Editorial statement

*Transnational Corporations* (formerly *The CTC Reporter*) is a refereed journal published three times a year by UNCTAD. In the past, the Programme on Transnational Corporations was carried out by the United Nations Centre on Transnational Corporations (1975-1992) and by the Transnational Corporations and Management Division of the United Nations Department of Economic and Social Development (1992-1993). The basic objective of this journal is to publish articles and research notes that provide insights into the economic, legal, social and cultural impacts of transnational corporations in an increasingly global economy and the policy implications that arise therefrom. It focuses especially on political and economic issues related to transnational corporations. In addition, *Transnational Corporations* features book reviews. The journal welcomes contributions from the academic community, policy makers and staff members of research institutions and international organizations. Guidelines for contributors are given at the end of this issue.

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A framework for FDI promotion

Henry Loewendahl*

Attracting foreign direct investment has become a central component of industrial policy in developed and developing countries across the world. There is a large volume of literature identifying why firms engage in international investment, the economic and political determinants of investment location and the impact of foreign direct investment on economic development. However, there is minimal research examining the role of investment promotion in attracting foreign direct investment. This is a major caveat, as most countries, and many regions within countries, have established investment promotion agencies with the specific objective to attract inward investment. In this article, a detailed analysis of investment promotion is provided, and a framework that investment promotion agencies can use to improve their effectiveness in attracting foreign direct investment and maximize the benefits for their local economies is developed. Based on case-study evidence, it is argued that the most successful investment promotion agencies have developed an integrated investment promotion strategy that combines marketing and company targeting with after-care and product development.

Introduction

Image, brand awareness, and perceptions are major factors influencing the location of foreign direct investment (FDI). Companies make investment location decisions on the basis of their information pool and understanding of an area’s location “offer”. Investment promotion is therefore an essential component of attracting inward investment, and there has been a rapid growth in the number of investment promotion agencies (IPAs) across the world.¹

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* Senior Consultant, PricewaterhouseCoopers-Plant Location International, Brussels, Belgium.

¹ Corporate Location estimated that 30 new IPAs were formed every year in the first half of the 1990s.
However, there is relatively little research on the role of investment promotion in attracting FDI. In this article, the reasons why investment promotion is important and how it affects investment location are outlined. A practical framework for the establishment and effective operation of IPAs is then developed, using case studies to provide practical insights into the different elements of successful investment promotion, from setting up an agency to marketing activities, company targeting, after-care and product development. Case studies presented draw in particular on the experience of the mature inward investment agencies in Europe, but also look at examples of investment promotion in developing countries. The framework developed here is aimed at both national and regional IPAs, as the relationship between investment promotion at the national and regional levels varies markedly between countries.

Why engage in investment promotion?

When making a decision on where to locate the information base of transnational corporations (TNCs) is far from perfect, and the decision-making process can be subjective and biased (UNCTAD, 1999). It is often a bureaucratic process, which may be affected by imperfect competition, distorted risk perceptions and political rivalry between affiliates of TNCs. The implication, as the International Finance Corporation (IFC) argues, is that: “Most companies consider only a small range of potential investment locations. Many other countries are not even on their map” (IFC, 1997, p. 49).

Countering market imperfections in the location decision making process is the key reason why L. T. Wells and A. G. Wint (1990) found that the net present value of pro-active investment promotion to be almost $4 for every $1 expended. Specifically, they found that investment promotion was most effective when it:

- Overcame information asymmetries.
- Compensated for the imperfect functioning of international markets, which makes parent companies reluctant to consider new production sites.
- Led to product differentiation of the host country as a location for targeted activities.²

² See Wells and Wint (2000) for an update of this research.
The first two factors provide part of an explanation for the follow-the-leader pattern and “bunching” in FDI that has been observed for many years (e.g., Knickerbocker, 1973). Companies acquire information primarily via learning-by-doing, demonstrating the importance of comfort factors, such as the FDI track record of a host country, in determining investment location. Often a “flagship” investment by a major company increases the information and reduces the risk for other TNCs (see Loewendahl, 2001 for the case of Japanese automotive investment in Europe). Left to the market, FDI may therefore be under-supplied (Moran, 1999).

However, despite the positive role that IPAs can play in attracting FDI, there is a lack of research on the subject of investment promotion (Wells and Wint, 1990), even as countries increase their expenditure on investment promotion activities. Drawing on interviews conducted in 2000 with 30 major TNCs and global professional services firms and the author’s own experience of working with 15 IPAs from across the world in the capacity of management consultant with PricewaterhouseCoopers, a framework for investment promotion is developed next.

**A framework for investment promotion**

Building on the work of IFC (1997), P. Christodoulou (1996), S. Young et al. (1994) and P. Dicken (1990), investment promotion can be divided into four main areas:

- **Strategy and organization** (setting the national policy context; setting objectives; structure of investment promotion; competitive positioning; sector targeting strategy).
- **Lead generation** (marketing; company targeting).
- **Facilitation** (project handling).
- **Investment services** (after-care and product improvement; monitoring and evaluation).

In the first half of 2000, Saudi Arabia, Brazil, New Zealand and Hong Kong have all announced major increases in expenditures to attract FDI. The European Union is also supporting investment promotion in developing countries through Phare funds, such as a 1,000,000 Euro tender in early 2000 to support the Bulgarian investment promotion agency.

The interviews were part of a study examining FDI in Turkey and Central and Eastern Europe, and were based on the open-ended question: how can governments more effectively promote their locations?
Strategy and organization

Stage 1: Setting the national policy context

The national policy context is an integral part of effective investment promotion. An IPA will find it very difficult to market and promote its location unless the basic policies to facilitate FDI are in place. As UNCTAD (1999) argues, an FDI-enabling framework is a pre-condition. The enabling framework includes:

- **Macroeconomic policies** set a positive framework for the attraction of foreign investment. Key policies include a liberal trade and payments regime and a favourable tax regime. A minimal state role in the economy and a non-discrimination policy stance are particularly important in sending positive signals to investors.

- **A degree of economic stability** is essential for attracting significant inward investment, with low inflation and country risk being of particular importance (Loewendahl and Ertugal-Loewendahl, 2000).

- **Supply-side “product development” policies** at the very minimum need to provide essential investment in the physical, communications and human infrastructure. Improvement of infrastructure, the supply of sites and properties for industrial and commercial use, the education and training of labour and the innovation system of the country all have implications not only for the attractiveness of the location to investors, but also for the quality of inward investment (Lall, 1997; Hood and Young, 1997; Thiran and Yamawaki, 1995; Mowery and Oxley, 1995; Brunskill, 1992).

- **Specific regional policies** to encourage investment in particular parts of a country form a major element of the national policy framework in many countries. While TNCs usually long-list countries rather than regions, it is at the sub-national level that TNCs draw up a short list of investment locations for in-depth evaluation and the policies and facilitation of regional agencies often play a critical role in determining who wins a mobile investment project.

- **Inward investment policies** to remove restrictions on FDI and to create or support dedicated national and/or regional promotional organizations are central to attracting inward investment.
When these policies are used in a combined and coherent way to promote investment, they can provide a powerful inducement for companies to locate or expand in a particular location.

**Stage 2: Setting objectives**

For an effective IPA strategy, it is important that there is clarity of objectives with a strong logic behind them. Building on Young et al. (1994), there are several key issues that need to be taken into consideration in setting objectives for investment promotion:

- **Why does a government want to attract inward investment?** This is a fundamental question, as it will influence the size, structure and priorities of the IPA. Objectives may include creating jobs in poor regions, technology transfer, increasing competition, compensating for a weak indigenous base, filling-in supply gaps, developing clusters and providing partnering opportunities for local firms.

- **What are the national priorities for sectors?** This is a key issue as IPAs have discrete resources and best-practice evidence (e.g. Wells and Wint, 1991) shows that effective investment promotion is focused on key sectors or industry clusters.

- **Is the objective sector size or sector positioning?** Will the IPA focus on any type of project within a sector, or on projects that meet positioning objectives, such as developing a centre of excellence or a particular business activity (e.g. headquarters or research and development) in a specific sector. The Singapore Economic Development Board (SEDB) is perhaps unique among IPAs in that it will not support investors unless they are in target sectors or clusters.

- **Will the IPA differentiate by the modality of FDI?** Is the objective new greenfield investment, expansions by existing investors, joint ventures, mergers and acquisitions (M&As) or other types of strategic partnerships? Many agencies in Europe, especially at the regional level, are now spending as much resources on supporting expansions as on attracting new investment. Oregon in the United States focuses exclusively on after-care with existing investors as the primary mechanism to generate new investment. Other agencies also support joint ventures between indigenous and foreign firms (e.g. SEDB, Welsh Development Agency...
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(WDA) and CzechInvest), while a few agencies also support M&As (e.g. Invest in Sweden Agency).

• What is the role for incentives? Incentives can and do affect investment location decisions (Loewendahl, 2001). However the emphasis on incentives varies considerably. For example, the Industrial Development Agency (IDA) in Ireland, SEDB and Investment, Trade and Tourism of Portugal (ICEP) are among the few agencies in the world that have control over incentives and can put an “offer on the table” to an investor even before they have committed to invest. At the other extreme, Denmark does not offer any incentives at all for foreign investors. Other issues include:

- Should incentives be across the board (mandatory) or discretionary? Mandatory incentives create policy certainty as an investor is automatically awarded incentives if they meet obligations set out in a predetermined criteria, while discretionary incentives allow focused support for projects that meet inward investment objectives, but involve greater unpredictability for the investor.

- What types of incentives should be on offer? Options include national, regional, or local grants, tax credits, research and development (R&D) and other special purpose incentives; employment incentives, recruitment and training assistance and site or infrastructure improvements (Young et al., 1994). Incentives can be up-front, or dependent on continuous upgrading of the investment project (e.g. SEDB and IDA).

- What criteria should be used to allocate incentives? Several commentators argue that only projects that meet “quality” criteria, such as R&D, quality of jobs, export intensity and functional mandate, or that are in target sectors or clusters should be awarded incentives (Rhodes, 1995; Amin and Tomaney, 1995; Amin et al., 1994). The example of Singapore shows how prioritising and integrating incentives with the targeting of specific investors can have positive effects (Oman, 2000).

- Which body should award the incentives? IPAs can have the powers to negotiate directly a deal for investors, facilitating a “one-stop-shop” approach, but many countries separate this function for accountability reasons, and to ensure that the IPA
markets its area based on competitive fundamentals rather than subsidies. A related issue is whether incentives should be controlled and awarded at the central or regional level.

- **What are the roles and actions of stakeholders?** A coordinated position on inward investment promotion needs to be developed, integrating the activities of IPAs at the national and regional levels, and working with other stakeholders involved in the investment attraction and facilitation process. For example, many IPAs use their governments’ network of overseas foreign offices for overseas promotion. There is also increasing cooperation between agencies. Examples include the Industrial Development Board (IDB) in Northern Ireland and the IDA and Locate in Kent (South of England) and Invest in Nord pas Calais (Northern France). In Scandinavia, the IPAs jointly promote the Baltic region.

**Stage 3: Structure of investment promotion**

A key issue is what kind of structure is most effective for investment promotion? In practice, the structure of investment promotion varies between countries, due to the different objectives in attracting inward investment, size of countries and differences in the importance of regional agencies. No single structure fits all countries. For example, a single, dedicated national IPA has been established in large countries like the United Kingdom (Invest.uk) and Thailand (Board of Investment) and in smaller countries like Bulgaria (Bulgarian Foreign Investment Agency) and Denmark (Invest in Denmark Agency). National IPAs are usually part of, and financed by, the ministries of trade, economics or industry, and often have strong links to the ministry of foreign affairs, which facilitates overseas investment promotion.

In other countries, investment promotion is handled primarily at the regional rather than national levels. For example, the United States has no national IPA, because of the economic and political weight of federal states. The United States feels it does not need promotion at the national level due to the strong brand awareness of the country as an investment location and due to the fact that the vast majority of “inward investment” is inter-state rather than inter-country. However, at the state level it is a completely different picture, with powerful investment agencies aiming at promoting their states and facilitating inward investment. Similarly, China has no dedicated agency for investment promotion at the national level.
While the remit for investment promotion at the national and regional levels and structural links between investment promotion and other government departments varies between countries, a common element of successful investment promotion is the establishment of a dedicated agency or department. M. M. Atkinson and W. D. Coleman (1985) highlight three key pre-conditions for the effective operation of an agency:

- The agency has a clearly defined role and value system that supports it, which is more likely if the agency has a functional mandate as opposed to one that obliges it to represent the interests of a particular clientele.
- Operational autonomy will be greater if functional responsibilities for a given sector are clearly assigned to a single agency.
- The agency requires independent access to expertise and information in order to act autonomously from firms and sectoral associations.

Atkinson and Coleman (1989, pp. 79-80) therefore argue that a centralized, autonomous and single agency or bureau in a given area will have the greatest capacity to make and implement policy. By the beginning of 2001, countries such as France and Brazil have addressed the fragmented responsibility and considerable bureaucracy associated with investment promotion through merging previous agencies to create a single, dedicated IPA at the national level for coherent pro-active marketing and streamlined project-handling and facilitation.

Whether operating at the national or regional level, IPAs need to be sufficiently independent from governments, giving the agency greater credibility with investors and flexibility. IPAs also need strong links to stakeholders, both public and private, so that an area's final offer is more than the sum of parts (Christodoulou, 1996). For example, government planning.

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5 IPAs are in-between government and business. They are accountable to governments, but at the same time have to operate in a highly commercial environment. They, therefore, require a broad mix of skills. Marketing skills are essential, and more specialized skills may be needed depending on the scope of the agency. Project officers must have a good grasp of international business, economics and usually some sector expertise, as well as good contacts in government. Investment agencies, therefore, need to have the flexibility to recruit and keep appropriately skilled staff, or maintain an external network of contacts (which may include existing foreign investors) that can give expert advice when needed, meet with potential investors and attend specialized conferences.

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housing and education and small business support departments may play a significant role in facilitating investment projects, as may universities, training colleges and professional advisers, such as accountants, lawyers, property developers and consultants. Key governmental links include:

- **For major investment projects, government ministers at the highest level may need to be rapidly mobilized** to create policy certainty and demonstrate the seriousness with which the project is viewed. Ministers can also be used on overseas visits to potential investors and on visits to existing investors at home. In France, a Minister is appointed as an “Ambassador at Large” for promoting investment and has a small department. Countries like Ireland and the Netherlands appoint designated senior officials with responsibility for inward investment in each Ministry. However, evidence (e.g. Spar, 1998) suggests that the promotion effort is often most effective when coordinated and led by the IPA, which plans the use of ministers.

- **Investment promotion needs to be coordinated at the national and regional levels.** Regional agencies within a country are often competing for the same investment projects (Oman, 2000), and it is essential that there is effective coordination of agencies to avoid wasteful competition and a duplication of effort and resources. This problem is particularly vivid in the United Kingdom (Loewendahl, 2001). One method that has been used by several countries to help overcome zero-sum competition is a periodic rotation of staff between agencies. This generates greater understanding and can facilitate personal networks and cooperation between agencies. Other national IPAs ask regional agencies to “buy-in” to target sectors so that investment promotion is integrated at the national and regional levels. The national and regional agencies share the cost of marketing, and when the national IPA has an investment lead it is clear which regions are most suitable.

- **The agency must be strong enough to influence decisions** affecting individual investments, as well as investment policy, and should have a voice in the policy making process. The agency should have an active say in tax policy, incentives, exchange rate policy and labour policy — all key variables affecting location attractiveness. For example, Invest in Denmark is consulted before changes in tax policy and has an influence on immigration policy, while the Invest in Sweden Agency produces an annual report highlighting
the key obstacles to inward investment explicitly for other government departments.

Stage 4: Competitive positioning

Successful investment promotion requires clear strategic direction and effective marketing. The analysis that underpins strategy and marketing is described as competitive positioning. Competitive positioning is an important activity for all new investment promotion campaigns, and it is therefore relevant for both newly established and for more mature agencies. It is also an important activity for agencies wishing to reappraise their strategic position and re-define their offers, as well as to provide project officers with the most up-to-date key selling messages, supporting information and market intelligence on key sectors and competitors. Several leading IPAs conduct a competitive positioning exercise on an annual or bi-annual basis. There are two core elements to competitive positioning:

- **Research.** An analysis of a location’s strengths, weaknesses, opportunities and threats (SWOT) relative to each industry sector’s requirements and key competitors for inward investment in each of these sectors. This may also include a SWOT analysis of the IPA itself relative to competitors, as well as the location.

- **Market planning.** Based on the above analysis, key propositions (often called unique selling points or USPs) are developed for key sectors and specific types of projects. The aim is to define a location’s offer and provide IPA project officers with competitive arguments to use when approaching potential investors.

A competitive positioning exercise should therefore provide at the strategic level a detailed understanding of a location’s position relative to competitors and different sectors, and at the project-level information allowing project officers to promote effectively their areas as a location for inward investment and handle investor enquiries.

Stage 5: Sector targeting strategy

Investment promotion agencies are moving towards a sector-based targeted investment strategy in order to attract investment most effectively and to prioritize limited resources to
where they are the most useful and to where the probability of winning projects is the highest.

Sector targeting should identify sectors in which the host country is best placed to attract investment and which meet inward investment objectives (Potter and Moore, 2000; Brand et al., 2000). Figure 1 illustrates one method IPAs can use to evaluate sectors. The aim is to identify sectors in the right-hand corner that meet investment objectives.

**Figure 1. Sector evaluation matrix**

The evaluation matrix positions sectors according to:

- **FDI opportunities** — sectors with the best potential for mobile projects. The key aim is to identify sectors that are growing and internationally mobile.

- **Competitive position** — the strength of the location vis-à-vis competing locations for the sector. It is important to identify sectors in which the host country has an existing competitive strength, or one that can be realistically developed.

- **Degree to which it meets FDI objectives** — extent to which the sector meets the overall objectives in attracting FDI. Increasingly, leading IPAs are:
- Focusing not only on job creation, but are also prioritizing sectors and activities that will need skilled labour, domestic research and development capability, and will help to build networks among innovative firms (OECD, 1999, p. 25; Christodoulou, 1996, p. 84).
- Attracting FDI that takes into account and capitalizes on the strengths of indigenous industry (de Vet, 1993), in order to generate the most benefits from FDI and embed TNCs in the local economy.

Furthermore, the most advanced IPAs, especially at the regional level, focus business activities within their target sectors and sub-sectors to complete and upgrade value-adding chains and develop advanced clusters. An example of a sector-activity positioning matrix is given in figure 2 below. It shows an IPA targeting three main industries (automotive, pharmaceuticals and telecommunications). Within these industries, the IPA is focusing on several sub-sectors where it has a competitive advantage to develop clusters.

