking to benefit from regulatory arbitrage.

## **6. Rapid internationalisation and inward MNE activity: will development also increase pace?**

Most indicators suggest that the level and intensity in the activities of MNEs – in terms of share inward FDI in the overall economic activity of individual economies - has increased generally and across the board in most developing countries. However, we are not convinced that increased inward MNE activity necessarily implies that this will result in more rapid industrial development. In principle, a potential positive outcome from the greater participation of MNEs in a developing economy would be a crowding-in effect, with MNE activity stimulating new and more efficient domestic economic activity that might not have occurred had not the MNE invested in that location. On the other hand, the contrary result – that of crowding-out – where domestic firms are displaced, out-competed or pre-empted by foreign-owned MNEs – is an outcome that countries seek to avoid.

Based on data for the period 1971-2000, for Latin America, Asia and Africa, Agosin and Machado (2005) found that at best the effect of FDI on domestic investment is a neutral one, with crowding-out having taken place in Latin America in the 1970s, and in Africa during the 1990s. Despite the limitations of aggregate data, these results lend support to studies on spillovers and raise the spectre – once again – of the importance of appropriateness and quality of FDI, rather than the prevalent focus on quantity. It draws emphasis to the need to match FDI with domestic capacity building and the importance of FDI embedding, and the need to understand FDI not as a discrete single-period FDI flow, but as a multi-period building up of FDI stock through deepening and spreading of value adding activities, not all of which occur as a consequence of new flows of foreign capital.

Crowding-in is a phenomenon that relies extensively on several separate but inter-linked actions. Crowding-in occurs through the *competition effect* through strengthening the existing ownership advantages of domestic firms, promoting horizontal growth of competing domestic firms' local operations. A positive competition effect implies that the presence of MNE subsidiaries that have a higher productivity in a given industry spurs domestic competitors to

raise their productivity by improving the efficiency of their operations in order to compete effectively. When crowding-in happens through a positive competition effect, existing domestic competitors (and possible new domestic entrants) in the same industry demonstrate increased capacity (itself a result of increased efficiency) and market share<sup>16</sup>.

Efficiency gains also happen through a variety of other means, and indeed it is difficult in practise to separate these different modalities by which MNE subsidiaries may affect domestic industry. For instance, efficiency gains in non-related industries where similar techniques may be applied is known as the demonstration effect. In addition there are numerous spillover effects that relate to the competition effect. For instance, through its more efficient organisation of its linkages with input suppliers, as well as with customers; which themselves also leads to indirect efficiency gains to competitors who reap the advantage of a more efficient set of suppliers. In addition, there are benefits that derive from indirect spillovers through employment effects, where domestic firms benefits from training provided by the MNE subsidiary to its employees, and who subsequently become available to domestic firms through the job market (and who may in subsequent periods establish new competitors themselves, thus a third degree effect).

Barrios et al (2006) found that in Ireland initially a negative competition effect prevailed, leading to the exit of domestic competitors, perhaps partly because of the inability of the more inefficient firms to respond as rapidly to the FDI. However, they also found that over time the negative relationship reverses itself, due to other positive externalities deriving from linkages and spillovers. This result is a significant one, since it implies that crowding-out is followed by crowding in, implying domestic firms eventually overcome structural inertia. However, a study by Wang and Yu (2007) using data for China reveals that increases in levels of FDI participation do not always follow a linear relationship with the extent of spillovers that derive there from, varying instead by industry. In technology-intensive sectors, net positive spillovers increased with foreign participation, but in labour intensive sectors, once foreign capital accounted for more than approximately two-thirds of an industry, there was evidence that net positive spillovers declined, and crowding-out was observed. These various results seem to point to the fact that there is probably an optimal size of foreign presence to promote domestic industrial

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<sup>16</sup> It may also occur in non-related industries where similar techniques for efficiency gains may be applied through what is known as the demonstration effect. In addition there are numerous spillover effects which we will discuss in another section. Indeed it is difficult in practise to separate these different means by which MNE subsidiaries may affect domestic industry.

development through net positive externalities therefrom, and this varies considerably upon the industry of activity, as well as the aspect of the value chain in which the MNE subsidiaries and the domestic firms are engaged in.

