



Location choice in low-income countries: Evidence from Japanese investments in East Asia



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ABSTRACT

Unlike most existing studies, this paper examines the location choices of multinational enterprises (MNEs) in low-income countries. Specifically, we investigate the location choices of Japanese MNEs among East Asian developing countries by estimating a four-stage nested logit model and a mixed logit model at the province level. Our findings are as follows. First, Japanese MNEs consider Cambodia, Laos, Myanmar, and Vietnam to be host countries different from China and the forerunners of ASEAN. In other words, for Japanese investors, ASEAN forerunners are countries replaceable by China. Second, the mechanics of vertical FDI are more likely to appear in FDI in low-income countries. For example, rather than the market size of the host country, tariff rates on products from investing countries are more crucial location elements.

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1. Introduction

China's emergence has forced other developing countries to contend with the threat of a concentration of multinational enterprises (MNEs) in the country. China has attracted a significant volume of foreign direct investment (FDI). Since 1979, the country has attracted foreign firms as part of its export promotion policy, and since 1990, the increase in inward FDI has been remarkable. In particular, China's FDI inflow expanded rapidly after Xiao-Ping Deng's "Southern Tour Speech" in 1992. Furthermore, the rate of its increase seems to have been steadier after the country joined the World Trade Organization (WTO). As a result, in 2008, according to FDI STAT (UNCTAD), China's inward FDI stock ranked first among developing countries (10th in the world). Because of this large inward FDI in China, policy makers in developing countries, particularly ASEAN countries, have been concerned about the decrease in inward FDI that their countries have experienced from the diversion of such funds to China. In short, China has been perceived as a potential absorber of the world's FDI to developing countries.

Existing academic literature has a large number of studies that apply the well-known location choice analysis to investigate the types of countries in which MNEs locate.¹ It contains two main topics. The first topic examines various types

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¹ Recent references are as follows: Head, Ries, and Swenson (1999), Belderbos and Carree (2002), and Head and Mayer (2004) for Japanese MNEs in the US, China, and Europe, respectively. Disdier and Mayer (2004) for French MNEs in Europe, and Mayer, Mejean, and Nefussi (2010) for those in the world. Castellani and Zanfei (2004) for large MNEs in the world. Crozet, Mayer, and Mucchielli (2004) for MNEs in France, and Basile, Castellani, and Zanfei (2008) for those in Europe.

of location factors, such as the agglomeration of firms belonging to the same firm group (e.g., Belderbos & Carree, 2002); investment climate-related elements (free trade zones in the US (Head, Ries, & Swenson, 1999)); special economic zones and opening coastal cities in China (Belderbos & Carree, 2002); and Objective 1 structural funds and cohesion funds in Europe (Basile et al., 2008). The second topic explores the substitution of locations by examining inclusive values in the nested logit model (Basile, Castellani, & Zanfei, 2009; Disdier & Mayer, 2004; Mayer et al., 2010). For instance, Disdier and Mayer (2004) investigate whether French multinational firms consider Western and Eastern Europe to be two distinct groups of potential host countries by examining the coefficient of the inclusive value in a nested logit estimation. They confirm the differentiation between Eastern and Western Europe in their decision on country location and show a decrease in this relevance.

This paper investigates the location choice of Japanese MNEs in East Asian developing countries² and shows three notable points compared with existing studies. First, our investigation on the location choice in developing countries might reveal results that differ from those in previous studies. Most existing studies examine the location choices of MNEs among developed countries, particularly European countries. In this sense, existing studies analyze the location choice in the case of market-seeking FDI. In contrast, our sample host countries comprise developing countries with widely different levels of economic development. For example, in Disdier and Mayer (2004), even the poorest host country of Bulgaria (USD3513) in terms of GDP per capita in 2005, has a middle per capita income between the richest (Malaysia, USD5329) and second-richest (Thailand, USD2797) host countries in the present paper. In addition, some countries, including Cambodia, Laos, and Myanmar, have per capita income of less than USD500. Thus, for investors from Japan, which has per capita income of USD35603, FDIs in such host countries are motivated by their market and cheap labor (cheap labor-seeking FDI).³