**Figure 2. Sector-activity positioning matrix (example)**

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<th>Logistics and distribution</th>
<th>Shared services</th>
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<td>- Software</td>
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- In the automotive industry, the IPA is focusing on R&D and headquarters activities. By attracting strategic and high value-added activities, the IPA may be aiming to embed an already strong automotive manufacturing industry.

- In the pharmaceuticals industry, the IPA is focusing on R&D in biotechnology and manufacturing and logistics and distribution activities in the complementary medical goods sub-sector. Here the strategy may be to fill in the
value-added chain and develop clusters, as well as benefit from the worldwide rapid growth in biotechnology.

- In the telecommunications industry, the IPA is focusing on manufacturing, R&D and shared services in telecommunications equipment and R&D in the software sub-sector. The strategy could be to develop an export-intensive manufacturing industry and also create a large number of supporting high quality service sector jobs through attracting shared service centres and software development in telecommunications.

Competitive positioning and sector/activity targeting is a complex process and requires:

- A detailed knowledge of industry sectors and trends, FDI trends, cluster development, company strategy, typical project requirements and parameters and best-practice IPA activities.
- Up-to-date, fact-based comparative research providing hard data to support image-building and investment propositions made to companies.
- A reflective analysis of the location and activities of the IPA.

For these reasons, many IPAs prefer to hire independent consultants. However, it is recommended that IPAs also exploit fully market intelligence gained from monitoring and evaluating their own investment promotion activities (stage 10).

**Lead generation**

**Stage 6: Marketing**

In order to promote a location, it is essential that there is an internationally recognized brand name that overseas investors can identify with. Brand and image can be critical in attracting inward investment as overall perceptions by companies and investment brokers (“multipliers”) of a particular location may prevent the location from making the long and short-lists (see box 1 for the case of Turkey).
Box 1. Turkey’s FDI performance: the importance of investment promotion

Given the size and dynamism of its economy, quality of its workforce, liberal FDI legislation and incentives and the presence of a customs union with the European Union, Turkey should be highly attractive as an investment location. However, Turkey has greatly under-performed in attracting FDI. From 1993-1999, Poland attracted nearly six times more FDI than Turkey and, adjusted for GDP, Hungary attracted nearly 13 times more. Key reasons for Turkey’s under-performance are minimal levels of privatization-related FDI and high inflation. However, a recent survey of 30 major investors and multipliers found that the third most frequently cited factor explaining Turkey’s under-performance was lack of information and poor perceptions. This indicates the weakness of Turkey’s investment promotion, with 85 per cent of respondents stating that it is ineffective. Turkey is an example of how bad practices in investment promotion can reduce FDI in the context of increasing competition for investment. Several key weaknesses of Turkey’s promotion include:

- The national IPA is not distinct enough from the government bureaucracy, and does not have the autonomy and budget to employ the necessary skills and engage in effective investment promotion.
- There is no widespread support for attracting FDI, with minimal commitment from many parts of the Government.
- There is no clear investment promotion strategy and sectoral focus, an inadequate understanding of Turkey’s competitive position, and no capacity to identify and exploit market opportunities.
- For such a large and diverse country, there is a total absence of regional agencies to support the investment promotion effort. It is extremely difficult for a national IPA to promote all of Turkey’s regions, facilitate the investment process and engage in post-investment services.
- Investment promotion activities revolve around investor conferences that generally lack business focus and do not involve the participation of the investment community. The IPA places minimal emphasis on and has little capacity to conduct focused marketing and company targeting, which are widely recognized as delivering the best long-term results.
- Investment promotion efforts generally lack commercial orientation and awareness.

...
Box 1 (concluded)

- Reflecting the above, the inward investment Web site combines all the worst features: it can only be accessed through the Treasury’s Web site, it is extremely slow, it has no sectoral or regional information, it provides unique selling points that are not supported by any verifiable and up-to-date facts, it has no information on existing investors and it makes poor use of English.

It is, therefore, not surprising that, in the survey of TNCs and multipliers, 60 per cent of respondents thought that Turkey has a poor brand image, 70 per cent said they would like more general information and 20 per cent said they would like information on regional differences. Over half of the respondents said that Turkey’s IPA needs to be able to provide very specific, investor-related information. In fact, after European Union membership, better investment promotion was identified as an important means for increasing FDI in Turkey.


Marketing aims at creating awareness of an area as a location for new investment among potential investors and multipliers and to correct weak or misperceptions about the area that could act as a “killer” factor. In other words, marketing aims at building up the image of the location and at putting it on the map. Marketing can also assist in repositioning areas that want to change the external image or perception of themselves.

Marketing is central to investment promotion, but is often a contentious issue. While evidence suggest that effective marketing can raise the profile of a location, there are always questions over the level of resources required, what marketing techniques should be employed and how much value marketing produces. Unfortunately, there is not a single answer. Each location is different, and marketing also has different objectives, from putting a location on the map, to developing a differentiated brand image or repositioning the existing brand image. Each location’s offer is likely to, and in fact should, be constantly evolving as its competitive position and the market opportunities change, which in turn may require new marketing initiatives.

There are many marketing techniques, each of which can be used separately or be combined together for investment promotion. While evidence suggests that general public relations
(PR) campaigns associated with image building are much weaker in producing investment leads than company-focused sector targeting (Wells and Wint, 1990), there is a strong argument for PR campaigns when:

- The reality in a country is better than the perceptions held by the international investment community (IFC, 1997, p. 50).6
- A country has not been a major host for FDI in the past (Wells and Wint, 1990).
- Domestic policies are reformed providing an opportunity for the agency to change its image.
- There is a change in strategic direction by the IPA, for example, by focusing on new sectors or activities.

Marketing is therefore particularly effective for locations that lack a recognized brand image. However, even if a location has a favourable brand image as an investment location, there may be bias among investors and investment brokers when it comes to specific sectors or activities. This is likely to be especially the case for an IPA that is changing the sectoral focus of its activities. Marketing techniques used by agencies to influence their brand image and generate leads include:

- **General PR campaign**, for example, through advertising in newspapers, on bill-boards, on television (such as in business class on flights), in business and industry specific journals and on Web sites. These have generally been found to be less successful than focused marketing techniques (Wells and Wint, 1990).

- **Printing of brochures, newsletters, CD-ROMs and fact-sheets** for distribution in conferences, investment missions and Web sites. Brochures and CD-ROMs are perhaps most effective when used in conjunction with other marketing techniques and when they are sector- or industry-focused (see box 2). Inward investment newsletters can highlight key changes in the economic environment, policy changes and recent project successes, and can be useful in keeping potential investors and multipliers up-to-date with the latest information on a location. Fact-sheets represent more focused marketing tailored to specific sectors and individual companies, and are often more effective in generating interest from companies (no company really wants to read

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6 See box 1 for the case of Turkey and UNCTAD (1998a) for IPAs in Central and Eastern Europe.
an 80 page investment brochure) and make more efficient use of limited investment promotion budgets (UNCTAD, 1999).

- **Participating in investment exhibitions**, such as the World Investment Conference held in Lisbon in June 2000. This is more about networking and learning from other IPAs than generating interest from investors.

- **IPA conferences** on investment opportunities to provide information, introduce potential investors into the culture of the location and regional differences and build the area’s image with interested parties. The most successful conferences are sector-based and include presentations by satisfied investors, as box 2 illustrates for Australia. This helps maintain interest in the conference, adds credibility, attracts a private sector audience and demonstrates the business-friendly approach of the IPA. Furthermore, the fact that the IPA has been able to gain private sector buy-in to its sector strategy is a good indication that the strategy is realistic.

- **Business conferences** are a relatively straightforward and effective method of making contacts and networking with companies in target sectors and locations, but they are often very expensive to attend.

- **Investment missions** in key source countries to generate interest in the area and start networking with potential investors and the wider investment community. Sector missions can be successful if guided by firm-specific research (company targeting) and feature customized “sales” presentations that match the presumed needs of the target investors with the alleged ability of the particular host country to meet those needs (Wells and Wint, 1990). Several techniques to maximize the effectiveness of investment missions are to include a satisfied investor, attend meetings with as few people as possible, and identify key decision makers and influencers as soon as possible and concentrate time and effort on them.

- **Trade missions** can be a very successful method to develop strategic partnerships (such as joint ventures, technology licensing, and outsourcing agreements) between domestic and foreign companies. Inter-firm partnerships are recognised as a vital to technology transfer and the business development of small and medium-sized enterprises (SMEs), especially in developing countries (UNCTAD, 1998b).
Furthermore, this non-traditional FDI can often be a precursor to more traditional market entry methods. The most successful trade missions are sector focused and involve the careful selection of a relatively small number of complementary firms from the domestic and foreign countries.

- **Direct mail campaigns** to private and public organizations. This is normally not the most effective method to generate interest and leads, at least if it is used as the sole marketing tool. Mail campaigns can be used in gaining market intelligence about companies as part of a longer-term company targeting campaign (stage 7).

- **Telephone campaigns** to private and public organizations. This is only likely to be effective and cost-efficient as part of a company targeting strategy, focusing on key players and contacts within target sectors.

- **Creating an IPA Web site** to develop the awareness and brand image of the IPA, provide information, gain market intelligence, and reduce costs and time in delivering marketing materials and brochures (box 3). The Web site is also becoming an important vehicle for generating leads, especially from companies in the information technology sector.

### Box 2. Sector-based investment promotion in Australia

Australia is trying to position itself as a global financial centre for the Asian-Pacific market. Its main competitors are Singapore, Hong Kong (China) and Japan. To promote Australia, the Government, in August 1999, established Axiss Australia, an organization with the aim of making Australia a leading financial service centre. Axiss has private sector involvement and a wide remit. Axiss is composed of four main units: (i) a promotion unit to implement a focused and imaginative investment promotion strategy; (ii) an information and analysis unit to promote understanding of Australia; (iii) a policy unit to influence government policy; (iv) an education and training unit for the financial service industries, and to identify and address potential skills gaps. Axiss is an industry-focused, single agency with clear objectives developed in partnership with the Government and the private sector, and a specific remit that integrates promotion, marketing and product development. In July 2000, Axiss cooperated with the national IPA (Invest Australia), regional governments in Australia and the private sector to organize an...
Box 2 (concluded)

image-building conference in London. The conference was hosted by the *Financial Times*, giving Axiss the benefit of the *Financial Times* network of business contacts. Axiss coordinated the conference with the press and ensured that there was extensive coverage in industry journals. A Financial Times Survey on Australia was released on the same day as the conference. Key speakers promoting Australia were not only members from Axiss and the Government of Australia, but also major businesses, including leading banks (AMP, Citibank) and software companies (Oracle). The speakers highlighted Australia’s advantages, using up-to-date, fact-based evidence. One-page, industry-specific marketing materials were available at the conference. Several investment leads were generated at the conference.


The Invest in Britain Bureau (IBB) is a case-in-point of one of the world’s leading agencies aiming at changing its image and making more effective use of the Internet. In June 2000, the IBB changed its name to *Invest.uk* in a swift attempt to both break-away from the image of a government “bureau” and to adjust to the “new economy”. *Invest.uk* conveys better the image of a market-focused, commercial organization. The Web site, www.invest.uk.com, is much more accessible than its predecessor and has been significantly updated and expanded.

Box 3. Benchmarking IPA Web sites: best practices from 10 sites

Almost every IPA has set up its own Web site, some far more sophisticated than others. While accurate data are not available on the hits leading IPA Web sites are receiving, and on the impact on brand image and leads, there are three arguments for IPAs to make effective use of the Internet. First, the increasing number and quality of IPA sites suggest that they are having a positive impact. Second, the rapidly growing importance of the Internet for marketing and information gathering indicates that it is probably only a question of time before the Internet becomes crucial for investment promotion. Third, there is a growing number of private sector Web sites offering a whole range of inward investment information, of which www.techlocate.com and www.ipanet.net are among the best, suggesting that there is a growing Internet-based market. Based on 10 IPA Web sites (five for developing countries and five for developed countries from the four regions of the world), the key types of information being offered include:

...
Box 3 (concluded)

- Geographical location and market access (with maps).
- Labour costs and availability and labour skills and education.
- Property and site costs and availability — through photographs, virtual tour and search functions.
- Infrastructure quality and costs (transportation, utilities, telecommunications, Internet).
- Technological infrastructure (R&D, patents, university-based clusters, graduates).
- Joint venture partners search function.
- Information and links to sub-national regions.
- Corporate climate, culture and quality of life.
- Support available from the IPA and other agencies and red tape.
- FDI trends, leading investors and testimonials.
- Sector-based information, presentations, research/annual reports and marketing brochures, all downloadable.
- Information on the wider region, e.g. Baltic region, Iberian region, Balkan region.
- Latest news — sometimes available as e-bulletins.

A best practice IPA Web site should combine the following features:

- A clear, easy-to-use structure, with a site map and search function.
- Speed, with simple, but effective graphics.
- Links to regions, government departments and other important stakeholders, as well as to IPA contacts.
- Sector-specific options, with tailored information on target sectors, industries and activities.
- Regularly updated (perhaps weekly) news reports, data etc.
- Registration, e.g. to e-bulletins, to gather market intelligence and deliver tailored marketing to users.
- Good quality foreign language options, especially for key FDI source countries.
- A strong sales message with unique and distinctive selling points.
- The use of reliable, up-to-date, comparative data supporting information and arguments.
- A “contact us” feature for potential investors to generate leads.

Sources: United Kingdom (www.invest.uk.com); Sweden (www.investinsweden.com); the Czech Republic (www.czechinvest.com); Ireland (www.idaireland.com); Bulgaria (www.bfia.org); Turkey (www.treasury.gov.tr); Singapore (www.sedb.com); Thailand (www.boi.go.th); Canada (www.investincanada.gc.ca); Costa Rica (www.cinde.or.cr).
Stage 7: Company targeting

Intensified competition for inward investment (Oman, 2000; Moran, 1999) makes it crucial to develop clear and distinctive business arguments to demonstrate competitive advantage in promoting areas for particular sectors. Leading IPAs are increasingly using sophisticated proposition-based marketing to target individual companies with specific business opportunities. This is a complex and long-term process with two main parts:

- Identification of potential investors.
- Relationship building with target companies.

The first part involves identifying a manageable number of potential investors in priority sectors. The traditional company targeting approach uses business databases and consultants to identify companies through an evaluation criteria, often based on factors such as the size and performance of company, R&D intensity, and exports to the host location. Companies that fit this criteria in each target sector may number in the thousands, and these can be narrowed down to a hundred or so by focusing on companies that are “active” investors with recent FDI projects and those with an explicit internationalization or globalization strategy. Accurate contact details for each company are needed so that the agency can make initial approaches.

Despite being resource intensive, this is only the starting point. It is very unlikely that the companies identified will have immediate FDI projects that the host location can compete for. The key to lead generation is relationship building, and a traditional company targeting approach can be useful in providing an initial list of companies from which to begin the process.

As IPAs now target activities as well as sectors, traditional company targeting becomes more difficult. Activities such as call centres, headquarters or e-business cut-across sectors and do not fit into standard business classification databases. Hence, many agencies, emulating the success of IDA, are focusing increasing resources on developing long-term relationships with senior contacts in existing investors, and are networking in business organizations and at conferences and investment and trade missions in order to identify potential investors and projects.

7 Academic research has found that R&D is a key ownership advantage of firms and is correlated to FDI (Hennart and Park, 1994; Kogut and Chang, 1991; Grubbaugh, 1987).
Whether target companies are identified using a traditional company targeting approach, or through business networking, relationship building is key. When an IPA first approaches a potential investor, the mindset of the project officer is crucial. If the officer believes that it is simply a case of asking a company if they have an FDI project and then moving on to the next company they will not only be unsuccessful, but they will also very quickly have their morale and commitment eroded. It is vital to appreciate that it is not companies that make investment decisions but people. A successful IPA is one that develops a long-term relationship with key people in potential investors.

Rather than a hard-sell, in the initial contact the IPA should outline the advantages of the location and the assistance the IPA can offer. If there is a specific opportunity, such as a new science park, this can be outlined to the company. The project officer contacting the company can offer to send more information by post. (Often the company will request this anyway.) A one-page well-presented, clear and succinct proposition-based summary focusing on the unique and distinctive advantages of locating in the region and tailored to the individual investor is often an effective approach (Spar, 1998; Christodoulou, 1996).

Approaching companies should not be seen as a methodical exercise; it is not about one-off approaches to a fixed number of companies each day, but rather a market intelligence gathering and relationship building campaign. For companies that appear to have a more immediate interest, suggesting an appointment to meet and discuss with the company in more detail the opportunities in the host location can be appropriate. If an appointment is made, a relatively senior figure from the IPA should meet the company, possibly accompanied by a sector expert.

It is important to have a sustained approach to companies and to develop long-term relationships. Techniques to build a relationship with target investors include:

- Drip-feeding the company with regular information updates on the location, tailored to the individual company & requirements.
- Organizing networking events that bring together the IPA, key target companies and the wider investment community. These can revolve around formal sector-specific conferences and more informal events, for example related to important national celebrations and cultural
activities. The use of embassies is one way to attract more attention and reduce costs. Contacts in the investment community, e.g. through expatriates, can be leveraged to support networking events.

Generating investment is both time consuming and labour intensive, and positive results do not come from one meeting or one investors’ conference. As the IFC (1997, p. 50) notes, some agencies have courted certain investors for years.

Facilitation

Stage 8: Project handling

No matter how effectively an agency markets its location and generates leads, this is unlikely to result in actual projects unless there is effective project handling. The aim of project handling is to convert an investment enquiry into an actual investment. Key issues to consider in enquiry and project handling include:

- **Ownership.** When handling enquiries, most agencies nominate a key account contact or project manager to every serious investment enquiry or potential project. This enables clear leadership and coordination. They act as the central point of contact for the investor. As well as being able to develop professional respect and personal rapport with the investor, the project manager needs good contacts with government bodies and private sector advisers to facilitate the project.

- **Investor requirements.** To win a project requires the full and accurate understanding of the investor’s location requirements. For example, Costa Rica’s IPA, CINDE (Costa Rica Investment and Development Board), adopted a micro-targeted approach to attract Intel, which included the build-up of detailed information on the electronics and semiconductor sector to understand the company’s needs (Spar, 1998). The more experienced agencies prepare a project brief, which includes a full description of the company, its strategy, expansion plans and exact project-specific requirements particularly relating to the property or site. It is important at this stage to win the trust of the company, and the project manager should gain confirmation from the company on what information should remain confidential and to whom. Information gathering can also
form part of a due diligence on companies. Quite often an enquiry can be from a small or start-up company which is looking for public finance that it could not get elsewhere, and therefore is unlikely to be a priority for the IPA. Additionally, due diligence can alert an agency to an investor who is “playing-off” different locations to bid up the “offer”.