Other complementary arguments have been proposed by (see e.g., Aitken and Harrison 1999, Mody 2004) which point to the possibility that MNEs enjoy at least two advantages over their domestic counterparts which do not necessarily promote positive effects because they are not easily transferable. First, MNEs may have a low marginal cost to utilize the O advantages of their parent (whether in the form of advertising, brand names, technological assets, or knowledge of networks). Such advantages of multinationality and size are simply not available to smaller firms. Second, they may be much more aggressive and flexible in utilising these advantages, not being encumbered with the inertia that derives from being integrated into the local system, and the associated path dependent political and social obligations (Wang and Yu 2007). These results also point to the size of the technology gap between the MNEs and their domestic counterparts. Where the gap is too large, crowding-out effects are likely to predominate. It is worth noting that the decline in domestically owned production in a liberalised milieu does not always reflect a crowding out in the traditional sense that the domestic firm 'exits' by virtue of being economically unviable. Narula and Marin (2005) note for the case of Argentina, liberalisation has permitted a number of the more successful domestic firms to be acquired by MNEs.

## **7. Conclusions and policy implications**

There has undoubtedly been a systemic change in the world economy with globalisation. MNEs, in particular, are cognizant of the opportunities for cost-economising, market-share expansion and learning that this implies, as well as the risks associated with greater competition. By and large, they have proactively responded to the changing circumstances and have reorganised themselves accordingly.

MNEs are using a richer variety of organisational modes, and while FDI remains the single most important modality by which they engage with developing countries, it is worth emphasising that there are a variety of other means by which MNEs may engage with, or influence domestic economic activity. Non-FDI means of engaging with host economies are

likely to grow in importance. We have also underlined that there is also a need to acknowledge the greater heterogeneity in the kinds of MNEs, their subsidiaries, and the potential development effects they might have.

Developing countries, on the other hand, have largely reacted to the circumstances by liberalising their policies towards FDI, but this is not the same as developing FDI policies. Most take a passive approach to attracting FDI flows, and pay insufficient attention to the nature of the benefits and costs associated with embedding subsidiaries and exploiting externalities. The adoption of neoliberal policies as part of structural adjustment programmes in many developing countries has meant that few have an explicit or well-considered industrial policy, often applying principles that belong as part of a more closed, import-substituting era. This is increasingly at odds with the economic realities of a post-WTO, interdependent world where such policies have limited purchase. But industrial policy still remains an essential tool to promote development, despite globalisation. As Haque (2007) puts it, '[liberalisation has]...changed the context but not the importance of policy in industrial development'. Specifically, policies towards MNEs need to be closely linked and integrated with industrial policy. MNE activity needs to be evaluated by considering the kinds of externalities that are generated; whether and how domestic actors can internalise them; and what kinds of L advantages may be required to achieve this. Indeed, the 'success stories' of MNE-assisted development have sought to attract MNEs, but have also built up domestic absorptive capacities in tandem. They have then tried to upgrade their L advantages to encourage MNEs to both deepen and broaden their local value adding activities. (e.g., Wade 1990, Kaplinsky 2000, Lorentzen 2005, Morris and Barnes 2008, Henderson et al 2002, Giuliani et al 2005, Rasiah 2006, Giroud 2003). The opportunities to upgrade value chains and linking them with non-domestic actors are still there, although the tools available to do so may have changed. Traditional infant industry policies that date back to List (1844) and others are inapplicable to open economies. Given the heterogeneity of MNE activity, it makes sense that policies are fine-tuned to specific industries in particular countries rather than a general, one-size-fits-all approach that was utilised during the import-substitution era. Nonetheless, it is also clear that completely unfettered access to domestic markets by MNEs can have a detrimental effect on sustainable domestic growth (Chang 2004).

The IDP as a framework has been useful in making the point that an increase in FDI (or MNE activity) does not result in a concomitant increase in development. There is no reason to

believe that countries will move any quicker through the stages of the IDP simply because MNE activity has increased. Quite apart from the dangers of crowding-out and the problems of stage-inappropriate MNE activities, it is not clear that increased MNE activity necessarily implies a proportional increase in spillovers and linkages. An important issue not dealt with in this paper (or elsewhere) is the potential development effects of MNE activity in the services sector. This has been an area of growth in terms of inward FDI. However, there is considerable variety in the nature of services – investments in telecommunications provides relatively few knowledge spillovers and linkages to domestic firms in the least developed countries, compared to banking. To our knowledge, there are no studies that evaluate relative benefits of investments in tertiary sectors, relative to primary or secondary sectors. Another ‘new’ issue that needs further exploration is outward MNE activity from developing countries. It is not necessarily clear how outward MNE activity benefits home countries, and how this varies by sector, motivation or part of the value chain.

