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Much ado about nothing: No fear of becoming a multinational

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ABSTRACT

This paper compares the home employment performance of Spanish “switching” companies, which carry out Foreign Direct Investment for the first time, with employment performance corresponding to non investing local (national) companies. We use data from manufacturing firms for the period 2000–2013. The counterfactual group of national companies is obtained using the Propensity Score Matching technique with a large sample of firms. The analysis shows that the reduction in employment was less relevant among switching companies in comparison with local ones. This result permits us to conclude that internationalization through foreign direct investment is not causing a more intense reduction in employment among parent companies than among local firms. This holds also true for the period prior to the crisis (2000–2007).

1. Introduction

Spain is a latecomer in comparison with other highly industrialized countries regarding outward foreign direct investment (OFDI) flows. Until the beginning of the 21st century foreign operations of Spanish firms grew only modestly and the net outward FDI position of Spain was largely negative. In line with Dunning and Narula (1996), this was a situation corresponding to a country that had not yet reached the highest phase of the so called Investment Development Path. Therefore, during the 1990s the main worry was whether inward foreign capital flows were a contributing factor for growth and technological upgrading through spillovers. Thereafter, a larger number of Spanish firms made a considerable progress in developing their own proprietary assets (knowledge capital and intangible assets) and found the way to exploit those internal assets in foreign markets by investing abroad. From 2003 to 2011 the estimated number of Spanish firms with foreign subsidiaries (FS) grew by 50% (2316 firms with approximately 3000 FS),¹ OFDI flows reached a peak of 3% over world total in 2007 and net outward FDI position became markedly positive. This growth took place not only during the booming years but also after the outbreak of the financial crisis, probably because of firms’ need to find new opportunities for growth in foreign markets. Anyway, once the international expansion of domestic firms reached a significant level and the crisis hit the country (especially regarding unemployment growth), the main concern about this phenomenon switched unsurprisingly towards

the potential home country effect on employment of the firms that venture abroad. That splits naturally the public opinion into two opposite views. On one side, business leaders and analysts often sustain a favorable opinion considering it is a strategic decision that augments firms’ competitiveness, market share and lastly employment too; on the other side of the debate skeptics (usually trade unions) consider that firms foreign activities have a negative impact on domestic employment. In fact the term delocalization used frequently as synonym for OFDI has often a negative connotation.

Hence, the principal hypothesis to be tested in this paper is whether outward FDI causes a reduction on domestic employment in the parent company of multinationals. As will be explained in the next section, the theory of the MNC does not resolve this issue because it does not provide clear predictions. Therefore only a well defined empirical strategy can shed some light on that question. To do so, we apply the Propensity Score Matching technique (PSM) by using a large firms’ database for Spain from 2000 to 2013, which is considered to be the most appropriate econometric approach to test the above mentioned hypothesis. In fact, what can be tested with this technique are two interrelated hypotheses; one is whether employment performance of firms “before switching” (before becoming a MNC) is better to that of firms that do not switch (local firms) and second whether employment performance of firms at home “after switching” (once they are MNC) is better than the one corresponding to local firms.²

The main contributions of the paper to the literature about this topic

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¹ These data are from the Foreign Investment Database (Registro de Inversiones Extranjeras del Ministerio de Economía y Competitividad) containing industry and geographical FDI breakdown. In Myro and Álvarez-López (2014) the interested reader can find a more detailed analysis on outward FDI in Spain based on this database.

² There may be also indirect effects on the employment of other firms in the home economy (macro or general equilibrium effects). In this paper we take a partial equilibrium view, assuming that the decision of one firm to locate production abroad does not have any impact on the performance (employment) of other firms through changes in aggregate income.

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are the following. First, it is another case study to add to the relatively scarce number of empirical papers on this issue and as far as we know there is no one based on Spanish firms using the above mentioned technique. Second, the case of Spain is particularly relevant since Spanish firms have only recently become foreign investors unlike other country case studies gathered in the literature. Third, in contrast to other similar papers the time span under study is long and includes the recent global crisis, which allows us to examine the impact of the crisis on the research question.

The remaining of the paper is organized as follows. Section 2 presents a literature review about the effects of OFDI on employment. Section 3 describes the recent evolution of manufacturing employment among our sample of firms. In the fourth section the PSM procedure strategy and its results are explained and discussed. Finally, Section 5 concludes the paper.

2. Literature review

2.1. International business and international economics approaches to FDI

Within the theory of the MNC, there are two major approaches that converge on the arguments put forward to explain why firms become multinationals. Summarizing very briefly, international business scholars led principally by the ideas of Hymer (1960), Buckley and Casson (1976) and Dunning (1977), were first in arguing that firms decide to invest abroad if they have advantages in three different broad aspects: Ownership, Location and Internalization. This is known as the “OLI” paradigm or eclectic framework popularized by Dunning (1993, 2000). On the other side, in trying to get sharper predictions than those arising from the OLI paradigm, different scholars within the broad area of international economics have formalized that paradigm and developed more detailed models of foreign trade and FDI.³ One of these models is the “proximity-concentration” trade off model (Helpman, Melitz, & Yeaple, 2004) which considers that the ways through which a firm can satisfy the demand of its differentiated product in a foreign market are alternatively exports (by concentrating production at the home plant) or with production in a foreign subsidiary through “pure” horizontal FDI (replicating the whole production process in proximity to that market).