- **Visit handling.** The investor is likely to make one or more visits to the proposed location, and it is very important that the IPA facilitates this process together with other stakeholders in the investment. As well as information provision, the investor will be aiming at looking at potential sites for the investment. These may be in several regions within the country, and often the investor will have a very tight timetable involving visits to other countries. The professionalism of the agency in preparing an itinerary and coordinating visits can be crucial in winning the investment, especially because the executive from the investor is likely to have a senior position in the company, and possibly will be based in the location where the new investment is made. Furthermore, meeting the IPA will sometimes be the first contact that the executive will have with the host country. If the agency makes the right impression, then this can reflect on the location as whole. As with conferences and investment missions, the (agreed) presence of a major existing investor at one stage during the visit can create a comfort factor.

- **Information provision.** Depending on the size and complexity of the investment, the investor may request information ranging from site and property availability, to local supplier quality, the number of graduates in certain disciplines, transport and communications infrastructure, energy resources and price to labour costs, labour availability and recruitment costs. Accurate information should be supplied in a well-presented format as quickly as possible, which often depends on the quality of links between the IPA and other stakeholders, especially regional agencies.

- **Package offer.** Successful investment locations develop ready-made packages of incentives and services for rapid response to enquiries that also cater for sectoral initiatives (Christodoulou, 1996, pp. 8-10). However, D. Spar (1998) argues that IPAs should refuse to engage in “extraordinary” measures, as it can undermine the professionalism of the agency in the eyes of the investor and it may also act against
the interests of the location if the agency tries to “pick winners” by offering over-sized subsidies. Often “softer” forms of support, such training and recruitment services and property and site provisions, are central parts of the offer. As with company targeting, the investor should be presented with high quality, customized information, effectively and succinctly addressing all the information and project-specific requirements. Any unique or distinctive arguments for investing can also be outlined, and the use of high quality photographs of sites or buildings and location maps can be provided.

- **Facilitation.** Most IPAs offer some kind of “one-stop shop” for facilitating the investment. The range of services offered can vary from consulting, expediting applications and permit processing, screening or evaluating the project, and providing incentive negotiation and approval (Young and Hood, 1995; Young et al., 1994; Wells and Wint, 1991). According to a study by Wint (1993), the speed and cost of obtaining post-approval permits, licences, and planning permissions are often crucial to the investor. Key to fast, efficient facilitation is not only the professionalism of the IPA, but also their links and influence with government ministries and other stakeholders. The facilitation may take weeks, months or even years, but throughout the process it is important for the project manager to maintain a relationship with the investor.

**Investment services**

**Stage 9: After-care and product improvement**

After-care refers to the post-investment services that an IPA can offer to existing investors, and it is a key area of policy for many agencies both for generating new investment and upgrading the quality of existing projects over time. In larger countries, after-care is normally administered at the regional level, but it is nationally coordinated. The objectives of after-care include:

- **Supporting re-investment** by existing investors. Most FDI is in the form of re-investment or expansions by existing investors, and the knowledge that the IPA will provide effective support in meeting any difficulties that arise can be a critical factor in winning an investment, especially for areas with weaknesses in their “offer”.
• **Increase the value of the investment to the host country** through increasing the share of value added sourced from local firms and upgrading the operations of the investor overtime (see Birkinshaw and Hood, 1998, for subsidiary evolution). Inward investment should form a dynamic relationships with local SMEs and linkage programmes and access to research institutes are important for genuine upgrading (Amin and Tomaney, 1995).

• **Helping to “embed” TNCs** more strongly in the area and reduce the risk of closure. This is becoming more important with ongoing rationalization and reorganization of TNC operations. Intermediary agencies and government programmes should create cooperative networks between firms and between firms and support institutions (Pyke, 1997).

• **Generate new leads** by reinforcing the quality of a location for a potential investor and by using existing investors as “ambassadors” who will influence other firms to consider the country as an investment site. Developing good links with local managers has been central to investment promotion of locations like Oregon and Ireland.

Product development refers to the supply-side policies that improve the competitive advantage of a location and its attractiveness for FDI. Product development is integral to achieving many of the objectives of after-care. The increasing emphasis of IPAs on both after-care and product development is making the distinction between indigenous and inward investors increasingly redundant (Christodoulou, 1996, pp. 11-13). For example, box 4 shows that the Northern Development Company (now One North East) spent only one third of its resources on attracting inward investment.

**Box 4. After-care and supply chain development in North East England**

North East England has been one of the most successful regions in Europe in attracting inward investment. However, in the 1990s the Northern Development Company (NDC), the agency charged with attracting investment into a region, broadened its objectives from not just attracting new investment, but also to making sure that inward investors stayed in the region and made a positive contribution to the region’s economy. The NDC developed a comprehensive after-care policy, with two main dimensions:
Box 4 (concluded)

- The United Kingdom’s first **Investor Development Programme**, which enables the NDC to remain in contact with around 400 strategically important companies. The NDC collaborates with foreign affiliates to help them meet their competitive needs, such as developing supply chains, cutting costs, or preparing business cases to their parent companies. The key aims are to guard against the risk of dis-investment and job loss by committing major investors to re-invest in the region and by supporting investors in the face of demands for rationalization or closure from the parent company.

- **Supply Chain Programmes**, with a team of business development managers (BDMs) interfacing between the major investors and the SME sector. The aim is to facilitate upgrading the quality of local suppliers to enable local industry to meet the needs of major investors, with the objective of increasing local sourcing and embedding TNCs by raising their exit costs. Furthermore, through helping local suppliers to upgrade and become first-tier suppliers, the NDC hopes that this will improve the attractiveness of the region to inward investment. In 1997 and 1998, each BDM was tasked with developing a thorough understanding of the supply chains of 10 final manufacturers or primary suppliers of sub-assemblies in each of their industries. They identified 20 potential regional suppliers and profiled their capability. Each of the eight managers, who have procurement and production engineering backgrounds, worked on 30 supply chains as a result of this activity.

In the mid-1990s, the Investor Development Programme was credited with creating over 9,000 new jobs. During 1996-1997, the Investor Development and Supply Chain Programmes helped to contribute nearly £1 billion to the regional economy — more than inward FDI. By the end of the 1990s, about half of the NDC’s traditional inward investment work was focused on existing investors, and less than one third of its resources went to the attraction of new FDI.


There are four main areas of product development relevant to an IPA:

- **Infrastructure and property development.** The availability of good domestic and international transport links is important for almost every investment project. Major
projects often involve infrastructure improvements and property development as part of the investment package “offer”. Some agencies develop pro-active infrastructure and property development programmes (“catalyst” projects) specifically tailored for target sectors and investors.

- **Supply chain development** in order to increase local sourcing and embed TNCs into the local economy. Several agencies have established supplier associations focused on large inward investors. These are combined with measures to build up the capacity of the supply base through targeted investment, training and enterprise development and cooperation between focused suppliers (Cooke and Morgan, 1998; Battat et al., 1996; Young et al., 1994; Turok 1993; Amin et al., 1994). Examples include Singapore’s Local Industry Upgrading Programme, Ireland’s National Linkage Programme and the Czech Republic’s National Supplier Development Programme, which was expanded in 2000 with the launch of a new Web-based service for foreign investors looking for joint venture partners.

- **Innovation development** recognizes that it is not simply a case of forcing inward investors to contribute more to the local economy (Lall, 1997; Dicken et al., 1994). Innovation policy has a crucial role to play in fostering the innovation base of the local economy to ensure that it is in the TNCs’ interest to allocate more complex and important functions to the location (Eisenschitz and Gough, 1993; Deeg et al., 1989). Among the most successful economies in innovation development include Germany, Taiwan Province of China and Singapore. Each has established institutions and financial incentives to promote technology transfer between inward investors, SMEs and research institutes, and encourage R&D and the progressive upgrading of foreign and domestic firms (Esser, 1988; OECD, 1999, p. 42; Battat et al., 1996). Innovation policy is widening to include support for new firm start-ups, university spin-offs, science and technology incubators and parks and the promotion of an innovative, entrepreneurial culture.

- **Skills development.** The most successful agencies develop an integrated inward investment, after-care and product development strategy, of which skills development is central (see box 5 for the case of Ireland). The effectiveness of policies to attract FDI and encourage links between inward investors, local firms and research institutes depends on the
quality of personnel available. In manufacturing and R&D, scientific and engineering skills are crucial, while in service industries, such as financial services and software, information technology skills are increasingly vital. Training solutions, such as those provided by Taiwan Province of China, China Productivity Centre and Republic of Korea’s Small and Medium Industry Promotion Corporation, and an education system that provides high-level technical skill are key components of a skills’ development policy (Lall, 1997; Christodoulou, 1996; Amin and Tomaney, 1995).

Box 5. An integrated targeting, after-care and product development strategy: the case of Ireland

In 1975 Ireland’s per capita income was only 63 per cent of the European Union average. Ireland’s industrial policy that centred on attracting FDI seemed to be failing. Unemployment rose to a peak of 18 per cent and the debt/GNP ratio approached 130 per cent. A report by the National Economics and Social Council in 1982 argued that Ireland had taken on the characteristics of an economy dependent on foreign branch plants. The report identified several key weaknesses of the dependent economy: (i) low skill content of much of employment; (ii) high cost and short duration of much of the assisted employment; (iii) low levels of commitment to R&D; (iv) the poor performance of the indigenous sector; and (v) limited linkages with the rest of the economy. In response, the Government made radical policy changes that have led to Ireland becoming one of the world’s biggest economic success stories. Key policies adopted included:

• **The National Linkage Programme** to foster links between inward investors and the domestic industry. The programme covers market research, matchmaking, monitoring and troubleshooting, business and organization development and the creation of a specific arm of IDA to promote indigenous firms.

• **After-care and plant upgrading**, which is concentrated on about 50 key companies in five target industries. The IDA targets companies that have a high potential for new investment, or that can leverage investment from other companies. Links are forged with the management, in particular with committed local managers, in order to improve plant competitiveness by making sure that the local management is fully informed of Ireland’s advantages and, through working with IDA, on future expansion plans and new investment opportunities. About 20 senior staff in the IDA are each responsible for some 2-5 target after-care firms.
Box 5 (continued)

- **High skills policy**, which involved the expansion of education so that over 40 per cent of school leavers now go on to third level education, a share set to rise to 50 per cent. The emphasis has been on information technology and science subjects as part of a pro-active strategy anticipating future needs. Computer provision and training in schools has increased dramatically, and IDA officers have visited every school and have written to every parent to explain the nature of the training. A wide range of training initiatives has also been introduced for older people.

- **Technology policy**, which includes the 2000 Technology Foresight Fund with a $1 billion expenditure plan to boost R&D in information technology and biotechnology. Telecommunications deregulation and a $65 billion National Development Plan, with a focus on e-business and infrastructure development, are also intended to support technology activities.

- **Targeted inward investment strategy**, which has become a best-practice model for other IPAs. The IDA’s industry-focused marketing and company targeting has evolved over time. In parallel, overseas operations were refocused on locations having a high concentration of target companies in new target industries. Sector/industry specialists were recruited to develop the industry-based strategy and meet with potential investors. United States electronics and pharmaceutical industries were targeted in the 1970s, software and internationally-traded services in the late 1980s and 1990s, and in 2000 IDA targeted information technology, multi-media and e-business. In the 1990s, IDA adopted a cluster-based targeting approach, where target industries and companies were attracted to industrial clusters. From 2000 onwards, IDA will focus on attracting companies to more peripheral regions, which are expected to benefit from the product development activities of Ireland’s November 1999 National Development Plan. The objective has shifted from job creation to the promotion of outsourcing linkages with domestic firms and attraction of headquarters and R&D functions.

- **Low corporate tax** has been a central pillar of Ireland’s attractiveness for inward investment. Corporate tax is currently set at 10 per cent and many exemptions are available.

...
Box 5 (concluded)

- **Property development** was developed as a joint initiative between the public and private sectors. A key element in the programme has been catalyst projects, in particular the high quality International Financial Services Centre in Dublin.

The impact of IDA’s integrated marketing, targeting and product development strategy has been impressive:

- During 1980-2000, real GDP growth has averaged almost 7.5 per cent per annum — the highest among Organisation for Economic Co-operation and Development (OECD) members.
- In 1999, per capita income was $24,353 — the twelfth highest in the world — and unemployment was 5.8 per cent.
- During 1980-1987, employment in indigenous industry fell by 27 per cent, but during 1988-1996 it increased by 6.4 per cent — opposite to trends in the OECD and European Union.
- In 1999, IDA recorded 17,590 new FDI-related jobs. With 9,000 job cuts by foreign firms, the net gain was nearly 9,000.
- Ireland has become the leading location in Europe for high value-added industries, such as software, teleservices, shared services and pharmaceuticals and health products. These are the same sectors IDA has targeted for many years.
- Between 1992 and 1997, IDA attracted over 150,000 new jobs in its target industries.
- In 1999, one quarter of the 17,590 new FDI jobs supported by IDA were high-skilled, with salaries over £25,000.

*Sources*: Pitelis, 1997; Barry and Bradley, 1997; Görg and Ruane, 1997; O’Donnell and Reardon, 1996; Greer et al., 1995; Battat et al., 1996; Amin et al., 1994.

Several leading agencies are integrating product development activities (infrastructure, supply chain, innovation, and skills) into catalyst projects and are combining them with sector and company targeting activities in order to develop advanced clusters. Ireland, France, Singapore and regions in the United States and Canada have each developed a cluster-based strategy for target sectors. Key examples include:

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8 Porter (1999) defines a cluster as a geographical concentration in a particular country – or region within a country – of a group of related and supporting firms that create information flows, incentives, spin-offs, new companies – an innovative vitality. The OECD (1999, p. 36) defines clusters as “networks of suppliers, customers, and knowledge-creating institutions which together create value-added”.

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• **Ireland** & International Financial Services Centre (IFSC) offers purpose-built new offices, reduced 10 per cent corporate tax and other tax benefits, a recruitment service and an expatriate support package for headquarters projects. These are combined with an intensive, focused marketing campaign to target companies and a longer term skills improvement programme, particularly targeted at information technology in schools.

• **The French technopoles** offer high quality sites and properties in specialist industrial parks and locations offering a very high quality of life to attract skilled R&D people, training grants and an expatriate support package. The sites are supplied by the private sector. To support high-tech clustering, technopoles have on-site research facilities and links to research establishments and universities. Technopoles were set up to attract R&D investment in specific sectors, such as multi-media, food technology and electronics.

• **Singapore** & life science strategy aims to encourage companies to move into higher value-added manufacturing, increase and commercialise R&D and build up value-adding partners. To achieve these objectives the SEDB has set aside 250 acres of land as a “Pharma Zone” — a catalyst initiative to develop a cluster of local and foreign pharmaceutical and biotechnology companies — and a Technopreneur Centre has been developed to support SMEs. These initiatives are integrated with the activities of other government departments, and there is a wide range of incentives tailored for manufacturing, R&D, new start-ups, and for developing links with research institutes. To support longer-term product development, there are training grants that cover up to 70 per cent of training costs, a new medical school established to train life science professionals, and several hundred scholarships for students to study life sciences.

• **New York** & “new economy” strategy is designed to attract “new economy” information technology and e-business companies. Integral to this strategy is a cluster-based, catalyst initiative called 55 Broad Street. This initiative has developed a purpose-built property block to stimulate and attract high value-added, “new economy” activities. The block, designed for the new economy, includes dedicated broad-band satellite telecommunication facilities. It is now home to hundreds of small businesses. The occupants pay
below market rents, and benefit from tax concessions and cheap utility bills. *55 Broad Street* was a partnership between the private owners of the property block, New York’s Economic Development Corporation and various corporate and institutional sponsors.

- **Quebec’s “new economy” strategy** aims at developing higher value-added activities in Quebec, and in particular at developing Montreal into a new economy hub. Central to this strategy is developing high value clusters around Montreal’s strong universities and high-technology industries and attracting R&D through very generous tax credits. To support the clustering of “new economy” businesses, a catalyst project was announced in Montreal called *E-Commerce Place*, based on the success of *55 Broad Street*. This is a dedicated 275,000 square meter campus, targeted at e-commerce businesses. It cost almost $500 million to build and will become operative in 2001. Companies that decide to locate there will be able to benefit from a 25 per cent tax credit on their employees’ salaries of up to $6,500 per person per year available until 2010, provided that at least 75 per cent of their activities are devoted to e-commerce development or services. Nasdaq International and CGI have already announced their decision to set up shop in *E-Commerce Place*.

The use of catalyst projects to develop clusters is particularly powerful for attracting activities from smaller, “new economy” companies that do not have the time or resources to conduct a detailed appraisal of new investment locations. Furthermore, these are difficult for investment agencies to target. These catalyst projects generally do not discriminate between foreign and domestic firms. The above examples suggest that cluster-based initiatives depend on several key success factors, including:

- The integration of product development, company targeting and highly focused marketing.
- Partnership with other government departments, universities and the private sector.
- Catalyst projects that are carefully developed to meet investors’ critical requirements.
- Transparent and mandatory incentives available for a limited time period (which has favoured the use of tax incentives tailored for particular activities and which do not discriminate between foreign and domestic firms).
Stage 10: Monitoring and evaluation

There is increasing recognition that monitoring and evaluation is becoming a more important activity for IPAs for three major reasons:

- **Internal organizational effectiveness**: to promote knowledge transfer and coordination between project officers and between offices, make effective use of market intelligence and increasingly to prioritise discrete resources to support companies which will create the most benefits for the location. A key method is satisfaction surveys of investors and economic impact studies. As IPAs become more commercially orientated and the investment market becomes more competitive, organizational effectiveness is very high on the agenda for many IPAs.

- **After-care and product development**: monitoring the purchasing, R&D and training performance of investors has been effective in ensuring that the innovation and skills supply-side infrastructure meets the needs of inward investors and encourages continuous upgrading of activities (Amin et al., 1994; Amin and Tomaney, 1995). The SEDB is a key example.

- **Accountability**: investment promotion is resource intensive, and often IPAs recruit people from business and pay higher salaries than other government agencies. However, as IPAs are almost always funded by tax payers, they are under public scrutiny, and issues such as financial accountability, efficiency and evaluation are becoming increasingly important (Halkier et al., 1998). IPAs are under increasing pressure to demonstrate impact, efficiency and effectiveness, heightening the role of monitoring and evaluation. Many agencies produce an annual report outlining jobs created and capital investment generated from inward investment, as well as a more detailed breakdown of the source and sectoral composition of FDI. Even IPAs with weak investment promotion, such as Turkey, monitor and make publicly available statistics on FDI.

