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The two faces of foreign management capabilities: FDI and productive efficiency in the UK retail sector

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ABSTRACT

We investigate the impact of management capabilities of foreign firms on the management capabilities and performance of domestic firms using survey data on the UK retail sector. On average, foreign-owned retail firms achieve higher management capability scores and are more productive than domestic firms. Our results suggest two faces of foreign management capabilities. On the one hand, capabilities that can be codified, for example human resource management capabilities, generate some positive spillovers on the relevant management capabilities of local firms. On the other hand, dimensions of capabilities that are more tacit and highly competitive exert a negative competitive effect on domestic firms' own management capabilities. While the overall management capabilities of domestic firms are found to have a significantly positive effect on their own productive efficiency, we find no evidence of a direct efficiency effect of foreign management capabilities on local firms.

1. Introduction

Management capabilities are a key determinant of the competitive advantage of firms (Teece & Pisano, 1994) and a major source of ownership advantage of multinational enterprises (MNE) (Cantwell, 1991; Dunning, 1988). Although there is a substantial literature on the impact of foreign direct investment (FDI) on local firms, most of the literature focuses on research and development (R&D) and technological capabilities. Research exploring managerial knowledge spillovers is rare, especially for the service sector, where management capabilities are likely to play an important role (Bloom & Van Reenen, 2007; Bloom & Van Reenen, 2010).

The share in GDP accounted for by the service sector in industrialized countries has been growing steadily over the past four decades and it now accounts for around 60 percent of value added (including public administration, health and education services) in all OECD countries (McManus, 2009). In the UK, the service industry represents by far the most important sector. Excluding public administration, health and education services, it accounted for nearly 50 percent of total employment in the UK by the end of 2009.[1] However, the relatively larger share in employment accounted for by the service sector is paired with lower productivity relative to the manufacturing sector (Griffith et al., 2004; Wölfl, 2005). Considering the enormous effort that has been devoted in the literature to understanding performance of manufacturing firms, further work targeted at understanding firm performance in the UK service sector promises to be particularly instructive.

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[1] UK Office National Statistics.

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Important issues in the discussion of firm performance in the manufacturing sector revolve around the presence of foreign firms and their effect on domestic firm performance through the generation of inter-firm spillovers and competition effects. Yet, such analysis is almost absent from the literature on the service and in particular the retail sector with a few exceptions (see for example, Añón-Higón & Vasilakos, 2008; Fortanier & van Wijk, 2010; Griffith et al., 2004; Hamida & Gugler, 2009; Miozzo & Grimshaw, 2008). These studies provide evidence on the impact of FDI in the service sector on local firms through training and linkages in the supply chain. Yet there is still a substantial lack of empirical evidence on the impact of FDI in the services and in particular the retail sector. Although many studies suggest managerial knowledge spillovers as a channel for FDI to affect domestic firm performance, direct empirical evidence is scarce. An exception is Fu (2009) who explores managerial knowledge spillovers from FDI in terms of dissemination of modern management practices. Also, in light of evidence such as Buckley, Wang, and Clegg (2007) who point out differences in the impact of FDI on local firms across industries according to their labor intensity, findings for the service sector may differ substantially from what has been found for the manufacturing sector.

In this paper, we examine the impact of foreign management capabilities on local firms' own management capabilities and productivity using comprehensive survey data of domestic and foreign firms' management capabilities in the UK retail sector. This paper contributes to the literature on FDI spillovers as the first empirical study investigating specifically the impact of foreign managerial capabilities on the performance of local firms in the retail service sector. Our findings suggest that foreign management capabilities have two faces with respect to their impact on local firms. On the one hand, capabilities that can be codified, for example human resource management (HRM) capabilities, generate some spillovers on the relevant management capabilities of local firms. On the other hand, dimensions of capabilities that are more tacit and highly competitive appear to be negatively associated with domestic firms' own management capabilities. Moreover, we do not find any evidence in favor of a robust link between foreign management capabilities and domestic firm performance. Nevertheless, we confirm previous findings that foreign-owned firms have on average higher productivity levels than domestic firms and establish a positive association between a firm's own managerial capability and its efficiency.

In Section 2, we discuss the existing related literature and the theoretical underpinnings of our empirical investigation; Section 3 describes our data set; Section 4 outlines the methodology adopted to carry out our empirical analysis. Section 5 provides a summary of the results and Section 6 concludes.

2. Literature review

2.1. The impact of FDI: knowledge spillovers and competition effects

Foreign direct investment, as a bundle of managerial and technological knowledge and financial investment, is likely to impact on local firms through knowledge spillovers and competition effects (Aitken & Harrison, 1999; Buckley, Clegg, & Wang, 2002; Buckley, Clegg, & Wang, 2007; Caves, 1974). Spillovers take place when the multinational firm cannot capture all quasi-rents due to its productive activities or to the removal of distortions by the subsidiary's competitive pressure (Caves, 1974). They may affect the performance of local firms in the same industry as well as of those located geographically close to the MNEs. Knowledge may spill over from foreign to indigenous firms through several channels. One of the mechanisms is the demonstration effect. The advanced technological and managerial knowledge used by MNEs can be known to competitors, suppliers and clients through demonstration-by-implementation and word-of-mouth transmission, and can then be imitated by competitors, suppliers and clients.

The second channel for knowledge spillovers is the movement of labor from foreign to local firms. Most MNEs invest in their personnel through training to improve their own productivity although the volume and quality of training by MNEs is uneven (Gershenberg, 1994; ILO, 1981). When the trained employees move from foreign to indigenous firms for various reasons, they carry with them new technical and managerial knowledge which they acquired in foreign firms. This is potentially the most important channel for spillovers (Almeida & Kogut, 1999; Djankov & Hoekman, 2000; Fosfuri, Motta, & Ronde, 2001; ILO, 1981). The movement of labor not only provides a one-time transfer of information but may also facilitate the transfer of capabilities, allowing further knowledge-building (Kim, 1997). Therefore, there may be horizontal knowledge spillovers from foreign to local firms within the same industry or region. Moreover, knowledge transfer may also take place within the supply chain between foreign and local suppliers as well as customers (Javorcik, 2004). On the one hand, MNEs may transfer relevant knowledge to their suppliers in order to improve product quality and reduce production costs. On the other hand, they may also be asked to provide training to their customers as a contractual requirement attached to the sales contract.

Knowledge spillovers may also be bi-directional. There can be spillover effects from domestic to foreign firms, although the strength of knowledge spillovers between MNEs and host country firms has been found to be asymmetric (Knott, Hart, & Wu, 2009; Singh, 2007). Using patent citation data, Singh (2007) discovers significant knowledge outflows from domestic to foreign MNEs in addition to the knowledge inflows from foreign MNEs to local firms. This is particularly the case in technologically advanced countries where knowledge outflows to foreign MNEs greatly outweighs knowledge inflows. In other words, spillovers have directionality and spillovers from innovative firms are more important than that from laggard firms (Knott et al., 2009). Reverse technology spillovers from domestic to foreign firms are found in the R&D intensive sectors in the UK (Driffield & Love, 2003). Kafourous and Buckley (2008) find that net R&D spillovers from MNEs vary depending on the technological opportunities, a firm's size and competitive pressure a firm faces.