

The Effect of Corporate Strategy and Organizational Design on the Spillover Effects of FDI

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Foreign Direct Investment (FDI), Multinational Enterprises (MNEs), Least Developed Countries (LDCs), ethnocentrism, polycentricism, geocentricism

Abstract

An important debate in the economics literature focuses on the role of foreign direct investment (FDI) in supporting the growth and development of the lesser developed countries (LDCs) globally. The ability of LDCs to capture the positive spillovers of FDI inflows depends in part on the organizational structures and corporate strategies of investing multinational enterprises (MNEs) relating to the establishment of operating subsidiaries in host countries. Investment promotion policies and practices in LDCs should be formulated with the objective of capturing the positive spillovers arising from the organizational characteristics of MNEs.

1. Introduction

Whether or not foreign direct investment (FDI) inflows are capable of spurring economic growth and development in lesser developed countries remains the subject of considerable debate in the economic literature. On the positive side, it is argued that FDI not only serves the capital needs of LDCs, but it also produces positive developmental spillover effects, promoting productivity and competition in the economies of host countries. (Alfaro et al, 2003, Ruane and Ugur, 2005, Casey, 2011, Meyer and Sinani, 2009).

Unfortunately, the effects of FDI inflows in developing countries have been disappointing in recent decades, raising the question of whether FDI can serve effectively as an engine of economic growth and development.

It is the position of this paper that the potential for FDI-induced economic development depends in part on the organizational structure and strategy of multinational enterprises (MNEs) in establishing subsidiaries in host countries.

Following a review of the literature covering the potential developmental benefits of FDI and the reasons for the recent disappointing developmental effects of global FDI, the paper links the effects of corporate organization and strategy on the ability of FDI to trigger economic progress in developing countries. Finally, the paper recommends policy approaches that developing countries should use in promoting the type of FDI that is best designed to serve their macroeconomic self-interests.

2. Literature Review

As a result of the rapid growth of global FDI during the last three decades of the 20th century, debates have arisen in the economics literature about the potential benefits of FDI as an engine of economic growth and development (United Nations, 2002, DeMello, 1999, Zhang, 2001, Casey, 2014). Proponents of FDI fueled economic development argue that FDI provides more than needed capital inflows. Specifically, FDI is said to generate positive investment spillovers, which combine to promote productivity gains in host countries (Blomstrom, Kokko, and Zejan, 2000). Productivity gains are captured by host countries when indigenous firms benefit from the internal transfer of product technology, process technology, and managerial know-how from MNE subsidiary operations. Transfers can be either horizontal, in which host country competitors gain knowledge or insight operating at the same level of production as MNEs, or vertical in which supply chain linkages between MNEs and indigenous firms (either upstream or downstream) provide the same benefits (Casey and Kafi, 2009, Hanson, 2001, and United Nations, 2011).

Local firms may benefit from technology transfers, improving the quality of their products and processes through observation, through direct or indirect contact with MNE subsidiaries or through former MNE employees. Relationships within the supply chain may also translate into productivity gains through the transfer of technology or managerial insight (Gorodnichenko, Svejnar and Terrell, 2007).

Despite the logic in arguments offered in support of FDI-induced economic development, the empirical evidence from economic research is mixed with a decidedly negative component. Although positive horizontal spillovers have been uncovered in host countries in the industrial world (Haskel et al, 2007), the same is not true of FDI flowing into the developing countries. Studies suggest that spillovers (particularly the horizontal variety) are either disappointingly weak or actually negative (Gorodnichenko, Svejnar and Terrell, 2007, Kosova, 2004, Yudaeva et al, 2003).