However, the level of monitoring varies enormously. Several IPAs require investors to give them a “receipt” with different grades depending on the level of support given to demonstrate that the IPA is facilitating investment, while other
agencies conduct sophisticated monitoring and evaluation of all their activities. Among the most advanced is Invest in Quebec, which provides detailed analysis of investment missions, foreign and domestic projects, regional segmentation, a satisfaction survey of assisted companies and a detailed evaluation — undertaken by an external economist — of the economic impact of its activities, as well full financial statements (www.invest-quebec.com). Detailed monitoring and evaluation not only increases accountability, but also indicates areas that can be improved and provides information valuable for strategy formulation.

Conclusion

This article has highlighted the importance of investment promotion for attracting inward investment. The framework provides four clear messages for successful investment promotion:

- An investment promotion strategy should be based on coherent objectives set and agreed by all the major stakeholders and underpinned by rigorous analysis of a location’s competitive position. Effective coordination between industrial policy and investment promotion is also essential at the central and regional levels.

- Lead generation is most effective when long-term relationship building with target investors in priority sectors is combined with focused marketing. The intelligent use of catalyst, cluster-based initiatives appears to be particularly effective in attracting “new economy” type firms and R&D activities.

- Effective facilitation is vital if leads are to be translated into actual projects. A coordinated and professional approach to project handling at the national and regional levels is essential if a location is to compete successfully for mobile international projects.

- To maximize the long-term benefits from inward investment and maintain and develop the competitive advantage of a location, after-care and product improvement activities should form a major component of investment promotion activities.

While the appropriate organizational structure for successful investment promotion will vary depending on the
objectives in attracting FDI, size of the country and role of regional agencies, the framework suggests that IPAs need to operate along business lines if they are to achieve results in a competitive, commercial environment. A significant degree of autonomy and sufficient resources are therefore required. At the same time, IPAs need excellent links with governments and private sector actors and a direct influence in policy. Getting the relationship right between national and regional IPAs is also of particular importance in larger countries. Regions within a country are often their own major competitors, and a national agency may have an important role to play in coordinating their promotion efforts and presenting to the investor an unbiased point of entry into the country.

The effective operation of an investment agency is far from easy, with agencies facing competing demands to attract FDI, demonstrate additionality and cope with pressures from different government departments and regions to serve their particular interests. Furthermore, IPAs in most parts of the world face intensified competition for investment, and are confronted by a rapidly changing FDI marketplace, in which the speed of response and quality of the product are becoming increasingly vital.

However, IPAs can play a powerful economic development role as they influence not only the attractiveness of their location for inward investment, but also the benefits accruing to the local economy. The framework outlined in this article should help guide IPAs through some of the complexities of successful investment promotion and provide many avenues for much needed further research in this important area.

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Does FDI contribute to technological spillovers and growth?
A panel data analysis of Hungarian firms

Maria Giovanna Bosco *

This article seeks to contribute to the growing literature on foreign direct investment and growth. A sample of Hungarian firms was used to answer the questions of whether foreign affiliates perform better than local firms; if there are spillovers from foreign affiliates to domestic firms; and whether the presence of foreign affiliates in high-technology industries enhances technological spillovers. The findings seem to confirm what has already been found in studies of other developing and transition economies, namely, that the performance of foreign affiliates in Hungary is better than that of domestic firms. The evidence for technological spillovers is weak and does not allow clear-cut conclusions. Foreign presence in high-technology industries does seem to have a positive effect on both local and foreign firms.

Introduction

This article aims at contributing to the growing literature on foreign direct investment (FDI) and growth. Three questions are addressed: do foreign affiliates perform better than local firms?; are there spillovers from foreign affiliates to domestic firms?; does the presence of transnational corporations (TNCs) in high research-and-development (R&D) industries enhance technological spillovers? FDI represents a powerful instrument of internationalization of economic activities, as both outward and inward investments accelerate the diffusion of knowledge across countries. International economics and growth theory meet in this field to answer the question: what is the growth impact of FDI for the host country?

* Research Assistant, Istituto di Economia Politica, Università Bocconi, Milan, Italy. This article is part of the author’s thesis presented for the Master of Science in Economics at Katholieke Universiteit, Leuven, Belgium, during the academic year 1999-2000. The author wishes to thank J. Konings for kind supervision and three anonymous referees for helpful comments.
FDI has played a crucial role in Hungary from the beginning of its transition to a market-based economy. Foreign capital entered the process of privatization and boosted the competitiveness of formerly State-owned firms, as well as the process of restructuring. FDI inflows (figure 1) increased from 1991 to 1995, when they reached a value over $4 billion. Hungary has been leading the group of FDI recipients in Central and Eastern European countries for the first five years of the 1990s (figure 2). The flow of FDI into Hungary is sustainable, even though the leading host country for FDI inflows in the second half of 1990s turned out to be Poland, followed by the Czech Republic. Romania and Bulgaria are moving upward in the ranking, but still lag behind the three Visegrad countries.

Figure 1. FDI in Hungary, 1991-1999
(Billions of dollars)


Figure 2. FDI in 5 Central and Eastern European countries, 1991-1999
(Millions of dollars)

Foreign presence in Hungary had been stronger than in the other transition economies at the beginning of the transition period because of better infrastructure and a conducive legal environment, as well as attractive fiscal incentives. Moreover, the transition process in Hungary started in the early 1980s, when some TNCs had started to establish themselves there. The risk of investing in Hungary, as perceived by investors, was lower than in other transition economies, and the experience of investing there acquired in the 1980s may have worked as a booster for subsequent FDI in the other transition economies.

Another key factor influencing FDI inflows has been the privatization process (UNCTAD, 1999, 2000). In the late 1980s, state ownership exceeded 85 per cent of Hungary’s assets in the so-called “competitive industries” (Voszka, 1999). In 1997, the share of property in private hands reached almost three-fourths of the country’s assets, of which domestic investors held close to 40 per cent and foreign investors the balance. The share still held by central and local governments fell to 16 per cent and 9 per cent of the assets, respectively. It is clear that FDI was crucial to the transition process, as in many cases foreign investors had the capital needed to buy out large State enterprises that needed deep reorganisation. Not surprisingly, 60 per cent of overall cash income from privatization was paid in foreign currencies. The Government of Hungary was concerned with creating attractive business conditions in order to induce foreign investors to use local partners as subcontractors (Lendvai, 2000; Soltész, 2000). The inflow of foreign capital is a major driving force for productivity and restructuring (Hunya, 2000). The contribution to privatization made by foreign investors in the process of transition is shown in table 1.

Table 1. Ownership structure of companies
(Per cent in assets)

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<tr>
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<tbody>
<tr>
<td>Total domestic private owners</td>
<td>25.1</td>
<td>29.0</td>
<td>32.9</td>
<td>35.2</td>
<td>34.7</td>
<td>38.2</td>
</tr>
<tr>
<td>Foreign owners</td>
<td>0.1</td>
<td>16.1</td>
<td>18.9</td>
<td>28.4</td>
<td>31.5</td>
<td>35.3</td>
</tr>
<tr>
<td>Total private ownership</td>
<td>35.2</td>
<td>45.1</td>
<td>51.8</td>
<td>63.6</td>
<td>66.2</td>
<td>73.5</td>
</tr>
<tr>
<td>Total State and other</td>
<td>64.8</td>
<td>54.9</td>
<td>48.2</td>
<td>36.4</td>
<td>33.8</td>
<td>26.5</td>
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1 The Government of Hungary launched the Subcontractors Target Programme in 1997, aimed at assisting local firms, mostly small and medium-sized enterprises, in their internationalization strategies, by promoting exports and setting up relationships with foreign investors.
The transition process in Central and Eastern European countries is not yet complete, and major institutional changes are still under way. From the legal point of view, for instance, according to the Hungarian affiliates before February 1999, foreigners could conduct business activities in Hungary only through Hungarian branches, or through incorporated Hungarian affiliates. This was affecting adversely foreign companies intending to carry out temporary business activities, e.g. construction. Since February 1999, this requirement has been abolished for certain types of activities. Foreign affiliates produce about one third of Hungary’s GDP and account for about 25 per cent of private sector employment. In 1998, the output in those industries that have received the bulk of FDI (machinery, computers, telecommunications equipment, electrical and electronic goods and transport equipment) increased by 41 per cent. Their export sales rose by 54 per cent. The manufacturing sector as a whole recorded a 16 per cent increase in output and a 30 per cent increase in export sales (EBRD, 1998). Comparatively, the performance of locally owned firms lags behind in terms of restructuring and modernisation, the main constraints being the lack of medium and long-term finance, poor business infrastructure, training and bureaucratic red tape. A recent survey (EBRD, 1998) assessed how competition results in increasing importance for local firms, as only through budget constraints and enhanced restructuring can growth be sustained. The most fundamental type of restructuring is the launch of new or improved products. Competitive pressure is one of the main factors contributing to the efficient allocation of resources: by introducing improved production methods, a firm can gain a competitive edge over its rivals and can earn extraordinary profits — the so-called return on innovation. A firm that is able not only to innovate, but also to exploit the benefits from innovation, gains an advantage that can be described as Schumpeterian. If innovation is the engine of growth, and the best-performing industries are those in which foreign presence is higher, then this seems to be positively correlated with innovation at the enterprise level. Of course quantifying innovation is not an easy task, since the effects stemming from innovation spread to many aspects of a firm’s operations. Nonetheless, one may think that looking at a firm’s profits and sales can be a good first proxy when one controls for possible external effects influencing the market and political context conditions. The problem of identifying the link between good performance and foreign participation is described next.

The past ten years have been a turbulent period for all transition countries: growth rates have been impressive in recent
years, in several cases, but disappointing in others. In the early years of transition, all countries faced high inflation and falling output; this was called the “transition recession”. Nonetheless, as shown in figure 3, the growth in GDP per capita in Hungary has been strong, though partially due to a slight decrease in population from 1991 to 1998. In many cases labour productivity also fell (EBRD, 2000), together with employment and wages (figure 4). The transition from central planning to market economy can be described as a process of “destructive creation” (EBRD, 2000).

Figure 3. GDP per capita in Hungary, 1991-1998
(Thousands dollars)


Figure 4. Trend in wages and employment, 1992-1999
(Per cent change)

Recently, the most advanced countries (and Hungary is the leader in this process) have entered a phase of rapid productivity growth driven by product innovation, fresh capital investment and modern management methods (EBRD, 2000). Massive investments increased the market share of the better performing firms and industries, resulting in rapid economic growth (Halpern, 2000).

The issue of spillovers from FDI has been discussed at length in the recent empirical literature. Many authors have focused on the relationship between the presence of foreign capital in a country and the effects of this presence on productivity and overall performance of domestic firms.

In this article, the competition and the spillover effects of FDI on local firms are assessed using an econometric approach that depends heavily on the type of data used. While increased competition is likely to drive local firms out of the market at the very beginning of the interaction process with foreign investors, the spillover effect should have a positive impact on the productivity of local firms because of the transfer of knowledge. What is measured here is the positive effect of a foreign affiliate in a host economy; obviously, if this presence exerts its effects mainly through technological transfer, then the estimates will measure this type of effect. However this will vary highly across firms and the technological spillover alone cannot be disentangled.

Until recently, the mainstream in econometric literature has been following a cross sectional approach, according to which FDI in different industries and countries was taken into consideration in the process of estimation. As the availability of data increased, a panel-data approach has become possible (Aitken and Harrison, 1999). Firm level data represent a rich field of possible experiments if a micro-based strategic behaviour is to be detected with the aim being taking into account firm-specific differences in technology, production and capabilities.

Microeconomic data allow for building a model for a single TNC, although there are still problems related to high variability and missing values in the observations. Alternatively, a macro approach can offer a more general view in trying to explain growth, even if corporate strategies at the industry level pass unobserved. Here, the first approach will be followed, using data on Hungarian firms observed during the period 1993-1997.
This article is organized as follows. A review of the literature illustrates the theoretical and empirical background, the hypotheses made and tested and the empirical results. Data and the econometric methodology adopted are described next. Finally, estimation results of alternative models provide the basis for the discussion of the findings.

**Background**

International economic interchanges can take many forms. FDI can be considered as a measure of the inflow of disembodied technology and knowledge (Baldwin et al., 1999). Empirical evidence to date has compared this channel of technology flows with two other main sources of innovation, namely, imports of new and differentiated goods and learning through exporting. The conclusion remains that FDI is the major, if not dominant, channel of technology transfer, at least for developing countries (Djankov and Hoekman, 1998). FDI contributes to economic growth through capital accumulation in the recipient economies and, through knowledge transfer, through labour training and skill acquisition. In the applied literature, the FDI variable is inserted into growth models (for an overview, see Blomström et al., 1994), as a possible source of capital accumulation that might explain increasing returns in the long run and sustained growth.

The prevailing view in some recent theoretical and empirical firm-level studies (Aitken and Harrison, 1999; Konings, 1999) is that FDI can have two opposite effects on domestic firms. The first is a *competition effect*, due to the fact that TNCs are usually more efficient than domestic rivals and thus are able to gain a share of the market in the host economy. This has actually been observed in cases in which domestic firms are lagging behind foreign companies in terms of technology and expertise, particularly in developing, newly industrialised or transition economies. This competition effect may lead to an improvement in the performance of domestic firms, as it can accelerate restructuring and search for efficiency. But in the very short run, as foreign entrants start selling in the host market, a crowding-out effect on sales can be observed, and this justifies a possible negative correlation between FDI and local firms’ sales.

The second effect is a *spillover effect*. Foreign affiliates bring with them capabilities, know-how, new products and processes that embed technological innovations (Wang and Blomström, 1992) that can be transferred in different ways to domestic firms,
e.g. by means of labour turnover. Initially, the intensity of technological transfer is likely to be higher in high-technology industries (chemicals, transport, engineering etc.), as these industries require a lot of investment in R&D (Kuemmerle, 1999) and whose benefits may “spill-over” to the environment (Chuang, 1999; Coe and Helpman, 1995; Findlay, 1978). However, TNCs that are keen to exploit their ownership and internalization advantages may try not to “leak out” their expertise or processes if these represent the key of their competitiveness. Under such circumstances, spillovers may not happen at all (Djankov and Hoekman, 1998). Moreover, if domestic firms are not prepared adequately to receive brand new technologies coming from abroad, they would not be able to upgrade their “information set” so as to use the technology transferred into their production processes. This is called the “gap” problem in the literature (Abramovitz, 1989; Fagerberg, 1994).

These two last possibilities can counterbalance any positive spillover effects. In the worst case, they can so overwhelm any positive spillover effects that negative spillovers may arise. One should also consider that general equilibrium approaches usually assumed in the literature on FDI impacts on host countries may not be correct, since transition economies are often in disequilibrium while evolving towards a competitive market structure.2

In empirical studies, an equation has been estimated in which several independent variables, such as capital/output or labour/output ratios, the extent of foreign presence and different control variables, try to explain the change in the dependent variable. The growth in per capita income (Blomström et al., 1994; Borensztein et al., 1998; De Mello, 1999), value added per worker (Kokko, 1994), labour productivity (Blomström and Sjöholm, 1998; Barrell and Holland, 1999), total factor productivity (Djankov and Hoekman, 1998; Aitken and Harrison, 1999), and overall firms sales (Konings, 1999) have been alternatively used as the dependent variable in the estimated equation.

While many empirical studies find, on average, a positive impact of FDI on productivity growth of host country firms (Borensztein et al., 1998; Blomström and Sjöholm, 1999; De Mello, 1999), case studies present mixed evidence on the role of FDI in

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2 Halpern and Korosi (1998) found evidence of deep reorganization at the corporate level and evidence of changes in market structure in Hungary during the transition period.
generating technological transfer and spillover to domestic firms. Positive effects have been found for Mexican firms (Kokko, 1994) and for different groups of developing countries (Borensztein et al., 1998; Blomström and Sjöholm, 1999). Weak evidence has been found for Venezuelan firms (Aitken and Harrison, 1999). There is also evidence of a complete lack of positive spillovers (Konings, 1999) and evidence of negative spillovers (Djankov and Hoekman, 1998; Haddad and Harrison, 1993). The competition effect is well analysed in B. J. Aitken and A. Harrison (1999). Figure 5 illustrates how the competition mechanism can interact with productivity gains.

Positive spillovers cause a domestic plant’s average cost curve to fall from $AC_0$ to $AC_1$. However, additional competition may force the plant to reduce output and move back along its new $AC_1$ curve. The net effect in figure 5 is to increase overall costs of production. While the market “stealing” effect leads to a decrease in the local firm’s production and to an increase in its average costs, positive spillovers, if any, would lead to a decrease in the local firm’s marginal costs and to a decrease in its average costs. The net effect is a reduction in output for the local firm. This illustrates the crowding-out effect observed above.

**Figure 5. Output response of domestic firms to foreign entrants**

The change in productivity observed after FDI takes place can be analyzed using different points of view. One of the testable hypotheses (Konings, 1999; Blomström and Sjöholm, 1999) is to assess first whether or not foreign affiliates perform well compared with other host-country competitors and subsequently evaluate the performance of local firms in the presence of FDI (e.g. by means of the effect on sales).
A problem encountered in the literature is the simultaneity between productivity of local firms and FDI. A key variable in the foreign affiliates’ decision process is the performance of the target industry. For example, a district in a host country can attract TNCs if it offers advantages built by experience or research and development. Or, a site that already offers local firms strategic advantages would also appear attractive to potential investors. In those cases, one cannot disentangle the productivity effect coming from the presence of foreign affiliates from the productivity effect due to local advantages or expertise. The two are likely to be simultaneous, and one major challenge is to detect them separately in an econometric analysis. If FDI targets more productive industries, then the observed correlation between the presence of foreign firms and the productivity of domestically owned firms will overstate the positive impact of FDI. Evidence of positive spillovers where no spillover occurs has been found in the literature (Aitken and Harrison, 1999; Konings, 1999). It may therefore be necessary to introduce in the specification of the model some control variables to take into account industry differences, environmental influences (e.g. changes in policies) and regional characteristics.