The discussion of MNEs and development has not as yet addressed the matter of points of inflection within the IDP, and in development in general. What are the threshold levels of MNE activity to promote growth, perhaps focusing on the industrialisation ‘failures’ which are sometimes located in the same geographical space as ‘successes’? Why has India been unable to move away from light manufacturing towards more innovation-intensive manufacturing, unlike China, or Brazil? Liang (2004) for instance, explores the relative success of the mobile telecommunications sector with the automobile sector in China and finds that although similar industrial policy was applied to the two sectors, very different outcomes have resulted.

We underline that MNE activity is not only about spillovers and linkages. Few individual MNE establishments can be all things – some may simply provide low-level employment, or primarily represent tax revenue streams. In other words, there is a need to match and understand what the potential benefits of specific MNE projects are, to specific outcomes from the host country perspective.

In discussing MNE-assisted development, economists pay too little attention to the political and sociological aspects. The politics of reform and the social and political costs of structural adjustment and institutional change are seldom taken into account. The extent to which external (non-national) organizations and countries determine national outcomes can also affect the efficiency with which *de facto* reforms have taken place. Henisz et al (2005) for instance,

find that there is considerable variation in the efficacy of market-oriented reforms across countries, and that coercion by international agencies may lead to a less than ideal outcome. Interest groups within a society can also impede or promote a specific agenda (e.g., Spiller 1990, Potters and Sloof 1996), but this has remained largely unexplored in development studies. Interest groups can engage in regulatory capture, and help shape public policy to suit their own particular commercial or political interests.

Understanding development and MNE activity require a cross-disciplinary approach, and understanding development in a post-Washington consensus world requires us to advance the analyses beyond aggregate economic growth. It is also about income disparities and what Amartya Sen defines as human development. Likewise, understanding the possibilities for MNE-assisted development requires us to move towards understanding the globalisation world as it is, unconstrained by academic disciplines. It requires us to move away from the two standard dimensions – MNEs and markets – and systematically take into account not just the dimension of international organisations and institutions, but also the role of civil society.



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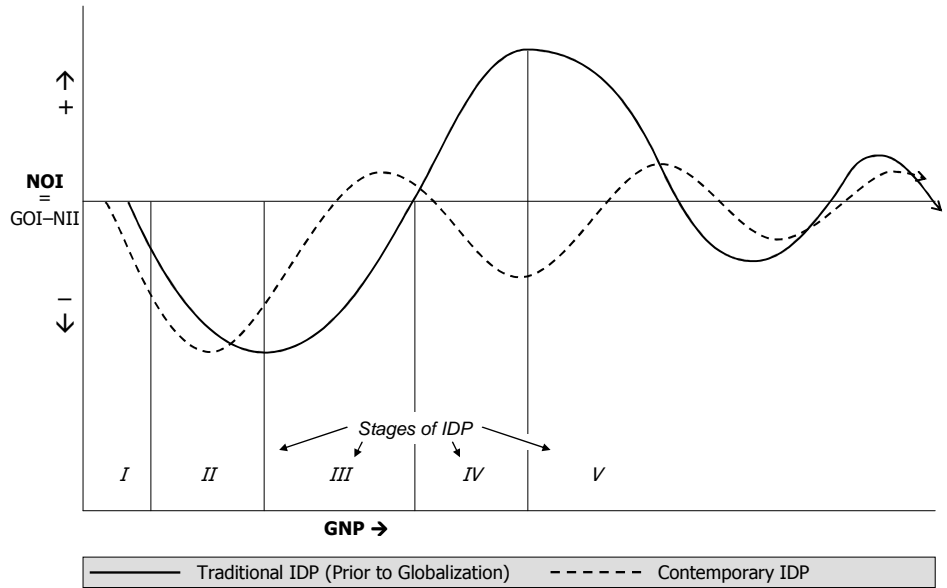
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# Figure 1: The Investment Development Path