Several studies confirm that the growth and development enhancing impact of inward FDI is dependent on host country economic/social conditions and economic policy, which may or may not be favorable (Casey, 2011). These studies include Borensztein et al, 1998, Zhang, 2001, Benjao and Sanchez-Robles, 2003, and Balasubramanyam et al, 1999. Other studies simply failed to find significant linkages between inward FDI and economic growth and development. They include Lyroudi et al, 2004, Choe, 2003, Carkovic and Levine, 2002, De Mello, 1999 and Aiken and Harrison, 1999. The impact of FDI on development has been most disappointing for the poorest of the LDCs. A disproportionate share of FDI flowing to the developing world goes to the largest and richest members of that group (e.g. China, India, Brazil, Mexico, etc.). These are countries either on the threshold of industrialization or those in the process of passing through the door (Casey, 2014).

Unfortunately, relatively little FDI in the area of manufacturing flows to the least developed countries, and evidence indicates that the relatively small amount of inward FDI that does reach these least developed countries generally fails to produce significant positive spillover effects (UNCTAD, 2006, World Bank Group, 2008, Collier, 2007, Casey, 2014).

The Economic and Social Council of the United Nations has identified those countries that rank among the poorest globally. Currently, the countries labeled as "least" developed include: Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina Faso, Burundi, Cambodia, the Central African Republic, Chad, the Comoros, the Democratic Republic of Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, the Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, the Lao People's Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, the Solomon Islands, Somalia, South Sudan, Sudan, Timor-Leste, Togo, Tuvalu, Uganda, the United Republic of Tanzania, Vanuatu, Yemen, and Zambia (United Nations, 2016).

Although a few of these "least" developed countries are Asian or Oceanian-based, a significant majority are located on the African continent. As reflected in Table 1 and 2, African nations have been unsuccessful in attracting their fair share of global FDI. Developing countries, broadly defined, have been successful in this regard, but these are mostly Asian countries (with a few Latin American countries such as Brazil and Mexico) that are on the threshold of economic development (Casey, 2014).

Table 2 indicates not only that the African Nations' share of FDI in LDCs has remained relatively low over the past two decades, but also that the trend is negative. The occasional spurt in inward FDI in Africa (e.g. in 1970 and 1985) is attributable to heavy investments in African extractive industries, not in development promoting manufacturing industries (UNCTAD, 2006).

The difficulty that LDCs have in competing for growth inducing FDI inflows can be best understood within the context of Dunning's OLI Paradigm (Dunning, 2001). The theory argues that MNEs are motivated to invest overseas as producers if they are able to exploit (1) ownership advantages, (2) location advantages, and (3) internalization advantages.

Ownership advantages arise from the property rights and intangible assets that are based on the resource structure of the MNEs. Firms seek to exploit existing technological and managerial superiority and to gain new knowledge from overseas business environments.

Unfortunately, LDCs benefit mostly from technology and managerial transfers which may compromise the MNEs' ability to maintain a competitive edge in the global marketplace. Furthermore, if MNEs are focused on gaining new knowledge and experience from FDI, LDCs are in a relatively poor position to compete with other FDI venues in this regard, particularly in the industrialized world.

In reference to location advantages, the least developed countries fail to attract significant amounts of inward FDI for several reasons. One reason relates to the absence of those economic/political/social conditions in target countries that traditionally have served as "magnets" pulling FDI from global MNEs, particularly in the area of manufacturing. Conditions important to MNEs that are not found in the poorest LDCs include large, stable internal markets, adequate infrastructure, productive labor forces, and enlightened public policy and regulations, including the governmental protection of property rights.

Finally, Dunning's internalization advantages relates to how a MNE should invest (entry mode) in order to serve a foreign market. Why not serve the market with an arm's length arrangement (e.g. exporting, entering into a licensing arrangement with indigenous firms in the target market area)?