Data

The data comprise a sample of 882 Hungarian firms for the period 1993-1997. A wide range of information is available for each firm, e.g. number of employees, capital factor endowments, geographic location, sales, foreign participation and industry branch by NACE rev.1 2-digits classification.³ SALES measures the value of annual sales in thousand dollars. The size of the companies in the sample varies from small enterprises employing only one unit of labour to big railway companies employing about 65,000 people. The variable EMPLOYMENT refers to labour units employed during the five-year period by each firm. CAPITAL is a proxy for the capital factor of production and may suffer from problems due to changes in firms’ asset values over time. The FDI variable measures the share of foreign participation in each firm, assuming values from 0 to 1 throughout the five-year period. The contractual type of foreign participation is not illustrated. The share of foreign affiliates’ sales over global industry sales is the proxy for spillovers, and it is indicated as SPILL. The hypothesis is that an increase in global sales tied to

³ The source of data is Jozef Konigs, Professor, Katholieke Universiteit, Leuven, Belgium.
an increase in foreign participated sales is an indicator of positive spillovers, that is, a dominance of the spillover effect over the competition effect. The industries in the sample cover the whole of the NACE classification (from 1 to 93). Regions are identified by zip code.

In the level variable estimates, logs were considered to overcome the usual problems. Figure 6 shows the trend in average sales for both foreign affiliates and local firms. Interestingly, the trend for both types is identical: after a slowdown between 1994 and 1995, an increase follows until 1997. But the level of sales of foreign affiliates is sharply higher throughout the whole period.

**Figure 6. Sales of the Hungarian sample firms, 1993-1997**

*(Thousands dollars)*

![Graph showing sales trend](image)

*Source:* based on own data set.

Figure 6 provides two basic intuitive answers to the hypothesis posed above. First, foreign affiliates seem, indeed, to perform better than local firms. However, this conclusion should be handled with caution, as it may well be that foreign affiliates are simply larger than local firms, and so their sales are also larger. This does not allow conclusions on efficiency and performance. In this case, however, if size was the factor making a difference, trying to evaluate the model according to the dimensions of firms would resolve the problem. Furthermore, it is not possible without an econometric analysis to assess if FDI is directed to the best performing enterprises, or if performance increased after foreign capital came in. This argument refers to the simultaneity issue already cited.

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4 Taking logarithms of a variable reduces heteroskedasticity, as extreme observations are flattened with respect to average observations.
Following M. Blomström and F. Sjöholm (1999), another variable, SCALE, was constructed to take into account the size of the firms in the sample. SCALE is defined as the sales of a single firm over the average sales in a given industry. Unfortunately, this variable created significant technical problems because it would bias the estimation result. Since it is a transformation of the SALES variable, collinearity caused inconsistent estimates. Another shortcoming of the database is the presence of missing values that can cause distortions in the estimation; nonetheless, the size of the sample is large enough as to guarantee that most firms are covered.

**The model and the econometric approach**

The estimated model follows narrowly the one presented in J. Konings (1999) and B. J. Aitken and A. Harrison (1999). As mentioned in the introduction, the idea is to try to estimate the global impact of FDI on the productivity of Hungarian firms and look for spillover effects. Two questions are posed in these studies: do foreign affiliates perform better than their wholly owned national counterparts? Is there any evidence of negative or positive spillovers to local plants/industries? The basic equation is the following:

\[
y_{it} = \beta_0 + \beta_1 l_{it} + \beta_2 k_{it} + \beta_3 Fdi + \beta_4 Spill + \beta_5 Time + \epsilon_{it} \tag{1}
\]

where \( \beta_0 \) is a vector of time-invariant fixed-effects, \( l \) represents labour input, \( k \) capital input, and \( Fdi \) is the percentage of foreign participation in the capital of a firm. While labour can be measured by labour units, it is always difficult to measure capital stock and even more problematic in a transition economy (Halpern and Korosi, 1998) because asset values are subject to high variation over time. This can cause distortions in the estimation, whose importance is hard to assess in advance. \( Spill \) is the index of technological spillovers at the industry level, and it is defined as the percentage of sales by foreign affiliates over total industry sales.

Konings noticed that, while equation (1) can reveal some kind of spillovers, it does not explicitly help to understand if they are technological or they are related to some other factors. But this can only emerge from survey level data of firms. Apart from this information, when only data on output and/or sales are available, a straightforward way to quantify spillovers is simply examining changes in quotes of production/sales of domestic firms with respect to foreign competitors. An alternative approach (Kokko, 1994) to quantify spillover is to consider capital intensity in the production process, or the quality or value added of the labour force, as positive spillovers should affect positively their productivity.
sales. One criticism here is that Spill could be a simple measure of market share or market performance, and nothing about spillovers could be inferred from it. But if it is assumed that market performance is a consequence of efficiency and organizational characteristics typical to each firm, and an attempt is made to control for these a priori effects by means of the model specification below, then it could be concluded that Spill could be capturing some dynamic effects, such as transfers from foreign participated firms to local firms, thanks to competition and spillovers. Time is a time trend. If some important shock (technological or institutional) affects the environment at a certain time, Time controls for it. The term $\varepsilon$ is the usual error.

Specifying alternative forms for equation (1) can help solve some common problems. A log-linear expression\textsuperscript{6} allows for diminishing heteroskedasticity among firms and for interpreting estimated coefficients as elasticities:

$$
\log y_{it} = \beta_0 + \beta_1 \log l_{it} + \beta_2 \log k_{it} + \beta_3 Fdi + \beta_4 Spill + \beta_5 Time + \varepsilon_{it} \quad (2)
$$

Interactions between regressors should be considered as well. Aitken and Harrison (1999) estimated the interaction of the coefficient for FDI at the plant level with the coefficient for FDI at the industry level to determine if the effects of a foreign presence on other foreign firms differ from the effects on domestic firms. Konings (1999) combined the measure for FDI with the time trend to control for the possible effects on both the level and growth of productivity. He also used the combination of spillovers and R&D to assess if firms that allocate more resources to research are more likely to experience spillovers.

In this article, panel data analysis will be used. The main benefit of using panel data lies in exploiting the advantages of repeated observations on the same units. The fixed effects model concentrates on differences “within” individuals. First-differentiating equation (2) leads to consistent estimates in our model. One of the assumptions required by the fixed effects model is that the $\beta_0$’s are not correlated with the regressors. Here, the $\beta_0$’s do capture heterogeneity and specific qualities of the surveyed firms, and hence they are likely to be highly correlated with the regressors (e.g. because of a very experienced and trained labour force). Therefore, estimates will not be consistent unless one controls for these effects. First-differentiating the equation solves this problem, and it is also a way of controlling for the potential

\textsuperscript{6} For a discussion on estimation on log linear expressions, see Verbeek (2000).
endogeneity bias in the choice of foreign firms to invest in local businesses:

$$\Delta \log y_{it} = \beta_0 + \beta_1 \Delta \log l_{it} + \beta_2 \log k_{it} + \beta_3 Fdi + \beta_4 \Delta Spill + \beta_5 Time + \epsilon_{it}$$  (3)

Results from estimating of the above equations are reported next.

**Estimation results**

The estimation method relied on panel data analysis with an additional first-difference specification. This method was used mainly to control for firm-level specific fixed effects that could bias estimates otherwise. Particularly, first-differentiating the equation allows for controlling for best industries or best performing firms that may have attracted the bulk of foreign investors. In this way, the pure productivity-competition effect can be isolated. The FDI variable measures this effect. With respect to a standard panel data analysis, the estimation becomes an ordinary least squares exercise over a first-difference specification. In order to assess if spillovers emerge in this case study, the variable SPILL captures the effect of a change in the foreign share of market sales over sales of all firms. As mentioned above, it is assumed that the dynamic effect in sales captures the presence of spillovers. Particularly, when the FDI variable is set to zero, only the effect over local firms is measured. Usual control variables are production inputs, capital and employment. In all specifications, a time dummy captures the environment or policy changes over time. The estimation techniques employed aim at correcting standard errors for heteroskedasticity and correlation within groups of observations. Clustering by id number allows the analysis to be carried over groups of observations that comprise the same firms over time. Observations are considered as independent between groups, but not necessarily within groups, and the associated standard errors reflect the adjustment made. In particular, the option “cluster” provided with the software package computes a covariance matrix for which not only are standard errors corrected for heteroskedasticity (White standard errors), but observations are also weighted so as to control for the possible correlation arising from individual characteristics observed over time. In other words, using the “cluster” option leads to a robust estimation similar in its role to a Newey-West covariance matrix for the usual autocorrelation-heteroskedasticity correction of standard errors.

Another optional type of regression has also been run to take into account the fact that, in a large data set (as the one used
here), there may be a lot of outliers causing dispersion in the data that could affect the goodness-of-fit of the regression. This is an alternative generalized least squares estimation technique called “robust regression”, which follows an iterative procedure to provide coefficients and standard errors based on a double-weighting\(^7\) estimation, aimed at giving a decreasing weight to observations with a residual larger than 1 in absolute terms.

Table 2. Productivity and spillover effects

| Variable | Cluster analysis | | | Robust regression | | |
|----------|-----------------|--|-----------------|--|-----------------|
|          | Local firms     | All firms |          | Local firms     | All firms |
| EMPLOYMENT | -0.1196582 | 0.5162147 | 0.1651714 | 0.2836848* |
|           | [-0.468]       | [1.41]    | [1.323]    | [3.647]      |
| CAPITAL   | 0.2852076*     | 0.4125885* | 0.1272889* | 0.2373118* |
|           | [2.615]         | [4.43]    | [4.961]    | [15.181]     |
| FDI       | 0.169131*      |           | 0.083981*  |           |
|           | [2.95]          |           | [4.523]    |            |
| SPILL     | -0.1169732     | -0.0422363 | -0.0628747 | -0.0107245 |
|           | [-0.859]       | [-0.33]   | [-0.878]   | [-0.211]    |
| Year dummies | Yes      | Yes      |           |            |
| R\(^2\)   | 0.12           | 0.19      |           |            |
| Number of observations | 587      | 1053      | 587       | 1051        |

Note: The t-statistics in squared brackets is based on heteroskedasticity and within correlation consistent standard errors.

* = significant at the 5 per cent level.
** = significant at the 10 per cent level.

The first question addressed here was: do foreign firms perform better than locally owned firms? From the second and the fourth columns of table 2, it can be seen that the FDI variable has a positive and significant sign. This means that, ceteris paribus, the presence of foreign participation actually enhances firms’ performance as measured by sales. Foreign participation is likely to increase sales by 8 per cent to 16 per cent.\(^8\) It can therefore be

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\(^7\) The double-weighting procedure consists of two steps. For further information, see Stata Reference Manual Set (Stata Corporation, 2000).

\(^8\) One must consider that the data set is quite large, and variations in both cross sectional and time series give rise to a lot of outliers. Goodness of fit decreases and marginal significant results (also at 10 per cent level) give a preliminary indication of the underlying economic problem.
inferred that foreign affiliates are probably more efficient than their local counterparts. The competition effect is at work: sales of foreign affiliates are significantly higher than sales of local firms, so that one may think that a substantial share of the market has been captured by foreign competitors.

As far as the issue of spillovers is concerned, the analysis does not provide a clear indication of the sign and magnitude of the phenomenon. The SPILL variable has a negative, but insignificant sign in all cases, even when the pure effect on local firms is only considered. Two explanations may justify this outcome. First, if any spillover effects exist, they are not strong enough to become evident in the regression analysis. Perhaps the changes induced in the local environment by the foreign presence are of a qualitative type, and it may be difficult to capture them by means of a statistical analysis. Or, simply, it takes quite a long time for spillovers to be internalized by local firms, and a five-year horizon is not long enough to make any significant effects evident. Second, it may be the case that the competition effect overwhelmed any gains in productivity caused by positive spillovers, so that on average and to a first extent (as mentioned above in the discussion of the model on decreasing average costs), local firms do not benefit from foreign presence, because even if any spillover effect had occurred (which might have increased their efficiency), the market share lost to foreign firms would have been much larger.

The CAPITAL variable is positive and significant, confirming a straightforward intuitive result: the better-endowed firms in terms of modern (and perhaps costly) machinery or equipment are likely to be the more competitive and efficient. This variable is a value for assets, but it can also be interpreted as a measure of size, together with employment.

Looking at the sign of the EMPLOYMENT variable, the great dispersion in the observations may justify the insignificant results in columns 1, 2 and 3; the employment variables actually take on values from 1 to 65,000. When outliers are excluded from the sample of all firms, the variable acquires again a positive and

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9 See previous discussion on the average cost effect of foreign firms’ entrance in the market.

10 As the dimension would imply a correlation between capital and employment, tests for correlation were conducted. Correlation is low (under 0.2). The standard errors (not reported here) are lower than the coefficients’ point estimates, also indicating the absence of strong possibly biasing correlation across regressors.
significant sign. Larger firms in term of labour size are associated with larger sales.

The dummy variables\textsuperscript{11} for years going from 1993 to 1997 are in all cases significant, confirming previous findings in the literature (Aitken and Harrison, 1999; Konings, 1999). A time trend helps to capture those institutional, legal or macroeconomic changes that are likely to affect the economy’s performance as a whole. Controlling for these time effects helps netting out their influence on the questions addressed here.

### Table 3A. Alternative model specifications

<table>
<thead>
<tr>
<th>Variable</th>
<th>Cluster analysis</th>
<th>Robust regression</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMPLOYMENT</td>
<td>1.642424 [1.460]</td>
<td>0.205641** [1.857]</td>
</tr>
<tr>
<td>CAPITAL</td>
<td>0.5869625* [3.833]</td>
<td>0.3785752* [15.611]</td>
</tr>
<tr>
<td>FDI</td>
<td>0.5665364* [3.051]</td>
<td>0.197556* [2.325]</td>
</tr>
<tr>
<td>SPILL</td>
<td>-0.0377797 [-0.107]</td>
<td>0.1753679** [1.915]</td>
</tr>
<tr>
<td>Year dummies</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>R\textsuperscript{2}</td>
<td>0.25</td>
<td>0.25</td>
</tr>
<tr>
<td>Number of observations</td>
<td>326</td>
<td>325</td>
</tr>
</tbody>
</table>

*Note:* The t-statistics in squared brackets is based on heteroskedasticity and within correlation consistent standard errors.

* = significant at the 5 per cent level.

** = significant at the 10 per cent level.

Tables 3A, 3B and 3C show results from alternative model specifications. In table 3A, the focus is on the sign and t-test of the FDI variable when only majority foreign-owned affiliates are considered (more than 50 per cent), replicating both the cluster analysis and the robust regression. Not only is the pattern of signs consistent with previous results, but when large foreign participation is considered, the FDI entry in the cluster analysis also has a higher (0.56) coefficient. One may conclude that the larger the foreign presence in an economy, the larger the effect on sales is likely to be. In other words, foreign affiliates do perform better than locally owned firms, and this discrepancy is even larger when high percentages of foreign capital enter the productive process.

\textsuperscript{11} Dummy variables for years are included and a constant, so as to be able to give R\textsuperscript{2} and the other descriptive statistics the usual interpretation.
### Table 3B. Alternative model specifications

<table>
<thead>
<tr>
<th>Variable</th>
<th>Cluster analysis</th>
<th>Robust regression</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMPLOYMENT</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Local firms</td>
<td>All firms</td>
</tr>
<tr>
<td></td>
<td>-0.1541173 [-0.569]</td>
<td>0.4493846 [1.461]</td>
</tr>
<tr>
<td>CAPITAL</td>
<td>0.2910852* [3.077]</td>
<td>0.4258292* [5.141]</td>
</tr>
<tr>
<td>FDI</td>
<td>0.1756345* [2.914]</td>
<td></td>
</tr>
<tr>
<td>SPILL</td>
<td>-0.127442 [-0.917]</td>
<td>-0.0915893 [-0.709]</td>
</tr>
<tr>
<td>Regional dummies</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>R²</td>
<td>0.1535</td>
<td>0.2096</td>
</tr>
<tr>
<td>Number of observations</td>
<td>587</td>
<td>1053</td>
</tr>
</tbody>
</table>

*Note:* The t-statistics in squared brackets is based on heteroskedasticity and within correlation consistent standard errors.

* = significant at the 5 per cent level.

** = significant at the 10 per cent level.

The results from tables 3B and 3C are robust when regional dummies and sector dummies are included. The regions were divided by zip code; this could be considered as a step towards a study on the location of firms. Further analysis could be
interesting, for instance, for assessing the presence of FDI agglomerating around large towns. The sector dummies were created from the NACE Rev. 1 industry branch classification, and subsequent work on high-technology industries was carried out on that basis. Sector- and industry-specific factors are tied to the quality of labour and sometimes to lower labour costs compared with Western Europe, or to a rising demand for new varieties of manufactured goods. Further research could be undertaken to assess which particular industries perform better and to correlate the size of privatization in an industry with foreign participation and overall performance.

Estimation results for the same model, still using basic ordinary least squares and correcting for standard errors (taken with level variables) highlight the simultaneity bias problem due to the “performing industries” effect. In this case, fixed individual effects are not controlled for. Also the role of spillovers is less well specified.

The most striking difference appears in the coefficients of FDI that are never significant, in sharp contrast with previous results. Moreover, the SPILL variable that was never significantly different from zero now becomes significant in one case. This may well capture the fact that foreign firms are attracted by the best industries/firms, and the fact (shown in the first column of table 4) that there are negative spillovers from foreign firms. In this context, however, the specification is not correct, because it

<table>
<thead>
<tr>
<th>Variable</th>
<th>Cluster analysis</th>
<th>Robust regression</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Local firms</td>
<td>All firms</td>
</tr>
<tr>
<td>EMPLOYMENT</td>
<td>0.0827875</td>
<td>0.1046152*</td>
</tr>
<tr>
<td></td>
<td>[1.197]</td>
<td>[2.130]</td>
</tr>
<tr>
<td>CAPITAL</td>
<td>0.3600827*</td>
<td>0.4433634*</td>
</tr>
<tr>
<td></td>
<td>[9.830]</td>
<td>[16.507]</td>
</tr>
<tr>
<td>FDI</td>
<td>-0.1031837</td>
<td></td>
</tr>
<tr>
<td></td>
<td>[-0.443]</td>
<td></td>
</tr>
<tr>
<td>SPILL</td>
<td>-0.2614447</td>
<td>0.1491027</td>
</tr>
<tr>
<td></td>
<td>[-1.499]</td>
<td>[1.100]</td>
</tr>
<tr>
<td>Year dummies</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>R²</td>
<td>0.32</td>
<td>0.42</td>
</tr>
<tr>
<td>Number of observations</td>
<td>1037</td>
<td>1821</td>
</tr>
</tbody>
</table>

Note: The t-statistics in squared brackets is based on heteroskedasticity and within correlation consistent standard errors.