(N.B.: Not drawn to scale; for illustrative purposes only)



**TABLE 1 Stages of the IDP**

|   | <i>Stage I</i><br>Natural resource based  | <i>Stage II</i><br>Investment driven   | <i>Stage III</i><br>Innovation driven  | <i>Stage IV and V</i><br>Increasing knowledge and service intensity; knowledge economy   |
|---|---|--|--|--|
| Balance of inward and outward FDI       | Little IFDI and negligible OFDI; low intra-industry trade and investment                                | Increasing IFDI and limited OFDI; low intra-industry investment, increasing intra-industry trade   | OFDI increasing faster than IFDI; increasing intra-industry trade and investment   | Substantial I and O; O often exceeds I; substantial intra-industry trade and investment; balance between I and O fluctuates: around net zero or positive level of in/outward FDI   |
| Characteristics of inward MNE activity  | Little inward FDI initially. As L advantages improve, resource based motives, and market seeking later. | Growing presence of market-seeking FDI - attracts labour-intensive manufacturing;  | Raising Inward FDI, market-seeking and increasing efficiency-seeking FDI in manufacturing , In activities supplying more sophisticated products for domestic market, or requiring more skilled labour  | Increasingly market-seeking, efficiency-seeking and asset-augmenting investment  |
| Characteristics of outward MNE activity | No outward FDI – strategic investments and capital flight.  | Little outward FDI. Mainly Resource- and market-seeking investment in other developing countries; some ‘escape’ investment to developed countries; mostly regional greenfield investment; natural resource investment; light manufacturing employing established technologies. | Growing outward FDI; All kinds of investment including efficiency-seeking and some asset augmenting investment; mass-produced differentiated consumer goods, e.g. electrical products, clothing; more service investment, e.g. construction, banking | Increasingly efficiency-seeking and asset-augmenting investment; regional and global; more M&As and alliances; investment in knowledge-intensive sectors, e.g. ICT, biotechnology, and high value-added services, e.g. consultancy; restructuring of global value chains |
| O advantages                            | Few domestic firms with O-adv.  | Ability to produce low-cost, standardised products, or those   | Strong domestic industries; Ability to differentiate products and/or   | Strong created-asset O-adv. of domestic firms; Substantial O <sub>a</sub> + O <sub>t</sub> ;   |

|   | <i>Stage I</i><br>Natural resource based   | <i>Stage II</i><br>Investment driven   | <i>Stage III</i><br>Innovation driven   | <i>Stage IV and V</i><br>Increasing knowledge and service intensity; knowledge economy   |
|---|--|--|---|--|
| of firms  |  | based on natural resources of home country   | adapt to local consumer tastes; some limited product and process innovation   | increasing importance of O <sub>i</sub> ; coordination of the internal and external network of the MNE; importance of open innovation  |
| Industrial upgrading & manufacturing comparative adv. evolution | Heckscher-Ohlin sectors  | Undifferentiated Smithian sectors  | Differentiated Smithian sectors   | Innovation-intensive Schumpeterian sectors   |
| L advantages of the home country                                | Few L advantages. Mainly presence of natural resources, but infrastructural support also important; government role in setting up legal and commercial system. | Growing L-adv., Low real wage costs; natural resources; Supply capacity and clusters of local industry; growing importance of education, transport and ICT infrastructure; | Created-asset L-adv. are increasing; Entrepreneurship; larger, more sophisticated, markets; government role in economic restructuring and enforcing competitive markets; increasing importance of informal institutions | Strong created-asset L-adv., Increasing importance of supply capabilities, support services and market-facilitating services; government role in minimising transaction costs, supporting innovation, and fostering economic restructuring; increasing importance of informal institutions |
| Economic structure  | PRIMARY Sectors  |  |   |  |