TABLE 1

Inward Foreign Direct Investment Flows (1970 – 2014)

	Total	Developed Economies	Developing Economies			
			Total	Africa	Asia	Central & South America
1970	\$13,346	\$9,491	\$3,854	\$1,266	\$854	\$1,599
1975	26,567	16,858	9,709	906	5,265	3,514
1980	54,069	46,576	7,469	100	532	6,416
1985	55,842	41,663	14,165	2,442	5,413	6,223
1986	86,394	70,629	15,794	1,771	9,278	4,639
1987	136,640	114,842	21,791	2,443	13,456	5,774
1988	164,094	133,581	30,490	3,032	18,130	9,123
1989	197,648	166,530	31,100	4,693	17,329	8,767
1990	207,362	172,525	34,762	2,846	22,658	8,925
1991	153,795	114,034	39,557	3,535	24,202	11,601
1992	166,028	111,143	53,221	3,796	33,094	16,139
1993	223,356	143,433	76,780	5,443	56,009	15,135
1994	255,980	150,578	103,357	6,081	68,117	28,994
1995	343,544	222,480	116,957	5,907	80,995	29,507
1996	391,439	236,032	149,536	6,298	96,873	46,248
1997	488,160	285,384	192,927	11,270	107,598	73,385
1998	705,935	508,739	189,074	10,229	92,978	85,565
1999	1,091,491	851,820	231,063	12,008	113,953	104,565
2000	1,413,169	1,141,558	264,543	9,621	156,581	98,048
2001	836,012	602,480	224,070	19,943	122,894	80,782
2002	\$626,831	\$445,597	\$169,212	\$14,613	96,062	58,487
2003	601,246	387,501	193,751	18,158	127,144	47,966
2004	734,148	423,654	280,262	17,370	166,300	96,241
2005	989,618	621,454	334,521	30,913	225,004	78,054
2006	1,480,587	985,888	432,113	36,575	295,926	98,293
2007	2,002,695	1,319,893	589,430	51,274	364,899	171,929

2008	1,816,398	1,026,531	668,439	58,894	396,152	210,679
2009	1,216,475	613,436	530,289	52,964	324,688	150,150
2010	1,408,537	696,418	637,063	43,582	400,657	189,855
2011	1,651,511	820,008	735,212	47,598	436,150	249,432
2012	1,350,926	560,718	702,826	50,041	406,770	243,861
2013	1,467,199	696,770	770,379	53,969	427,879	186,151
2014	1,228,283	498,784	729,499	53,912	465,285	159,405

US Dollars in millions

Source: United Nations Conference on Trade and Development, UNCTADSTAT

TABLE 2

Regional Shares of Inward FDI to LDCs (1970 – 2014)

In percentages

Year	To Africa	To Asia	To Central & South America
1970	32.8	22.2	41.5
1975	9.3	54.2	36.2
1980	1.3	7.1	85.9
1985	17.2	38.2	43.9
1990	8.2	63.2	25.7
1995	5.1	69.3	25.2
2001	8.9	54.8	36.1
2002	8.6	56.8	34.6
2003	9.3	65.6	24.8
2004	6.2	59.3	34.3
2005	9.2	67.3	23.3
2006	8.5	68.4	22.7
2007	8.7	61.9	29.2
2008	8.8	59.3	31.5
2009	9.9	61.2	28.3
2010	6.8	62.9	29.8
2011	6.8	59.3	33.9
2012	7.1	57.9	34.7
2013	7.0	55.5	24.2
2014	7.4	63.8	21.9

Source: United Nations Conference on Trade and Development, UNCTADSTAT

MNEs will incur the costs of entering the market as a producer by establishing operating subsidiaries if they can gain new assets and insight and if they can best protect whatever competitive advantage they may have through internalization.

Unfortunately, there are fewer opportunities in LDCs for MNEs to gain new knowledge or insights compared to other investment venues. This is particularly true of the potential for MNEs to benefit through host country technology transfers.

Also, transfers of technical insight and managerial know-how are actually what LDCs need in their relationship with MNEs. This will not benefit MNEs if such transfers have the effect of compromising the competitive advantage that induced the MNE to invest in the first instance.

However, even in those cases in which LDCs succeed in attracting the type of FDI capable of providing positive spillovers, results tend to be disappointing. For example, inward FDI has the potential to close the technology gap between technologically advanced MNEs and technologically backward LDCs, but the presence of a manufacturing subsidiary operating with

a sophisticated technology in an LDC is not guaranteed to close the gap by technology transfer (Meyer and Sinani, 2009, Haddam and Harrison, 1993, Kokko, 1999).