* = significant at the 5 per cent level.
** = significant at the 10 per cent level.
does not allow for controlling for external effects; the estimation is therefore biased. Moreover, the sign of SPILL changes continuously, indicating the non-robustness of the underlying level specification.

It may be the case that a model like this could capture the factors affecting the willingness of investors to start a new business, such as performance, fiscal incentives (e.g. tax holidays), or large scale privatization. The data do not allow us to take into account the scale of privatization here, but additional work could be undertaken to analyze the privatization effects on the behaviour of foreign inventors.

The third question addressed here concerns technological spillovers. Does foreign participation in high-technology industries have any effect on the performance of local firms? High-technology industries, sorted according to 2-digit NACE branches, were identified according to the Revision of the High-Technology Industry and Product Classification (Hatzichronoglou, 1997). Although the debate on the definition of high-technology industries is not over and a common definition has not been reached (Chabot, 1995), the first proxies used to define high-technology industries are capital intensity and volume of R&D. The OECD has formally adopted this view. The relevant industries are indicated in table 5.

<table>
<thead>
<tr>
<th>Table 5. High-technology industries overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>EMPLOYMENT</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>CAPITAL</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>FDI</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>SPILL</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>High tech</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Spill_high tech</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Year dummies</td>
</tr>
<tr>
<td>R²</td>
</tr>
<tr>
<td>Number of observations</td>
</tr>
</tbody>
</table>

* = significant at the 5 per cent level.
** = significant at the 10 per cent level.

Note: The t-statistics in squared brackets is based on heteroskedasticity and within correlation consistent standard errors.
The main empirical findings (see table 5) suggest that foreign presence in high-technology industries has a positive impact on global sales. The direct effect measured by the High tech variable is positive and significant in three out of four cases. The effect of investing in industries with intensive activities in R&D affects positively the sales of all the firms considered here. This suggests that competition in those industries is particularly intense, and that enterprises struggle to stay in the market and keep up with innovation and progress.

The variable Spill_high tech is a measure for spillovers in the high-technology industries (NACE 24-35), and it is computed as the percentage of foreign sales in the sales of all firms in high-technology industries. Although significant only in the regression for all firms and at the 10 per cent confidence level, its sign is negative and seems to suggest that high-technology industries gained a substantial share in the market, damaging indirectly other firms. An increase in the sales of high-technology firms seems to cause a decrease in overall firms’ sales ranging between 10 per cent and 32 per cent. However, this result could be interpreted as evidence of a technological gap: more competition from technology-advanced industries boosts restructuring and search for efficiency. The first effect to emerge is crowding-out; there is no evidence of positive spillovers, but a negative interaction becomes likely in the short run. To sum up, there is weak evidence, if at all, of negative spillovers. The competition effect has been so strong, or the technological gap so wide, that local firms were not able to benefit positively from the presence of foreign firms in the high-technology industries.

Conclusions

This article examined FDI, externalities and spillovers. The three fundamental questions addressed were: (i) do foreign firms perform better than local firms?; (ii) are there spillovers from the activities of foreign affiliates for a host economy as a whole and for local industries in particular?; and (iii) is the type of these externalities related to foreign presence in high-technology industries?

These questions are important because Hungary experienced a massive inflow of FDI that contributed greatly to industry restructuring, and to the privatization processes, and provided experience and know-how to the local workforce, thanks to high labour turnover (which causes an externality in itself). Altogether, FDI exerted strong competitive pressures on local
enterprises that had the double effect of inducing a search for major efficiency gains (leading to an increase in their performance) and of driving out of the market enterprises that were not able to restructure or cope with the intense foreign competition.

The findings seem to confirm what has already been found in previous studies, namely, that the competition effect is prevalent among Hungarian firms. Foreign presence has a positive impact on overall sales of firms, but this could simply mean that foreign affiliates are more efficient. Indeed, when one tries to control for the effect of foreign presence on local firms only, it does not seem that any beneficial effects apply to domestic enterprises. So, the answer to the first question above would be that foreign affiliates do seem to outperform their domestic rivals.

Spillover effects, if any, are not likely to result from this type of econometric analysis. The results mainly indicate that domestic firms suffer from foreign presence and do not seem to benefit from the transfer of technology due to the high R&D embodied in TNCs. The variable (SPILL) that captures spillovers both at the global and industry levels is never significantly different from zero. This indicates that the effect of decreasing average costs due to gains in productive or organizational efficiency at the local firm level has been more than overwhelmed by the “market-stealing” effect, represented by a decrease in market share for domestic firms. As far as the second question is concerned, the answer is a big question mark. A possible explanation for this disappointing result is that the transition period is not over yet, and many of the structural changes likely to affect the performance of the whole economy are still under way.

At this state of the analysis, it was not possible to answer adequately the third question mentioned above. Technological spillovers may not find room to be embedded in local production functions, as the technological gap may be too wide; alternatively, the analysis is carried over a five-year period that is not long enough to observe significant positive spillover effects from foreign presence. There is only weak negative evidence for spillovers in high-technology industries, in which foreign investors are likely to have a comparative advantage.

What are the policy implications arising from the findings? Fostering competitiveness of domestic enterprises has become a political priority since the late 1990s. The Government of Hungary has put a lot effort in trying to promote internationalization
strategies of local firms (Lendvai, 2000). In 1997, the Subcontractors Target Programme was launched in the interest of strengthening the economic role and enhancing the market position of small and medium-sized enterprises with the aim of increasing the number of exportable products, replacing imports and increasing the value added and innovation contents of domestic products. Of course, also boosting the transfer of technology was one of the goals. The programme was created at a time when TNCs that had moved to Hungary earlier could make use of their improved local knowledge, and thus undertake the risk of replacing their subcontractors, mostly from their countries of origin, with local subcontractors (Soltész, 2000). The programme became publicly known in May 1999, but at the beginning it did not have the expected success, mainly because of organisational deficiencies and bureaucratic difficulties. Moreover, the scope of subcontractors in Hungary was quite low, especially compared with that in other developing countries. Nonetheless, the programme has built up a fairly advanced local institutional network within the framework and premises of the Hungarian Enterprise Development Foundation. Recently, the ownership of this institutional setting was transferred to the Regional Development Holding (a joint venture between the State Privatisation Agency and two venture capital funds). The establishment of such a network has been a precondition for the long-term sustainability of the programme.

References


RESEARCH NOTE

Competition policy and FDI: possible relationships based on Brazil’s experience

Gesner Oliveira*, Richard Hochstetler** and Carolina Kalil***

Based on evidence from a sample of 66 countries and information on mergers and acquisitions from the Brazilian competition authority, this note attempts to show three points: (i) there appears to be no evidence that the development of competition policy deters foreign direct investment inflows; on the contrary, there seems to be a positive association between the proxy for the degree of development of competition policy and foreign direct investment inflows; (ii) Brazil’s experience suggests that mergers and acquisitions involving foreign capital merit scrutiny by the competition agency because of their potential effects on competition; furthermore, cooperation among competition authorities of different jurisdictions is shown to be important due to the share of mergers and acquisitions that are of global scope; and (iii) there is a significant level of denationalization of Brazilian firms reflected in the sample chosen, but the phenomenon does not seem to present specific competition problems that would justify a differential treatment, such as a possible change in the notification requirements for foreign firms. Obviously, the above points should be qualified by the general nature of the information used. Further research would be helpful, especially using a case study approach.

1 This note contains results of a research project supported by Núcleo de Pesquisa e Publicações of Escola de Administração de Empresas de São Paulo (EAESP) and relies on earlier research in the context of World Investment Report 2000: Cross-border Mergers and Acquisitions and Development (UNCTAD, 2000).

* Professor at Getulio Vargas Foundation, São Paulo, Brazil and former President of Conselho Administrativo de Defesa Econômica (CADE) (1996-2000).

** Graduate student at the University of São Paulo, Brazil.

*** Undergraduate student at the University of São Paulo, Brazil.
In the past two decades, there has been a widespread policy shift towards liberalization of national economies. It has entailed the lowering of tariff barriers, elimination of discriminatory treatment of foreign capital, deregulation and privatization. These changes have contributed to an increase in foreign direct investment (FDI) and greater demand for competition policy. The number of countries with competition laws has increased from less than 40 in the 1980s to more than 80 in the late 1990s. More than 20 countries are preparing new legislation in 2001.

These trends raise a number of questions:

(i) What is the impact of competition policy on FDI? Does competition policy deter or attract FDI?

(ii) Should FDI be exempt from competition policy analysis and from merger control in particular? Can FDI have an anticompetitive effect?

(iii) Does the acquisition of domestic firms by foreign firms rise particular competition concerns?

This note examines empirical evidence to try to answer these questions. The first section discusses the questions under (i) using a sample of 66 countries. The second and third sections tackle the questions under (ii) and (iii), respectively, using the set of transactions reviewed in 1999 by Conselho Administrativo de Defesa Econômica (CADE), the Brazilian competition commission.²

Exploring the relationship between the level of institutional development of competition policy and FDI

There are two opposing views regarding the relationship between competition policy and FDI. On the one hand, one could argue that developing countries should not prioritize competition policy because it would discourage FDI by creating additional

² CADE is the Brazilian competition tribunal with adjudicative functions. Investigations are conducted by the Secretaria de Direito Econômico (SDE), a Secretariat affiliated with the Ministry of Justice. Another Secretariat, Secretaria de Acompanhamento Econômico (SEAE), affiliated with the Ministry of Finance, gives non-binding opinions in the process. A governmental proposal to consolidate the three bodies is currently under discussion.
regulatory barriers and risks for the investor. The argument is analogous to the notion sometimes suggested implicitly, namely, that developing countries should accept lower environmental standards to avoid deterring potential investments. On the other hand, it could be argued that competition policy helps to attract FDI because it provides a level-playing field for fair competition among firms and a sound and stable institutional environment, which diminishes the risk of investing in the country.

If either of these views is correct, one should be able to identify a correlation between the degree of implementation of competition policy and FDI. A negative correlation would suggest that competition policy possibly deters FDI, while a positive correlation would suggest that competition policy possibly helps to attract FDI. In order to explore this relationship, the correlation between FDI inflows over the period 1992-1997 and the level of institutional development of competition institutions in a sample of 66 countries will be considered.3

**Measuring the level of institutional development of competition policy**

Assessing the degree of institutional development of competition policy of a particular country is not a trivial matter. The evolutionary view of competition policy implementation, proposed in G. Oliveira (1998a, 1998b) and inspired by the work of S. Khemani and M. Dutz (1995) and S. Khemani (1997) is adopted here. Competition policy is assumed to be implemented gradually, in a process containing several stages. This gradual implementation process results from the circumstances usually faced by competition authorities.

On the one hand, it is urgent to adopt competition policy in the liberalization process in order to promote a competitive economy. If competition policy is not adopted at an early stage, the risk that anti-competitive structures will be established is large and *ex post* solutions tend to be more costly. On the other hand, newly established competition institutions do not have the experience, personnel and financial resources to implement all aspects of competition policy at once. Thus, the agency must focus its efforts on a few tasks, and gradually expand the scope of its actions as it becomes equipped to encompass those dimensions.

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3 Data on FDI come from UNCTAD (1998) and UNCTAD (1999); other macroeconomic indicators are from World Bank (1999).
of competition policy that require more resources relative to their impact on social welfare.

This gradual growth in the scope of competition policy can be expressed as a sequence of stages of institutional development. The stages are determined according to the degree of difficulty in evaluating if the benefits of a particular task of the competition institution can more than compensate the costs of its implementation. The early stages will therefore focus primarily on combating firm behaviour that is unequivocally damaging to the market. Advanced stages would then include more complex tasks, which require less trivial analysis to determine their net welfare impacts. The stages adopted here are presented in Table 1 and described briefly below. The tasks are cumulative, each stage including the tasks listed in the previous stages.

Table 1. The stages of institutional development in competition policy

<table>
<thead>
<tr>
<th>STAGE 1</th>
<th>STAGE 2</th>
<th>STAGE 3</th>
<th>STAGE 4</th>
<th>STAGE 5</th>
<th>STAGE 6</th>
<th>STAGE 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competition law non-existent or in process of implementation</td>
<td>(1) Competition advocacy</td>
<td>(4) Vertical agreements</td>
<td>(4) Vertical agreements</td>
<td>(6) Agreements with regulatory agencies</td>
<td>(6) Agreements with regulatory agencies</td>
<td>(6) Agreements with regulatory agencies</td>
</tr>
<tr>
<td>(2) Repression of horizontal agreements</td>
<td>(5) Merger control in process of implementation</td>
<td>(5) Merger control fully implemented</td>
<td>(7) International cooperation agreements in process of implementation</td>
<td>(7) International cooperation agreements in process of implementation</td>
<td>(8) Second generation international agreements</td>
<td>(9) Pro-active competition advocacy</td>
</tr>
<tr>
<td>(3) Technical assistance</td>
<td></td>
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Stage 1 includes countries that have no competition law, or that have only recently begun its process of implementation.

In stage 2 the competition authority focuses on three main tasks: the dissemination of the competitive paradigm, the repression of horizontal agreements and efforts to obtain technical assistance from multilateral organizations and other jurisdictions. Competition advocacy seeks to promote competition culture. This task is particularly important in countries in which the economy has been largely state controlled in the past, such as those in Eastern Europe and Latin America. The repression of anticompetitive behaviour refers to the prosecution of those practices that are clearly anticompetitive, such as price agreements among competitors.

Stage 3 is characterized by the addition of the initial steps for examining vertical agreements and merger control. Both require careful analysis of the net impact on social welfare.
In stage 4, merger control and monitoring of vertical agreements have been fully implemented.

In stage 5 the initial steps of institutional agreements are taken. In the domestic arena, cooperation with regulatory agencies is needed to enforce competition policy in industries characterized by temporary natural monopolies. In the international arena, cooperation is sought with other jurisdictions to enforce better competition policy in regard to cross-border practices and transactions. This goes beyond the technical assistance mentioned in stage 2; it entails further technical exchange and standardization of the criteria and procedures.

In stage 6, the cooperation agreements with regulatory agencies and foreign competition institutions are established and become operational.

Finally, in stage 7, institutional maturity is obtained. In this stage, “second-generation agreements” among competition institutions of different countries are established in order to rule on mergers outside the particular competition institution, but with significant ramifications in the local economy. The competition authority also takes on a pro-active stance in competition advocacy, participating in the analysis of new legislation that may have an impact on competition.

**Adjusting FDI inflows for country size**

In order to compare the attraction of FDI among countries, it is necessary to control for the relative size of each country. Two ways of adjusting for the relative size of countries are examined: FDI per capita and FDI per gross domestic product (GDP).

Traditionally, FDI inflows are normalized using GDP. This normalization is adequate when considering cross-border investments between developed countries, where the motivations for FDI are expansion or regional diversification, for example.

When considering FDI from developed countries into developing countries, normalizing by using GDP may bias the analysis. One would expect capital to flow from richer countries to poorer ones, because capital is scarcer in the latter, causing the marginal productivity of capital to be higher there. Thus, countries with a lower GDP should have a large share of FDI, all else being the same. Adjusting FDI using GDP would therefore understate the level of investment inflows to developed countries.
To avoid this problem, another variable should be used to normalize the level of FDI. Normalizing FDI into developing economies by population size may be a more appropriate procedure in this case. The results using both forms of normalization will be considered here (see appendix tables 1A and 2A).

The results

The correlation between the level of institutional development of competition institutions and FDI per GDP is -0.080880, while the correlation using FDI per capita is +0.280047. Figures 1 and 2 present the scatter diagrams for the level of institutional development and FDI adjusted for population and GDP, respectively.

This simple correlation is not an appropriate indicator, because the level of institutional development of competition policy in the sample countries is only a qualitative indicator. The ranking of the institutional development of competition policy in the different countries is non-parametric, being used to establish

Figure 1. Correlation between FDI and competition policy using population*

(Thousands dollars)


* The outlier in the first graph represents Singapore. In line with the arguments of the delegates of this country in various international fora, one could argue that Singapore and other countries may have an advanced competition regime though they do not have a competition law. This argument has been refuted in Oliveira (1998a). In any event, if Singapore were excluded from the sample, the correlations would tend to be more positive.
ran ordinal ranking of the countries’ competition institutions, not a cardinal ranking. A more appropriate way to examine the relationship between the institutional development of competition institutions and FDI inflow is the Spearman correlation of the rankings by the two variables.4

The Spearman correlation indicates that there is a small, significant and positive correlation between the two variables, as presented in table 2. The Spearman correlation is positive and significant at the 95 per cent confidence interval when FDI per capita is used, and positive and significant at the 90 per cent confidence interval when FDI per GDP is used.

The findings (table 2) show that there is no evidence that the institutional development of competition institutions hampers FDI. On the contrary, there appears to be a small but positive relationship between the two variables, which suggests that institutional development of competition institutions may be associated with more FDI inflows.

4 Among others, see Anderson, Sweeney and Williams (1990). The ranking of the institutional development of competition institutions within each of the stages was made in decreasing order of the FDI inflows per GDP variable.
Table 2. Correlation between FDI and level of institutional development of competition policy

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* Significant at the 90 per cent confidence interval.
** Significant at the 95 per cent confidence interval.

Merger control and FDI: evidence from Brazil

The second group of questions focuses on the need of competition policy, and in particular merger control, when considering the impact of FDI. Even if competition policy does not hamper FDI inflows, the application of competition policy on cases involving foreign investment is sometimes questioned because of the argument that FDI always has a positive effect on competition.

However, when FDI occurs through mergers and acquisitions, one could argue that productive capacity is not increased, and there may be an increase in market concentration. In fact, an increasing share of FDI stems from mergers and acquisitions as opposed to greenfield investment. According to recent data by UNCTAD (2000a), the ratio between mergers and acquisitions and FDI in developing countries has risen from 15 per cent during 1991-1995 to 35 per cent during 1996-1999. This section will focus on the verification of the validity of this argument based on the examination of mergers and acquisitions involving foreign capital in Brazil.

An examination of all mergers and acquisitions reviewed by CADE in 1999 suggests that much of the FDI in Brazil may have a potential effect on competition and thus merits scrutiny. Recent studies of the Brazilian economy using sectoral data (Moreira, 1999) have shown that FDI has provoked impacts upon market structure. Instead of sectoral data that may not depict the anti-trust concept of the relevant market, the set of mergers and acquisitions involving foreign capital analyzed by CADE in 1999 is used. The sample was divided into four categories:
(i) Foreign firms that effectively participated in the Brazilian market through exports prior to the merger or acquisition.

(ii) Foreign firms that effectively participated in the Brazilian market with affiliates operating in Brazil prior to the merger or acquisition.

