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Innovativeness, offshoring and black economy decisions. Evidence from Italian manufacturing firms

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ABSTRACT

Following recent models in international trade this paper examines the characteristics that businesses should possess to pursue internationalization strategies. We do this in the peculiar context of Italy, the G-7 country with the largest share of the black economy in GDP. Specifically, we posit that Italian manufacturing firms may use three strategies to counter the competitive threats by emerging economies: (i) improve the innovative content of their products (ii) venturing into offshoring, or, alternatively, (iii) entering the black economy. We estimate the impact of these moves with firm-level data drawn from two waves of the Italian Manufacturing Survey (IMS) covering a six-year period (1998–2003). We find that offshoring firms are larger, more innovative, have higher capital/labour ratio and are located in provinces where the share of the black economy is lower. Firms belonging to provinces in which the share of the black economy is larger are less likely to choose the internationalization mode. The offshoring-black economy nexus bears relevant policy implications. In particular, vis-à-vis their offshoring companions, firms choosing to enter the black economy may be producing negative spillover effects by lowering productivity and the propensity to innovate.

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1. Introduction

Over the last decades, globalisation brought about not only opportunities but also challenges for industrialized countries. International trade grew by 5.5% a year between 1960 and 2006 – 2.4% more than world GDP – and the growing role of emerging economies is testified by their export/GDP ratio that increased from 20 to 35% between 1984 and 2004. As emerging economies' producers were growingly included in the circuit of international trade, they competed away companies from industrialized countries. The response by firms in advanced countries is strictly linked to firm's characteristics and productivity in each country and to their ability to keep concentrating into higher value added activities.

Italy's economy was largely affected by emerging economies' competition for two main reasons. Firstly, compared to the other industrialized countries, the Italian economy kept relying to an unusually large extent on manufacturing – with a slow expansion in the service sector – and specializing in traditional manufacturing goods (e.g., textiles and clothing, leather and shoes, furnishing, and other light industry segments) with a low content of innovation/technology. Secondly, in spite of its high export propensity, Italy counted very few multinational enterprises, the type of companies, which are more prompt to exploit the opportunities offered by production offshoring (one of the strategies to tackle the increasing competition from emerging countries). Accordingly, among industrialized countries, Italy coupled the largest need with the smallest ability to offshore. Not surprisingly, then, the process of offshoring gained momentum at Italian firms as a result of the introduction of the euro, which precluded the policy of competitive devaluations of the exchange rate frequently used until the mid-1990s.

To address the innovation and competitive challenges, we consider that Italian firms may choose among three different strategies. Firstly, they may raise the innovation/technology content of production. Innovating is the move, which may give firms the largest medium-long term competitive edge and improve their performance. Thus, this move should be ranked first. Secondly, they can take advantage of the drastic reduction in communication and transportation costs and fragment internationally their own production processes – i.e., venture into offshoring. The increasing extent of offshoring is proved by the fact that FDI flows and international trade of final and intermediate goods rapidly expanded in the last decades. FDI flows from rich

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countries to emerging economies increased fifteen-fold, from $39 billion in the early 1990s to beyond $500 billion in recent years, while the trade flows of final and intermediate goods just about tripled, from $5119 to $16,104 billion. The figures are even more impressive looking at FDI flows to transition economies, the largest recipients of FDI from EU companies: from $204 million in 1991 to $93.4 billion in 2007 (see UNCTAD, 2006 statistics). In Italy the wave of intense manufacturing offshoring is observed in the three-year period 2000–2003 in which the percentage of offshoring firms tripled to above 7% from 2% of the previous period 1998–2000. Thirdly, firms can try to reduce costs at home, possibly by shifting (some parts of) production to the black economy.[1] This move is exclusively defensive. It will allow cost reductions but will hardly deliver well-rooted competitive gains. Thus, we expect that entering the black economy is alternative to innovating and to offshoring.

Both in the management and international trade literature the term offshoring indicates either the relocation of activities abroad in their own affiliates (within firms: international insourcing) – where firms maintain full ownership and control of the stages offshored–or offshore outsourcing to denote the relocation of one or more stages of the production process, formerly carried out entirely in the home country, to an unaffiliated company abroad or other independent foreign suppliers (international outsourcing) (see Arnold, 2000; Contractor, Kumar, Kundu, & Pedersen, 2010; Jensen, Larsen, & Pedersen, 2013; Kedia & Mukherjee, 2009; Olsen, 2006 for similar definitions).[2]

Following the literature, we classify offshoring firms in our data base as either international outsourcing or international insourcing.