This paper does not aim at differentiating the crucial location elements among FDI types by separately estimating the location choice model for those types. Existing literature proposes several types of FDI: market-seeking FDI, efficiency-seeking FDI, horizontal FDI, and vertical FDI. Conceptually, market-seeking FDI and horizontal FDI are the same, and efficiency-seeking FDI and vertical FDI are the same. Methods to determine the empirical differentiation among those types of FDIs have also been proposed. For example, in Hijzen, Jean, & Mayer (2011), FDIs are simply classified according to the destination country; FDIs to developed countries are regarded as market-seeking FDI or horizontal FDI, and those to developing countries as cheap labor-seeking FDI or vertical FDI.⁴ However, particularly in the context of FDI in East Asia, the motivation of each MNE's FDI is mixed. A typical example is FDI in China, of which the aim is to exploit cheap labor (efficiency-seeking FDI) and gain access to the huge local market (market-seeking FDI or horizontal FDI). In addition, Japanese MNEs in particular may become engaged in a vertical division of labor between the home plant and the plant in China (vertical FDI). As subsequently listed, these types of FDIs share some location elements as well unique elements. As a result, in this paper, we do not examine the crucial elements in specific type of FDI by differentiating FDI types and exclusively analyzing the location elements; rather, we examine which mechanism is more likely to appear in FDIs in low-income countries – a horizontal FDI mechanism or a vertical FDI mechanism. Whereas FDIs in high-income countries are mostly motivated by the market of the host countries, those in low-income countries have a mix of various motivations.

Second, despite our focus on developing countries, our examination of location choice is conducted at the sub-national level, similar to previous studies on the location choice in developed countries. Such a sub-national level analysis is important, particularly in the location choice in developing countries. Differences that are more relevant seem to exist across not only countries but also provinces within a nation for less developed countries than for advanced countries. In general, only capital cities are rich in developing countries in terms of income and infrastructure. Indeed, policies to enhance economic development are sometimes conducted selectively or gradually in terms of regional coverage. For example, the target provinces of Xiao-Ping Deng's "Open Door Policy," of which the concept is to attract FDIs, were originally concentrated in the coastal region of China. Thus, a sub-national level analysis is important for examining location choice among less developed countries; however, collecting sub-national level data in less developed countries is much more difficult. Such data are not available in a ready-made format, unlike in the case of European countries, that is, EUROSTAT. Thus, to the best of our knowledge, this study is the first to analyze the location choice of MNEs among developing countries at the sub-national level.

Third, as in the second topic in the literature on location choice, we seek the more appropriate nesting structure of the location choices of Japanese MNEs in East Asian countries, that is, their substitution patterns among these countries. For example, we intend to empirically investigate whether Japanese MNEs consider China and ASEAN countries to be two distinct groups of potential host countries by examining the inclusive value parameters in the nested logit estimation. This analysis is expected to provide some insight into the aforementioned policy makers' concern regarding whether China is a substitute for or a complement to ASEAN countries for foreign investors. In particular, unlike existing studies, we estimate

² These include China, Cambodia, Laos, Myanmar, Vietnam, the Philippines, Thailand, Malaysia, and Indonesia.

³ The numbers presented in this paragraph are drawn from the World Development Indicators Online.

⁴ Alfaro and Charlton (2009) differentiate FDI types based on the differences in sectors between home and overseas plants. While horizontal FDI is classified as the activity of overseas affiliates in the same industry as their home plant, vertical FDI is the activity of overseas affiliates in industries that are upstream from their plant's industry. Because our dataset does not allow us to identify sectors in a home plant and/or overseas plant at a detailed level, we cannot adopt these criteria in Alfaro and Charlton (2009).

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