(iii) Foreign firms that were potential competitors in the Brazilian market prior to the merger or acquisition.\(^5\)

(iv) Foreign firms that were not potential competitors in the Brazilian market prior to the merger or acquisition.

The first three types represent mergers or acquisitions that may have potential effects on competition in the spirit of the *caput* of Article 54 of the Brazilian competition law. Only for the fourth type of transaction one could say that there would not exist potential negative impacts on competition.

**Figure 3. Cases involving FDI by transaction type, 1999**

(Number)

Source: CADE.

---

\(^5\) This category represents firms that did not actively participate in the Brazilian market either in Brazil or through exports, but were already active in the same (or close) relevant markets in other countries. For an example of a case considering potential competitors, see the Brahma-Miller joint venture judged by CADE in 1997.
The evidence for Brazil is summarized in figure 3. Only four out of the 192 cases analyzed by CADE in 1999 involved the entry of new competitors in the market without possible anti-competitive effects. Thus, most mergers and acquisitions involving FDI do pose a potential effect on competition, thus justifying merger control.

Globalization, denationalization and competition policy

Whether or not the mergers and acquisitions were national or global transactions — that is, if the motivating factor was predominantly domestic or international restructuring — is also analyzed here. Again, we consider the merger and acquisitions data reviewed by CADE in 1999. The data indicate that roughly a quarter of all mergers and acquisitions involving FDI are the result of global transactions (figure 4).

Figure 4. Breakdown of cases involving FDI, 1999
(Number)

Thus for the merger control alluded to in the previous section to be effectively and efficiently enforced, a cooperative effort is necessary among competition authorities from different jurisdictions. Harmonization and simplification of merger review seem to be quite important in order to assure that the domestic market is well integrated into the global economy.
The share of mergers and acquisitions that results in the denationalization of a Brazilian firm is also identified. There seems to be a growing concern in Brazil about the origin of the control of firms. Among other presumably negative effects, it is frequently argued that the outflow of profits and dividends could pose balance-of-payments problems. Here, the concern is with possible peculiarities in the cases involving denationalization as far as competition policy is concerned. The division into the above four categories of the sample of merger cases provides a convenient instrument to investigate this question. One could argue, for example, that the subset of denationalization cases would present a different statistical distribution from the rest of the sample. In particular, one could make the hypothesis that one would obtain a larger share of cases with a potential for harm to competition in the subset of the denationalization cases.

In 1999, over a third of the cases examined by CADE involved foreign acquisition of control of a national firm (figure 5). There is no evidence, however, that those transactions should raise more concern than others as far as competition effects are concerned. Indeed, as figure 6 shows, the share of transactions with no potential to affect competition negatively in 1999 was larger in cases that involved foreign acquisition of control of a national firm than in all other cases: 3 in 80 versus 1 in 104.

Figure 5. Ratio of cases involving FDI in which domestic firms were acquired by foreign firms, 1999
(Percentage)

Source: CADE.

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Conclusions

In summary, this note has provided evidence to answer the three groups of questions proposed in the introduction:

(i) There appears to be no evidence that the development of competition policy deters FDI inflows.

(ii) Brazil’s experience suggests that mergers and acquisitions involving foreign capital merit scrutiny by the competition agency because they do have potential effects on competition. Furthermore, cooperation among competition authorities of different jurisdictions is shown to be important due to the high share of mergers and acquisitions that are of global scope.

(iii) There is a significant level of denationalization of Brazilian firms reflected in the sample chosen, but the phenomenon does not seem to present specific competition problems that would justify a differential treatment, such as a possible change in the notification requirements for foreign firms.

The above conclusions should obviously be qualified by the nature of the information used. Further research would be helpful, especially using a case study approach.
References


Appendix table 1. FDI per capita and level of institutional development in competition policy

<table>
<thead>
<tr>
<th>Country</th>
<th>Stage</th>
<th>FDI per capita</th>
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<th>Ordering by FDI per capita</th>
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Appendix table 1. FDI per capita and level of institutional development in competition policy (concluded)

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Appendix table 2. FDI per GDP and level of institutional development in competition policy

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<td>11</td>
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<td>33</td>
<td>12</td>
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<td>3.15%</td>
<td>7</td>
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<td>36</td>
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<tr>
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<td>1</td>
<td>2.99%</td>
<td>46</td>
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<tr>
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<td>2.21%</td>
<td>50</td>
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<td>2</td>
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<td>484</td>
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<tr>
<td>Indonesia</td>
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<td>2.03%</td>
<td>51</td>
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<tr>
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<tr>
<td>Israel</td>
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<td>1.99%</td>
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<td>17</td>
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<td>121</td>
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<tr>
<td>Philippines</td>
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<td>52</td>
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<td>529</td>
</tr>
<tr>
<td>Denmark</td>
<td>5</td>
<td>1.70%</td>
<td>18</td>
<td>30</td>
<td>144</td>
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<tr>
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<tr>
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<td>19</td>
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<td>1</td>
<td>1.50%</td>
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<tr>
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<td>41</td>
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<td>49</td>
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<tr>
<td>France</td>
<td>6</td>
<td>1.46%</td>
<td>8</td>
<td>35</td>
<td>729</td>
</tr>
<tr>
<td>Honduras</td>
<td>1</td>
<td>1.41%</td>
<td>54</td>
<td>36</td>
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...
## Appendix table 2. FDI per GDP and level of institutional development in competition policy (concluded)

<table>
<thead>
<tr>
<th>Country</th>
<th>Stage</th>
<th>FDI per GDP</th>
<th>Ordering by stage</th>
<th>Ordering by FDI per capita</th>
<th>Squared dispersion</th>
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<tbody>
<tr>
<td>Portugal</td>
<td>5</td>
<td>1.40%</td>
<td>20</td>
<td>37</td>
<td>289</td>
</tr>
<tr>
<td>Morocco</td>
<td>1</td>
<td>1.37%</td>
<td>55</td>
<td>38</td>
<td>289</td>
</tr>
<tr>
<td>Canada</td>
<td>7</td>
<td>1.33%</td>
<td>4</td>
<td>39</td>
<td>1,225</td>
</tr>
<tr>
<td>Greece</td>
<td>5</td>
<td>1.31%</td>
<td>21</td>
<td>40</td>
<td>361</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>4</td>
<td>1.27%</td>
<td>29</td>
<td>41</td>
<td>144</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>3</td>
<td>1.07%</td>
<td>36</td>
<td>42</td>
<td>36</td>
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<tr>
<td>Brazil</td>
<td>5</td>
<td>1.06%</td>
<td>22</td>
<td>43</td>
<td>441</td>
</tr>
<tr>
<td>Switzerland</td>
<td>6</td>
<td>1.04%</td>
<td>9</td>
<td>44</td>
<td>1,225</td>
</tr>
<tr>
<td>Finland</td>
<td>5</td>
<td>1.03%</td>
<td>23</td>
<td>45</td>
<td>484</td>
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<tr>
<td>Uruguay</td>
<td>1</td>
<td>0.96%</td>
<td>56</td>
<td>46</td>
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<tr>
<td>Moldavia</td>
<td>1</td>
<td>0.88%</td>
<td>57</td>
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<td>Mongolia</td>
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<td>0.84%</td>
<td>58</td>
<td>48</td>
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<td>7</td>
<td>0.82%</td>
<td>5</td>
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<tr>
<td>Austria</td>
<td>5</td>
<td>0.76%</td>
<td>24</td>
<td>50</td>
<td>676</td>
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<tr>
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<td>1</td>
<td>0.70%</td>
<td>59</td>
<td>51</td>
<td>64</td>
</tr>
<tr>
<td>Senegal</td>
<td>1</td>
<td>0.64%</td>
<td>60</td>
<td>52</td>
<td>64</td>
</tr>
<tr>
<td>Russia</td>
<td>2</td>
<td>0.58%</td>
<td>42</td>
<td>53</td>
<td>121</td>
</tr>
<tr>
<td>India</td>
<td>3</td>
<td>0.53%</td>
<td>37</td>
<td>54</td>
<td>289</td>
</tr>
<tr>
<td>Malawi</td>
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<td>0.51%</td>
<td>61</td>
<td>55</td>
<td>36</td>
</tr>
<tr>
<td>South Africa</td>
<td>4</td>
<td>0.51%</td>
<td>30</td>
<td>36</td>
<td>676</td>
</tr>
<tr>
<td>Turkey</td>
<td>4</td>
<td>0.47%</td>
<td>31</td>
<td>57</td>
<td>676</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>5</td>
<td>0.35%</td>
<td>25</td>
<td>58</td>
<td>1,089</td>
</tr>
<tr>
<td>Italy</td>
<td>6</td>
<td>0.34%</td>
<td>10</td>
<td>59</td>
<td>2,401</td>
</tr>
<tr>
<td>Jordan</td>
<td>1</td>
<td>0.31%</td>
<td>62</td>
<td>60</td>
<td>4</td>
</tr>
<tr>
<td>El Salvador</td>
<td>1</td>
<td>0.31%</td>
<td>63</td>
<td>61</td>
<td>4</td>
</tr>
<tr>
<td>Nepal</td>
<td>1</td>
<td>0.23%</td>
<td>64</td>
<td>62</td>
<td>4</td>
</tr>
<tr>
<td>Cameroon</td>
<td>1</td>
<td>0.21%</td>
<td>65</td>
<td>63</td>
<td>4</td>
</tr>
<tr>
<td>Germany</td>
<td>7</td>
<td>0.13%</td>
<td>6</td>
<td>64</td>
<td>3,364</td>
</tr>
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<td>Japan</td>
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<td>0.03%</td>
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<td>65</td>
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<tr>
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<td>66</td>
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</tbody>
</table>

Notes on Brazil’s merger and acquisitions data for 1999

The number of merger and acquisition cases involving foreign companies judged by CADE in 1999 was 184. The following cases were excluded from the analysis, for the following reasons:

(i) *Ato de Concentração* (Concentration Act) AC nº 08012.008619/98-86 did not involve FDI into Brazil; it consisted of a merger between two firms that exported to Brazil.

(ii) AC nº 180/97 involved a bankruptcy proceeding, in which the failed firm was bought by several firms (including a foreign firm).

(iii) AC nº 08012.005232/98-50 involved the purchase of a foreign firm by another foreign firm, thus it only consisted of a substitution of foreign capital.

(iv) AC nº 08012.005234/98-85 was the consequence of another acquisition case already included in the sample in AC 08012.007154/97-38.

(v) AC nº 63/95 was a joint venture involving several domestic firms and an international firm, thus not a case of FDI.

(vi) AC nº 08012.005760/98-18 was excluded because the transaction was a consequence of an acquisition already considered in AC nº 08012.009887/98-61.

Although Concentration Act nº 08012.007682/98-87 was a joint venture between a national and an international firm, it was included in the sample because it involved FDI in a market in which 78 per cent of the supply was through imports.

Concentration Act nº 08012.009729/98-10 was also included inspite of the fact that it consisted of an internal rearrangement of the control group of the company.

The sample also included the following cases involving State telecommunication firms that were privatized in 1999: Embratel Participações S.A., Telesp Participações S.A., Tele Sudeste Celular Participações S.A., Tele Centro Oeste Celular Participações S.A., Tele Nordeste Celular Participações S.A., Telemig Celular Participações S.A., Tele Norte Celular Participações S.A. e Tele Celular Sul Participações S.A.
The joint venture examined in Concentration Act nº 08012.007682/98-87 was also included in the sample because it involved several foreign firms, which would gradually enter the Brazilian market, even though initially only through exports.

The four categories used in the analysis are based on three simplifying assumptions:

(i) Only one relevant geographic market is considered in each case.
(ii) Only one relevant product market is considered in each case.
(iii) Firms belonging to the same product market, but different geographic markets have a positive effect on competition in the relevant geographic market by increasing contestability.

The above simplifying assumptions were necessary in order to deal with the large number of transactions. A case study approach would permit the analysis of all relevant markets in each case.
Cross-border acquisitions in response to bilateral/regional trade liberalization

Prescott C. Ensign*

This note examines why a major change in economic policy will require a change in policy at the firm level. Specifically examined is how bilateral or regional trade and investment liberalization causes a firm to pursue international restructuring or integration of operations. Regional economic integration results in increased competition and a larger market. It also results in new opportunities and threats. In this environment, the search for competitive advantage may require a firm to make a cross-border acquisition, especially within the region. It is suggested in this note that a cross-border acquisition may be needed in order for a firm to internationalize operations; rationalize operations; maximize advantages; and minimize disadvantages. The major drivers of this response are considerations of market share and market power; linkages — both intra-firm linkages and inter-firm linkages; technology/innovation; and cost/efficiency.

Introduction

An understanding of cross-border acquisitions involves understanding trade, foreign direct investment (FDI) and the reasons why firms become transnational. Over the years, many explanations have been provided. They have had one central focus: trying to understand the behaviour of the transnational corporation (TNC). Early theoretical work focused on the market and viewed TNCs as oligopolists (Hymer, 1960; Knickerbocker, 1970). More recent work has focused on the advantages of TNCs for firms (Dunning, 1980; Rugman and Dacin, 1985).

* Research Fellow, Hautes Études Commerciales, Montreal, Quebec, Canada. This work has benefited from comments made by Andrew Delios, the anonymous referees of this journal and participants at the 1997 Canadian Economics Association meetings. The author appreciates the abundance of criticisms provided by Ig Horstmann, most of which remain to be resolved in empirical analyses. Support as a Fulbright Scholar from the Foundation for Educational Exchange between Canada and the United States, the Institute of International Education and the J. M. Smucker Company is gratefully acknowledged.
Succinctly put, “direct investment will not occur in industries with pure competition” (Kindleberger, 1973, p. 247). A firm entering a new market must have “some special advantage” over firms currently competing in that market. Superior coordination is one such means, “because of its knowledge [the entering firm is] able to economize through synchronizing operations” (Kindleberger, 1973, p. 247). Further, “Hymer’s theory of direct investment states that foreigners can pay more for an earning asset, such as a business, in country A than residents of country A would, not because they are content with a lower [rate of return], but because they can earn a higher [stream of income]” (Kindleberger, 1973, p. 249). More recent research includes an emphasis on assets, especially firm resources and capabilities that are created or learned. Finally, the external environment that included trade barriers has been viewed as a primary reason for FDI.

Beginning in the early 1970s, global oligopolists — in particular the entry of the Japanese Keiretsu into the United States market — began to change radically the competitive environment (Chesnais, 1993). International cross-investment gave firms the capacity to become what Kenichi Ohmae (1985, 1990) calls “global insiders”. Global oligopoly, primarily among the Triad (Japan, Europe and the United States), describes the extent to which rivals can enter (cross-invest) and operate in each other’s markets. Such global concentration has given rise to a search for corporate growth and transnational expansion. The present trend towards trade liberalization — with a change from multilateral/global efforts to bilateral/regional efforts — has resulted in increased intra- and inter-regional competition. Greater economic integration has forced firms to serve larger markets and operate in new ways.

Growth in FDI and trade has resulted in an irreversible pattern of dominance by TNCs. In fact, most firms recognize that “globalization” or international strategies may be necessary in order to compete in the present economic environment. In some industries/sectors, FDI may even be an imperative for maintaining the status quo. Explanations for cross-border acquisitions have focused on the increase in global competition, the desire for market share and market power, overcoming trade and certain investment restrictions etc. Depending on the time period and location of cross-border acquisitions, different theories were put forth to explain firm behaviour.
The focus of this note is on cross-border acquisitions during trade and investment liberalization\(^1\) — an environment of increased economic integration. It is suggested that there is a difference between the environment of multilateral/global trade liberalization and that of bilateral/regional trade liberalization. The distinction is that one may create the need to become global insiders, the other the need to become regional insiders. This note examines the response to bilateral/regional trade agreements by firms that are affected — due to the nature of their physical location — by such economic integration.

This note considers the response a firm makes to a new environment of bilateral or regional trade liberalization. A firm’s response to such a major economic policy change can range from doing nothing; increasing trade; entering an alliance; undertaking greenfield investment; or acquiring another firm. This note focuses on the last response — the acquisition of foreign assets.\(^2\) There is reason to speculate that such a response is likely; Milford B. Green (1990) finds evidence that government policy (including trade and investment regulation) plays a role in cross-border acquisitions. The specific question covered is why a cross-border acquisition is chosen in response to bilateral/regional trade liberalization. Regional economic integration results in increased competition. In the search for competitive advantage during trade liberalization, an international response, i.e. the restructuring of operations may be required. I suggest that a cross-border acquisition may be needed in order to internationalize operations; rationalize operations; maximize advantages; and minimize disadvantages. The major drivers behind a response to trade liberalization are market share/market power; linkages (intra-firm linkages and inter-firm linkages); technology/innovation; and cost/efficiency.

The premise is that acquisitions may afford opportunities not available via other entry modes. Certainly, industry rationalization is one scenario. Aside from buying up assets for efficiency and market power reasons, a firm may undertake an acquisition to gain control over downstream assets (e.g. marketing or advertising skills) or upstream assets (technology or innovation).

---

\(^1\) In practice, trade and investment liberalization are inseparable; the two have become conjoined in “real world” economic policies. Throughout this note, the term “trade liberalization” will commonly be used to refer to trade and investment liberalization.

\(^2\) In this note, “acquisition” will be used to signify the taking of a direct controlling interest of productive assets, be they a firm or a portion thereof.
In addition to opportunities, cross-border acquisitions may also be the only means available to meet constraints satisfactorily. Costs and risks may be minimized through entry into an existing array of connections; acquisitions provide such a foray into inter- and intra-firm linkages. For example, Ignatius Horstmann and James R. Markusen (1987) find that, for a firm contemplating international expansion, firm-specific assets dictate that full control is preferred to partial control. They (1996) also find that full control is superior to other entry modes in cases in which the market is large and the variability in profits is small. Both these conditions are likely to be met in the case of a region undergoing trade liberalization.

From multilateral/global trade liberalization to bilateral/regional trade liberalization

Major progress towards multilateral/global trade liberalization is considered to have started with the General Agreement on Tariffs and Trade (GATT). Signed in 1948, it helped to address the problems associated with trade protection that had plagued the world market for a number of years. This accord initiated proactive measures to keep world markets open. It was an effort to prevent or eliminate the kind of tariff and non-tariff trade barriers that were imposed with legislation such as the Smoot-Hawley Act. In the years that followed, the GATT rounds (e.g. Kennedy, Tokyo and Uruguay) have attempted to keep multilateral trade liberalization moving forward. Over the past 50 years, significant progress has been made to reduce trade restrictions on a worldwide basis (Scherer, 1994).