It cannot be assumed that the operating technology of MNE subsidiaries can be easily observed and transferred, particularly if the MNE has the incentive to block the transfer in order to protect its competitive advantage. It is argued that successful transfers depend on "awareness, motivation, and capabilities." Indigenous companies in LDCs in contact with the subsidiaries of MNCs either through competition or through supply chain relationships must be aware of the specifics of the technology and must be motivated and capable of assimilating it (Smith et al, 1991). This is asking a great deal from indigenous companies in technologically backward and technologically challenged LDCs.

3. FDI and Organizational Structure

One additional reason for the disappointing effects of growth induced inward FDI in developing countries is based on the organizational structure and corporate strategies of investing MNEs. Using the organization frameworks suggested by Perlmutter (1969), MNEs have three choices in establishing an organizational design for operating subsidiaries overseas: 1) an ethnocentric (home country oriented) structure, 2) a polycentric (host country oriented) structure and, 3) a geocentric (world oriented) structure (Moon, 2016).

An ethnocentric design identifies corporate headquarters in the investing country as the locus of decision-making authority, applies home standards in matters of performance evaluation and control, and emphasizes the recruitment and development of home country personnel for key positions in overseas subsidiaries.

By way of contrast, a polycentric design designates the subsidiary in the host country as the locus of decision-making authority, establishes a system of performance evaluation and control that is determined locally in the host country, and recruits and develops locally for key positions in operating subsidiaries.

Finally, a geocentric design aims to establish a collaborative approach between MNE headquarters and subsidiaries and attempts to achieve balance between home country and host country recruiting, seeking to reward the most productive personnel regardless of their countries of origin. (Perlmutter, 1969).

4. A Conflict Of Interest

As indicated above, MNEs are motivated to invest overseas in order to exploit a competitive advantage, typically in the form of a superior product technology, a superior process (production) technology, or more efficient managerial talent or approaches. Continued success in overseas operations depends on the success of subsidiaries in maintaining technological and managerial superiority.

Accordingly, competitive advantages can be best maintained by the exertion of maximum home country control (the ethnocentric structure) and the use of home country personnel recruiting as the most effective way to maintain technological managerial superiority in competition with local firms in host countries.

However, host countries have the incentive to encourage those managerial approaches and practices that are best designed to capture the positive externalities of inward FDI. As indicated above, the keys to the use of inward FDI flows in promoting economic growth and development are the transfers and diffusion of technology and managerial know-how, emanating from the operations of MNE subsidiaries.

The conflict of interest arises because host countries are best served if MNEs adopt more of a polycentric organizational design in which decision-making authority, evaluation, and control are more locally based and in which corporate managerial recruitment and development are more local as well. Local managers have more of an incentive to assimilate and adopt new technologies and less of an incentive to block technology transfers in an effort to maintain the technological superiority of the MNE. Thus, in summary, whereas the ethnocentric organizational structure is best designed to protect the long-term competitive position of the

MNE, the polycentric structure favors the self-interest of the host country, providing the best opportunities for indigenous firms in host countries to capture positive FDI externalities.

5. Discussion and Summary

The conflict of interest, cited above, can be best resolved if the MNE adopts more of a geocentric organization design, seeking more of a collaborative approach between MNE and host country interests. This would include the recruitment of the best personnel to manage the firms' subsidiary operations whether from the home country or from the indigenous managerial pool.

In establishing truly international companies, subsidiary managers would be rewarded for achieving both local and global objectives. Technology transfers in the host country would be encouraged and rewarded, assuming that the MNEs' competitive advantage globally is not compromised.

With this in mind, LDCs should use incentive programs in recruiting those MNEs most likely to institute organizational structures and arrangements best suited to the transfer of technology and managerial know-how.