Within the international business literature, horizontal FDI (HFDI) has been conceptually defined as “market seeking investments”, being access to foreign markets the main objective by firms doing such kind of FDI operations. In any case, the “proximity-concentration” model predicts that the most productive firms will substitute exports entirely with HFDI and therefore a trivial outcome of the model is that production and employment at the parent firm will decrease in tandem with the fall in exports.⁴ However, this negative effect of HFDI derives from the static view of the model and from the two assumptions that are made regarding “pure” HFDI (the firm replicates the whole production process in its foreign subsidiary and the firm produces only one product). If those simplifying assumptions are relaxed to be closer to the real world, and if a more long run (dynamic) perspective is considered, then the net final effect is ambiguous. If the firm replicates only the final part of the production process in its FS (as is typically the case for instance in foreign assembly plants) and if the proximity of the FS to the foreign market helps to increase the demand for its output in that market, the demand (employment) for intermediate products and services

(headquarter services) from the parent firm may subsequently increase too, compensating partially, totally or more than totally the fall in employment of having shifted abroad part of the production in the beginning. In the case of a multiproduct firm, HFDI for one product may also increase demand for other firm’s products and have a subsequent bandwagon effect on exports, production and employment at the parent firm.

The model regarding vertical FDI (or intra-firm offshoring, Helpman, 1984), when firms fragment and shift part of their production process to a foreign country to exploit factor costs differences (typically unskilled labor costs in a less developed country), predicts a clear negative effect on parent firm’s employment too. The corresponding types of FDI within the international business taxonomy resembling this idea are “natural resource” or “efficiency seeking” investments. In any case, vertical FDI (VFDI) should determine some relocation of (unskilled) labor from home to foreign plants thus reducing (unskilled) employment at home. However the same considerations as above can be put forward. With a longer run perspective, VFDI may increase firm’s competitiveness and therefore output, employment and headquarters services at home too.⁵

Moving from the dichotomy between HFDI versus VFDI and taking into account that there is likely going to be both dimensions to any multinational activity, make the analysis of the effects on employment of becoming a multinational firm even more ambiguous. The so called literature on more complex integration strategies (Yeaple, 2003; Grossman, Helpman, & Szeidl, 2006) leads to multiple strategies that offer little guidance about the long term effects on employment.

2.2. Empirical literature review on OFDI

As already mentioned in the introduction, theory helps only partially to address the issue of this paper and it is therefore a main concern to properly specify a suitable empirical strategy. In particular we try to investigate what is the effect on employment in the parent firm of establishing a foreign subsidiary abroad.⁶ This question is a complicated one when it comes to the empirical analysis, because firms that become multinationals tend to be different ex-ante from those that do not engage in overseas FDI: they are often larger (in terms of employment) and more productive on average. This induces a self-selection bias into multinational activity that in econometric terms generates endogeneity in the variable capturing OFDI. One way to tackle this endogeneity problem is to use dynamic panel data with a lagged dependent variable (GMM- Arellano Bond) and specify a linear equation that allows using past observations of the dependent variable and of the independent regressors as instruments. Another option is to employ matching techniques. This approach divides the sample’s firms that were not domestic multinationals at the beginning of the observation period into two groups: firms that become multinationals during the observation period (switchers or treatment group) and domestic firms that did not internationalize (nationals or control group). To accurately estimate the effects of OFDI on employment, the control group is

³ Suppose for example that a firm relocates a production stage which accounts for 15% of the value added within a foreign affiliate. All else equal, this reduces its value added at home by 15%. But let the relocation reduce the price of the good produced by the firm by 5%. Suppose the price elasticity of demand is 3 at home and 4 in other countries. Suppose further, that the firm exports half of its output. Falling prices yield 17.5% higher demand for the good which yields 14.875% higher value added at home. Higher demand for the good which is induced by the lower price almost compensates for the 15% loss of value added at home due to the relocation of production in this example. The gains might be much higher, if the lower prices allow for instance to enter a new export market. Thus, value added and therefore employment does not need to fall in reaction to the relocation of production (Kleinert and Toubal, 2007).

⁴ There may also be indirect effects on the employment of other firms in the home economy (macro or general equilibrium effects). In this paper we take a partial equilibrium view, assuming that the decision of one firm to locate production abroad does not have any impact on the performance (employment) of other firms through changes in aggregate income.

³ This is the case for instance of the “knowledge-capital” model by Markusen, (2002) about the MNC that encompasses many other contributions.

⁴ However the model is embedded in a general equilibrium framework where flexible wages do always clear the labor market; in fact in the export model, labor (and capital) moves from low productivity firms that lose domestic market share (because of increased import competition) and are not able to compensate it through exports, to high productivity firms that are able to over compensate a lower domestic market share through exports.

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