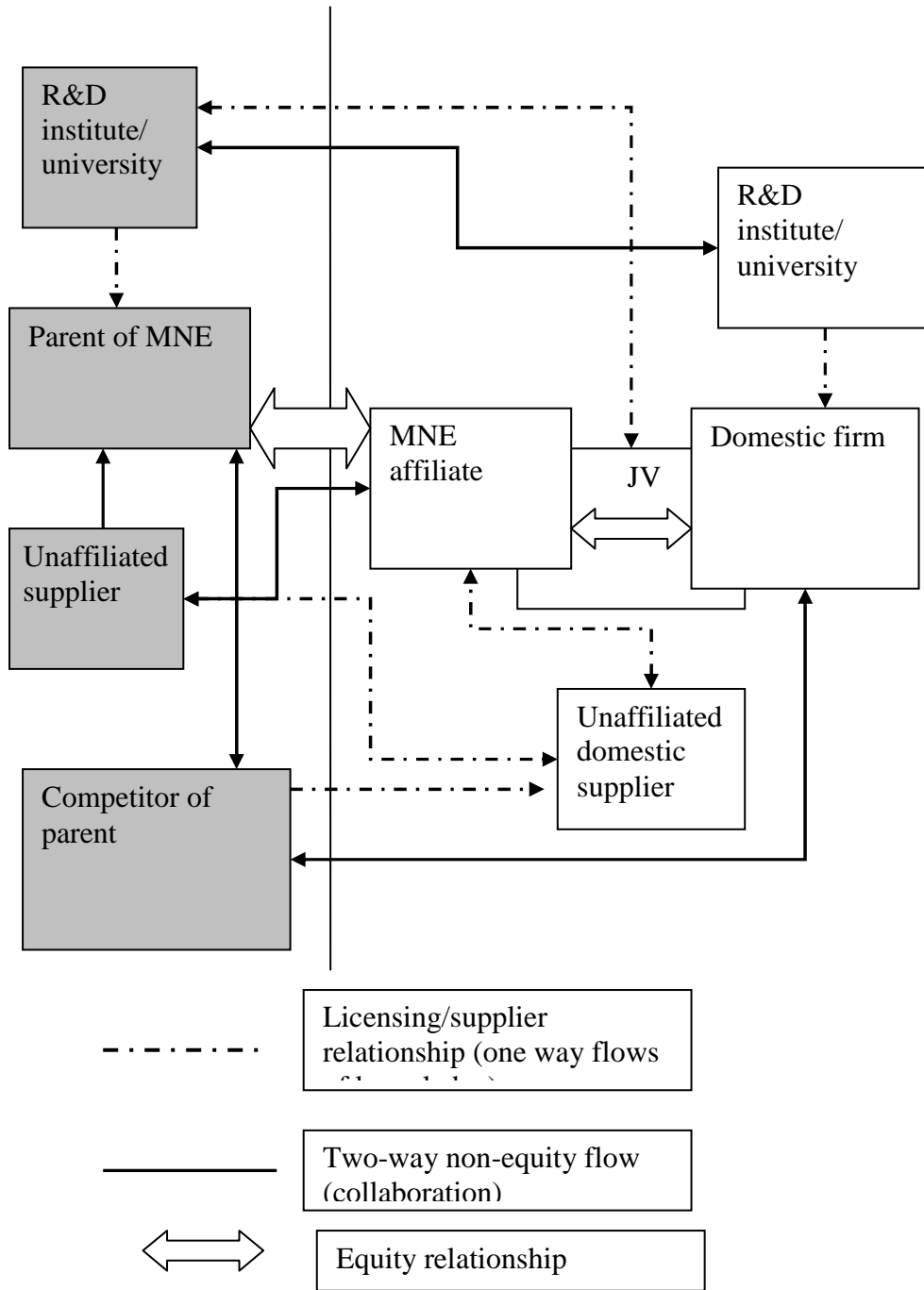


|                                   | <i>Stage I</i>  | <i>Stage II</i>   | <i>Stage III</i>   | <i>Stage IV and V</i>   |
|-----------------------------------|---|---|--|---|
|                                   | Natural resource based  | Investment driven   | Innovation driven  | Increasing knowledge and service intensity; knowledge economy |
|                                   | Increasing  |   |  |   |
| Preferred modality of IB activity | Imperfect markets and peripheral nature imply either trade or FDI linkages. | Tendency for firms to prefer more equity ownership to protect proprietary knowledge and to control markets, and more licensing activity | Increasing use of cooperative and/or contractual relationships to manage the external network of the MNE; focus on 'core competence' with extensive use of outsourcing |   |