Given this background, the aim of our paper is two-fold. On one hand, we investigate the features of firms that choose to offshore. Specifically, we explore whether significantly offshoring firms show a larger size and a positive bias in terms of skill composition of their (domestic) labour force. On the other hand, we try to assess whether offshoring is substitute or complement either with the innovation intensity of the firm or with the extent to which it relies on the black economy. All our firm-level measurements are taken from the Capitalia Italian Manufacturing Survey (IMS).

The rest of the paper proceeds as follows. Section 2 draws a concise survey of the literature to which we mostly refer. Section 3 lays out our testable hypotheses. Section 4, describes the data set and provides additional details on the complementarity/substitutability effects among firm's offshoring, innovativeness and reliance on the black economy. Our empirical methodology and main results are presented in Section 5. Section 6 highlights some limitations of the analysis and Section 7 sketches the main conclusions.

2. Literature review

The profound transformations that have taken place in the world economy boosted theoretical and empirical research aimed at assessing the effects of foreign investments and reorganization of production across national borders. Even though some clues to this changing economic environment lie within the framework of the traditional theory, there was an undisputable need of new approaches. The standard Heckser-Ohlin neoclassical trade theory – carrying restrictive assumptions on the immobility of production factors and identical production functions across countries – cannot explain internationalization and offshoring decisions. Similarly, Ricardian-type comparative advantages need to be revised since trade is not "wine for cloth anymore", as claimed by Grossman and Rossi-Hansberg (2006). Indeed, while the majority of trade continues to be horizontal, international outsourcing and vertical specialization-based trade have increased significantly.

The interest on this issue is growing among international business (IB) scholars alike (see Contractor, Kumar, Kundu, & Pedersen, 2010, 2011; Doh, 2005; Graf & Mudambi, 2005; Holcomb & Hitt, 2007; Kedia, Lahiri & Mukherjee, 2006; Lewin & Peeters, 2006; Stack & Downing, 2005, among many others). As stated by Kedia and Mukherjee (2009): "the growth of offshoring offers a wide gamut of opportunities for IB scholars to formulate new frameworks or revisit extant IB theories" (p. 250). Extant IB theories on multinationals (MNEs) are based on the eclectic paradigm developed by J. Dunning in a series of seminal works (Dunning, 1988, 1998, 2001, 2009; Dunning & Narula, 2004). Dunning's theory has served as the basis for much of research on MNEs and has inspired several contributions in the IB literature.

Dunning's taxonomy explains the potential advantages of foreign direct investment (FDI) decisions by MNEs embodied in the triad of variables: ownership (O), location (L), and internalization (I). The meaning is that enterprises' FDI are determined by ownership advantages, by the profitability to locate production at home or abroad as well as by the ability to internalize these advantages within their own boundaries. The ownership advantages, which include product differentiation, managerial and technological expertise, scale economies should balance out the disadvantages of entering a foreign market and compete with local firms. The disadvantages of foreign firms are numerous and include higher risks and uncertainty, less information, physical distances and differences in culture, legal systems and business regulations. Dunning's approach – which has undergone various revisions over time – identifies four typical strategies of MNEs: market-seeking, resource – seeking, efficiency or cost reduction – seeking and asset-seeking (Dunning, 1998). While the first two strategies fit well with traditional requirements of horizontal FDI respectively in developed and developing countries, the last two fit with vertical FDI or international insourcing. Efficiency seeking strategies include the production of inputs and semi-finished products in a network of plants located in different countries, especially low-wage countries (offshoring). Asset-seeking strategies fit better with the need of external knowledge and human resources through mergers and acquisitions since the scope of the investing firm is to protect ownership advantages.

Among the three aforementioned factor's advantages of the OLI framework, *Internalization* is seen as the key factor, which essentially explains why some activities are carried out within firms and others through arms-length transactions (*to make or to buy, internalization* versus *externalization decisions*). Explanations are based on the transaction costs theory originated with Coase and firstly applied to MNEs by Buckley and Casson (1976) and Williamson (1979), among many others. Internalization occurs because of the public-good nature of ownership advantages and market imperfections and the decision will depend on various specific factors either at industry, country or firm levels. Compared with other entry-mode of internationalization (licensing and exporting), internalization allows firms to lower transaction costs for intermediate goods, components parts and services and to be more efficient. As argued by Ronald Coase (1937) in his pioneering work the optimal degree of internalization reflects a balance between the transaction costs of using the market and the internal

[1] In the literature one can often find interchangeable references to "black", "hidden", "illegal", "irregular", "shadow" or "underground" economy. For clarity, we will only speak of the black economy.

[2] Both from international trade and international business theories, one can find different terminologies to describe different aspects of the same phenomenon. However, the definition reported in the text is widely accepted. As stressed by Jensen et al. (2013) "whether implemented by foreign wholly-owned subsidiaries or outsourcing partners, all point to the process in which firms relocate activities to foreign locations in support of domestic or global operations" (p. 1).

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