As indicated above, local workers and managers trained in the subsidiaries of MNEs are in the best position to learn new technologies and managerial/entrepreneurial skills and to transfer the same to local firms or to entrepreneurial startups (Moon, 2016). As local firms develop new competencies, demand will be stimulated, costs will be better controlled, and healthy competition will be stimulated.

The use of investment incentives by host countries today is commonplace. However, if the least developed countries are to succeed in attracting their fair share of global FDI, a proactive, aggressive, and targeted investment promotion strategy is needed (Casey, 2014, Sanjaya, 2002).

Specifically, LDCs should aggressively target those MNEs willing to adopt more of a geocentric organizational design in establishing subsidiary operations and also willing to assist in the transfer of technology and managerial skills. This willingness assumes, of course, that such transfers do not weaken the global competitive portion of the MNEs.

It would, of course, be naïve to assume that MNEs would be willing to transfer the most up-to-date technologies. However, given the wide technology gap between globally competitive corporations and the least developed countries in the world, technologies that may be obsolete in the industrialized world may be useful in the third world. A targeted promotion strategy adopted by LDCs should be designed to identify those MNEs that would be willing to assist in the transfer of those technologies that no longer serve at the core of the firms' competitive advantage.

As indicated above, it is also true that technology transfers occur vertically within the supply chain as well as horizontally among competitors. A targeted investment promotion strategy therefore should seek out those MNEs willing and able to develop supply relationships with indigenous suppliers in host countries. This would promote both the vertical transfer of technology and of managerial insight and skill.

LDCs should avoid the general use of subsidiaries and tax relief in investment promotion packages. Rather, financial and tax incentives should be reserved for those MNEs that assist in the transfer of knowledge and know-how either horizontally or vertically, or at least do not block the same.

Finally, the marriage of interest between knowledge seeking LDCs and knowledge transferring MNEs should be an objective of foreign aid programs established by governments of industrialized countries. Foreign grants and loans may be useful, but LDCs need more than capital. Under the right circumstances, FDI can bestow much more.

6. Limitations of the Study

The purpose of this article is to provide a conceptual framework for studying the impact of organizational structures and corporate strategies of MNEs relating to the establishment and management of operating subsidiaries in target countries.

The conclusion reached in the article that a geocentric organizational design is preferable to alternatives is based on deductive reasoning not on empirical evidence. Statistical evidence of MNE corporate strategies in this regard is not offered in the article.

The article uses an analytical framework of organizational structure and corporate strategy alternatives formulated by Perlmutter (1969). Given the purpose of the article, this seemed to provide the most relevant and useful framework. No effort was made in the article to compare the Perlmutter paradigm to others, which could serve as an interesting extension of this study.

7. Suggestions for Further Research

Certainly, additional research is needed to trace the flow of FDI to LDCs, particularly in reference to the poorest lesser developed nations. Of particular importance in this regard are the reasons why the poorest nations with the greatest need for capital infusions have received in recent decades a disproportionately small share of global FDI.

In reference to the focus of this paper, studies are needed to assess the importance of the organizational structures and corporate strategies of investing MNEs in governing the volume, pace, and direction of global FDI flows.

In addressing these issues, regional studies are needed, attempting to determine whether the particular investment venue governs the type of organizational strategy used by MNEs in establishing and managing operational subsidiaries in target areas. For example, are MNEs more comfortable using an ethnocentric organizational design in subsidiaries operating in industrial regions and more reluctant to use this home country oriented structure, giving locals more decision-making autonomy, in LDCs?

Overall, it is important for future research to address the question of whether global FDI is capable of closing the GDP gap between rich and poor countries, and whether the MNE investment strategy and organizational design are responsible for promoting or retarding the same.

At a time when the benefits of globalization, free trade, and free capital movements are being challenged politically, including in the US, it is important for studies to measure the economic benefits and costs of FDI on both investing and host countries and on both rich and poor countries. Is FDI a "zero sum game", as some would suggest, with losers offsetting winners? Or, can FDI, particularly the type flowing to LDCs, produce a positive sum game benefitting the home country of the MNE as well as the LDC?

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