**Table 2 How MNE motives have evolved over thirty years.**

| Type of FDI                       | In the 1970s  | In the 2000s.  |
|-----------------------------------|---|--|
| <b>A. Resource seeking</b>        | <ol style="list-style-type: none"> <li>1. Availability, price and quality of natural resources.</li> <li>2. Infrastructure to enable resources to be exploited, and products arising from them to be exported.</li> <li>3. Government restrictions on FDI and/or on capital and dividend remissions.</li> <li>4. Investment incentives, e.g. tax holidays.</li> </ol>                           | <ol style="list-style-type: none"> <li>1. As in the 1970s, but local opportunities for upgrading quality of resources and the processing and transportation of their output is a more important locational incentive.</li> <li>2. Availability of local partners to jointly promote knowledge and/or capital-intensive resource exploitation.</li> <li>3. Entrepreneurship, trustworthiness and honesty of local partners.</li> <li>4. Extent and quality of national or regional enforcement mechanisms.</li> </ol>   |
| <b>B. Market Seeking</b>          | <ol style="list-style-type: none"> <li>1. Mainly domestic, and occasionally (e.g. in Europe) adjacent regional markets.</li> <li>2. Real wage costs; material costs.</li> <li>3. Transport costs; tariff and non-tariff trade barriers.</li> <li>4. As A3 above, but also (where relevant) privileged access to import licenses.</li> </ol>   | <ol style="list-style-type: none"> <li>1. Mostly large and growing domestic markets, and adjacent regional markets (e.g. NAFTA, EU, etc.).</li> <li>2. Availability and price of skilled and professional labour.</li> <li>3. Presence and competitiveness of related firms, e.g. leading industrial suppliers.</li> <li>4. Quality of national and local infrastructure, and institutional competence.</li> <li>5. Less spatially related market distortions, but increased role of agglomerative spatial economies and local service support facilities.</li> <li>6. Macroeconomic and macro-organizational policies as pursued by host governments.</li> <li>7. Quality of local norms and standards, and social capital.</li> <li>8. Growing importance of promotional activities by regional or local development agencies.</li> </ol>  |
| <b>C. Efficiency Seeking</b>      | <ol style="list-style-type: none"> <li>1. Mainly production cost related (e.g. labour, materials, machinery, etc.).</li> <li>2. Freedom to engage in trade in intermediate and final products.</li> <li>3. Presence of agglomerative economies, e.g. export processing zones.</li> <li>4. Investment incentives e.g., tax breaks, accelerated depreciation, grants, subsidized land.</li> </ol> | <ol style="list-style-type: none"> <li>1. As in the 1970s, but more emphasis placed on B2,3,4,5, and 7 above, especially for knowledge-intensive and integrated MNE activities, e.g. R &amp; D and some office functions.</li> <li>2. Increased role of governments in removing obstacles to restructuring economic activity, and facilitating the upgrading of human resources by appropriate educational and training programs.</li> <li>3. Availability of specialized spatial clusters, e.g., science and industrial parks, service support systems, etc: and of specialized factor inputs. Opportunities for new initiatives by investing firms; an entrepreneurial environment, and one which encourages competitiveness enhancing cooperation within and between firms.</li> <li>4. Ability of locations to offer trust-intensive, covenantal relations of an inter-personal, inter-firm and firm/government kind.</li> </ol> |
| <b>D. Strategic Asset Seeking</b> | <ol style="list-style-type: none"> <li>1. Availability of knowledge-related assets and markets necessary to protect or enhance O specific advantages of investing firms – and at the right price.</li> <li>2. Institutional and other variables influencing ease or difficulty at which such assets can be acquired by foreign firms.</li> </ol>  | <ol style="list-style-type: none"> <li>1. As in the 1970s, but growing geographical dispersion of knowledge-based assets, and need of firms to harness such assets from foreign locations, makes this a more important motive for FDI.</li> <li>2. The price and availability of “synergistic” assets to foreign investors.</li> <li>3. Opportunities offered (often by particular sub-national spatial units) for exchange of localized tacit knowledge, ideas and interactive learning.</li> <li>4. Access to different cultures, institutions and value systems; and different consumer demands and preferences.</li> <li>5. Ability to form productive relationships with acquired firms.</li> </ol>   |

**Figure 2: equity and non-equity cross border knowledge flows**



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