More recent trade liberalization initiatives have been less multilateral and more regionally driven or have been even bilateral in scope only. They indicate a pattern of economic integration that is largely centered on the three major economic regions of the world: Asia, Europe and North America. The European Union (EU) is the result of many nations joining together in an economic union that not only provides liberalization of trade and investment but also moves its constituents closer to monetary and political integration. The European Commission’s 2000 report indicates that EU markets are continuing to integrate and that acquisitions are strong catalysts for such change. North America’s evolutionary course towards trade liberalization has also expanded regional economic integration. This effort has resulted in specific sectoral trade pacts (e.g. the Canada-United States auto pact) as well as general agreements including the Canada-United
States Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA). Within the Asian region, there have been a number of initiatives aimed at trade liberalization on a regional basis, e.g. the Association of Southeast Asian Nations (ASEAN). Regional economic integration has also been evident in the non-capitalist (communist) countries, the Caribbean, Africa and Latin America (Gibb and Michalak, 1994; Scherer, 1994). Regional economic integration even emerges as an issue within countries, e.g. Canada (Ensigh, 1994a, 1994b).

The rise of such regionalism has resulted in a number of new issues. First, trade liberalization has increased the economic power of the three major regions, in essence the power of the Triad. Closer economic cooperation among nations on a regional basis has resulted in what are now referred to as continental trading blocs (Gibb, 1994; Michalak, 1994). A second and related issue is that trade liberalization has resulted in a new kind of protectionism (Rugman and Verbeke, 1991). The rise of regional trading blocs begs the question of whether markets are really open. The issue becomes one of who is included (protected). Some nations receive preferential treatment and become insiders while others lack such treatment and are excluded — become outsiders. The rise of regional trade liberalization therefore begs the question of how liberalizing these trade agreements really are. It remains controversial whether multilateral/global trade liberalization will fracture into discriminatory regional blocs, or regional trading arrangements will provide momentum for continued world trade liberalization (Frankel, Stein and Wei, 1996). According to Carlo Perroni and John Whalley (1996, p. 57) "history shows that cooperation is the handmaiden of subsequent conflict". Dani Rodrik (1998, pp. 4-5) notes that "international economic integration is politically contentious from the start. ... For reasons that are not fully understood, national borders continue to act as barriers to economic exchange even in the absence of formal restrictions". In this “stumbling blocks versus building blocks” debate, Jeffrey A. Frankel (1997) observes that preferential trade arrangements are indeed concentrating trade regionally and that enhancement rather than reduction of global welfare is dependent on a decrease in barriers between blocs. Frankel allows for the possibility that regionalization becomes “excessive”, whereby

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3 According to Baldwin (1993), the incentive for outsiders to join a trade agreement is positive and increases for each subsequent member. A “domino” scenario is portrayed for entry.

4 To some degree “liberalization” is a misnomer. Whether an arrangement results in greater trade and investment liberalization or continued restriction is a matter of perspective (Gibb, 1994).
detrimental effects of trade diversion outweigh the positive effects of trade creation. The ultimate compatibility between regional trade arrangements and global trade liberalization is not presently known for certain. Frankel calls for the taking of all possible measures to ensure that regional trade evolves in a manner consistent with global trade liberalization.

With the rise of trade blocs, a number of complaints have been voiced warning that these cooperative agreements are “competitive tacks” and “strategic posturings” to exclude firms of particular countries from certain markets. There is a certain amount of irony in this since complaints about trade restrictions often come from those countries that have entered some kind of regional trade agreement or that practice protectionist measures. Indeed, Jagdish Bhagwati and Arvind Panagariya (1996, p. 82) point out that trade agreements “as distinct from non-discriminatory trade liberalization, could harm both member country and world welfare” — that is trade blocs could be trade diverting rather than trade creating. The determination of welfare effects revolves around conditions of physical distance — and therefore transport costs — among members; and the initial level of trade that may itself be the result of artificial inducements. Welfare calculations also invariably involve estimating trade in the absence of trade agreements. In practice, determining alleged levels of trade (what trade would have occurred) in lieu of the present trade arrangements is a matter of pure — though perhaps well informed — speculation.

With countries choosing to enter regional agreements, the multilateral negotiations under GATT have slowed or stalled (Gibb, 1994). John H. Dunning (1995) notes that the growth in intra-regional economic activity in the Americas, Europe and Asia is greater than the growth in inter-regional economic activity. Although Dunning (1995, p. 126) is hopeful — “like ripples in a pond, regionalization may spread outward” — the stand-off between regional interests and global ones should not be entirely surprising: “the unilateral behavior of governments, which is geared to promote the good of their own citizens, may not maximize welfare globally because of the possible adverse affects, or negative externalities” (Dunning, 1995, p. 133). In the end, the movement towards bilateral/regional trade liberalization may

5 From the session on “Improving the design of regional trade agreements”, see the papers by Frankel, Stein and Wei; Perroni and Whalley; and Wonnacott. From the session on “Regionalism versus multilateralism”, see the papers by Bhagwati and Panagariya; Sampson; and Levy and Srinivasan in the American Economic Review, 1996 Papers and Proceedings.
force the decision to again move towards multilateral/global trade liberalization. Some in fact are already calling for a new vehicle if world trade liberalization is to continue.6 This impasse may be avoidable. Shang-Jin Wei and Jeffrey A. Frankel (1998) assert that, if trade blocs are to fit harmoniously with the aim of multilateral/ global trade liberalization, two criteria must be met: there must be trade liberalization \textit{vis-à-vis} non-members; and there must be no decrease in trade between members and non-members after formation of the bloc.

The relationship between trade liberalization and competition

A cycle exists in which trade liberalization and increased competition feed off each other. Competition — especially in an environment of TNCs — has had a significant impact on the development of trade liberalization. The converse also holds. Trade liberalization has had a direct impact on global and regional competition among firms. As economic integration and trade liberalization increased under the continuing efforts of GATT, firms in countries undergoing trade liberalization were faced with an increasingly competitive environment. The result was that some of the firms within these countries recognized that their proportional share of economic growth was being eroded by a rise in the economic growth of firms from other countries. That is, despite this being a positive sum game on the whole, for some firms the result was a loss or at least a reduction in growth.7 One way to counter this was through bilateral/regional trade agreements, i.e. protection in the form of free trade and investment within their own region (Gibb, 1994). At the nation-state level this same logic as held by fearful firms has been expressed. In 1982, in response to the situation in Europe, the United States made it apparent that it was “willing to dance” with interested parties; shortly thereafter the United States-Israel Trade Agreement and Caribbean Basin Initiative were formed.

Firms believing that their profitability was being eroded took action. Those that were already competitive (most able to capitalize on increased competition) pressured governments for

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6 Ironically GATT’s success — the opening of markets resulting in greater competition — may have led to its demise.

7 It is at this point that industry rationalization is often observed — some firms look for assets to acquire while other firms look for buyers. Paulson (2001, p. vii) finds that some firms “design their corporate strategy specifically to become attractive acquisition candidates”.

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lower trade barriers. For them, free trade could provide greater access to existing or new markets and improve their opportunities for growth. Firms that were less-competitive — or in certain industries/sectors — were often the ones in favour of retaining the status quo, i.e. the shelter from competition provided by trade barriers. Through iterations of this process, winners and losers begin to emerge. Those firms thriving under heightened competition generally favour greater trade liberalization. Those firms unable to adjust wish to shore up their positions or consider selling and search for buyers. When barriers do come down there may be a rush to act. Greenfield entry may be too slow to establish a market presence; alliance or acquisition might be preferred modes, each with their own unique distribution of strengths and weaknesses.

Even in a world with a “growing pie”, competition reveals a mixture of winners and losers at the firm, industry and country levels. In terms of trade liberalization efforts, the result of this fear — rational or otherwise — can be a standoff (with no further liberalization) or else movement to a new stage that may include bilateral/regional trade liberalization rather than multilateral/global trade liberalization. To a large extent, this is arguably what has happened with the emergence of three conspicuous trading blocs (Gibb, 1994; Michalak, 1994).

With the world moving towards regions of economic integration, competition will continue to increase within each trade bloc as well as among trade blocs. Firms competing across trade blocs (from one trade bloc to another) will find trade and investment barriers an interference — a hindrance to their ability to compete — but firms conducting business within a trading bloc will be sheltered, at least to some degree. With increased access to markets and the opportunity to generate and capitalize on competitive advantage, insider firms may be most able to achieve a competitive position within the regional bloc. That enviable insider status may not be attainable through greenfield entry or even alliance. Since competition increases within the bloc, firms face even greater challenges in the new environment of regional trade liberalization. Based on this discussion, it is possible to conclude that an increase in competition is directly related to economic integration (Humbert, 1993; Nunnenkamp, Gundlach and Agarwal, 1994).

Porter (1990) and others have suggested that it would be rational for a firm to welcome the opening of its markets to new competition as this allows the firm to develop its advantages; in essence, become more competitive.
Trade liberalization as a driving force for FDI

Bilateral/regional trade liberalization — resulting in an environment of greater economic integration — has a pronounced impact on FDI. In order to understand the relationship between trade liberalization and FDI, it is important to first recognize that international trade has undergone a transformation. Today, a large share of international trade is accounted for by intra-firm trade rather than market-based trade. Robert C. Feenstra (1998, p. 34) observes that “the disintegration of production itself leads to more trade, as intermediate inputs cross borders several times during the manufacturing process”. There is also a pattern of more intra-industry trade. Traditional (early) trade theory provided a justification for market-based trade by examining factor costs and market opportunities. While not universal, there is acceptance that “trade clearly arises for reasons of both comparative advantage and imperfect substitution” (Frankel, Stein and Wei, 1996, p. 54). To understand intra-firm and intra-industry trade will require different explanations or at a minimum, extensions to existing theory.

It is also important to understand that both trade and investment have increased dramatically in recent years. Growth in FDI has increased even more dramatically than the volume of trade or growth in GDP (Chesnais, 1993). For many years, economists saw trade and FDI as substitutes. Explanations for FDI were often based on the need to overcome trade restrictions. The argument was that FDI was undertaken to avoid tariffs and therefore replaced trade. In an environment of declining trade barriers or freer trade, FDI was expected to decline and be replaced by an increase in trade (Cox and Harris, 1986; Dunning, 1993). In light of bilateral/regional trade liberalization and changes in the nature of trade, this view is being revised. Data showing that FDI and trade have increased help to support the conclusion that trade and investment are complements, not substitutes. One does not necessarily replace or offset the other; they can be compatible.

In an era of TNCs, it is important to remember that FDI consists of reinvestment and new investment. Both are important and not always easily distinguished. A TNC increasing its established position may build or acquire assets in a manner similar to that of a new entrant. When examining FDI after trade liberalization, many take FDI decisions as if they were made tabula rasa when in fact significant unrecoverable costs may exist. Resources may have been extended that are intractable or imperfectly so. It may not be the case, therefore, that trade could
simply replace investment. First, the context is all-important. Second, few decisions a firm makes are isolated. Third, a single firm may increase both international trade and FDI. Moreover, although trade restrictions are reduced, tariff or non-tariff barriers may still be significant enough to warrant direct investment.

Finally, it is worthwhile to consider the significant role that innovation — improvement in technology — plays in these relationships. Technological advance has an influence on competition. In turn, technology has a bearing on trade and investment. Growth in international trade and the number of TNCs supports such a conclusion. Additionally, technology has had an impact on trade liberalization — both directly and indirectly. The prevalence of TNCs and intra-firm trade attests to the fact that decisions are often based on technological considerations. The opposite is true too. Trade liberalization has had an effect on advances in technology. In summary, such innovation may be the outcome of heightened competition due to trade liberalization, it may be an input in raising the level of competition, or perhaps it is both.

From this discussion, it is apparent that competition, trade, FDI, and technology have a major impact — both individually and collectively — on trade liberalization. Trade liberalization — based on major economic policy changes — creates a new and more competitive external environment. It leads to a change in environmental conditions such that the market is freer, more efficient, more competitive in the sense of economy. The result is that firms will have to become more competitive; they will have to respond and make adjustments to economic integration. The next two sections suggest why cross-border acquisitions may be the appropriate response to trade liberalization.

Firm response to bilateral/regional trade liberalization: a search for competitive advantage through cross-border acquisitions

A firm faces a number of strategic and organizational challenges during bilateral/regional trade liberalization. Under the heightened competition of trade liberalization, a firm must search for ways to increase as well as capitalize on advantages. Either to capitalize on or add to these advantages, it may be necessary for the firm to make direct investments internationally. In many cases, this will require the firm undertake a cross-border acquisition. A Business International (1971, p. 5) report indicates
that “firms are turning to the acquisition route as the surest, fastest, and cheapest way of increasing their foreign markets.” This same report indicates that, in addition to certainty, speed and cost, cross-border acquisitions are advantageous to the firm “seeking to expand its human and technological resources ... [and] may offer a well-developed distribution network” (Business International, 1971, p. 7). Such findings persist: “Cisco Systems realize that developing technology using internal resources may not be the least expensive or least risky course when compared to acquiring” (Paulson, 2001, p. vii).

Bilateral/regional trade liberalization also leads to greater market opportunities. Firms will need to respond to an expanded market. With freer entry — for trade and investment — the “local market” is no longer several markets but one regional market. A firm’s way of viewing the market will have to change. To respond to opportunities created during bilateral/regional trade liberalization, a firm may need to increase trade and investment within the region. The optimum way for some firms may be through cross-border acquisitions.9

In the search for competitive advantage during bilateral/regional trade liberalization, a firm must respond to increased competition and greater market opportunities. Factors influencing this response are summarized in figure 1. The diagram suggests that a firm may need to internationalize (with an eye towards competitors and the new market) and rationalize operations (with an eye towards increasing productivity and lowering costs). In essence, the decision to internationalize is a demand-side reaction while the decision to rationalize is a supply-side response. Both of these are opportunities for a firm to exploit or gain competitive advantage. Decision making in either internationalization or rationalization of operations should incorporate considerations of the internal and external environment. Orthogonal to these, a firm’s response must be to maximize advantages and minimize disadvantages. A cross-border acquisition can help a firm maximize advantages — both firm specific advantages (its own and those of a target) and location-specific advantages (in the home country as well as host country). A cross-border acquisition can also be used to minimize pre-acquisition disadvantages — both those it faces within the firm as well as those in the home

9 Although significant, determining whether an acquisition is needed primarily for proactive or defensive purposes will not be examined in this note. Neither will divestitures — the selling of controlled assets — be examined.
country. With the same caveat as applied to the vertical axes, decision making along the horizontal axes involves a consideration of both the internal and external environment.

**Figure 1. Firm response to trade liberalization: a search for competitive advantage**

![Diagram showing firm response to trade liberalization](image)

### Internationalize operations

The challenges of competition and an expanded market can create the need for a cross-border acquisition. With this new level of economic integration, firms will have a keen awareness of the importance of the prevailing opportunities (Crookell, 1990). With a bilateral/regional trade agreement, firms have a larger market. Essentially, the result is an opening of markets abroad but there may also be an impact on markets at home. Home markets must be reexamined in light of increased competition. Adjustments are going to come during a search for ways to expand market scale and scope within the region. This search may take the form of increasing a firm’s share of an existing market, finding new markets to serve, or both. In many industries/sectors, responding to market opportunity abroad will become a priority.

Such opportunities — the result of a major economic policy change, in this case trade liberalization — may pull a firm into FDI. There may be market and policy factors that make other countries in the preferential trade area attractive. These may include:
the relatively greater size and diversity of the ... market; ... political risk perceived to be lower ... ; greater productivity and cheaper factor costs ... ; investment incentives (often given by ... governments ... ); and the opportunity to customize products and identify niches for successful marketing (Rugman, 1987, p. 11).

There may also be factors in the home country that push a firm to make a direct investment in a host country. These specific factors come from markets and policies in the home country. As Rugman (1987, p. 11) states:

They encourage firms to make direct investments abroad in order to maintain or enhance a competitive position. They may include: differential costs for factors such as labor and capital; tax and related policies affecting the investment climate; economic regulations and other government-related cost factors; and the increasing ability of the maturing ... managerial and economic system to support outward investment.

These factors do not operate in isolation but pull factors are primarily market-driven while push factors are often secondary factors.

With the opening of a larger market, a firm becomes an insider. The “foreign” market is now part of the “home” market. In order to serve that market, the firm may need to become a “local” player. Becoming a local participant through acquisition can provide benefits that could not otherwise be achieved. In some cases, serving this new market may not be profitable or even feasible through trade; this shifts the decision to a consideration of entry mode. Issues of proximity take on greater significance in an environment of trade liberalization (Crookell, 1990).

**Rationalize operations**

An increase in competition and the expansion of markets — including “guaranteed access” to new markets — also means reassessing operations, primarily but not exclusively production. Depending upon the specific firm and industry, this will result in a readjustment — either a contraction or expansion — of facilities.
There is a consensus in the literature that bilateral/regional trade liberalization will generally result in the need to rationalize production (Bishop and Crookell, 1986; Burgenmeier and Muchhielli, 1991; McFetridge, 1986; Panic, 1991). Rationalization implies that, with increased competition and greater market efficiency, a firm will need to reassess its organization of production and recalculate its factor costs. For some firms, this may require changes such as the closing of operations. For others this may require adding or expanding an international operation to take advantage of economic integration resulting from trade liberalization (Gibb, 1994). Again, depending on issues of speed, timing and available options, acquisitions may be the only or preferred course of action. While an alliance may even be quicker and meet other criteria, there may be overriding concerns (e.g. protection or procurement of proprietary assets) that preclude this option. In an environment of bilateral/regional trade liberalization, rationalizing operations means that changes occur on an international basis.

Paul M. Bishop and Harold Crookell (1986, p. 313) state that “rationalization is a strategy open only to multinationals. There must be both a parent and a subsidiary”. If TNCs lower their costs through rationalization, national firms may face a loss of market share if they do not respond. A national firm may have to respond by making a cross-border direct investment and it will have to do so quickly, precluding the use of a greenfield investment. In addition, as Bishop and Crookell (1986, p. 313) point out, “rationalization ... requires the administrative arrangements of a single large firm”. Such an administrative requirement (hierarchy) eliminates the choice of an alliance.

With rationalization, productivity considerations become of paramount importance (McFetridge, 1986). A firm will rationalize to gain economies. Serving a larger market makes it possible to have longer production runs and greater efficiency. Product lines are narrowed in some facilities (from multi-product to single product), at others they are widened. Specialization may occur at some facilities as redundancies are made apparent and efficiencies realized. In the rationalization process, the assignment of operations is based on the optimum use of resources (transferable and non-transferable) and the optimum allocation of factors (mobile and immobile) (Panic, 1991).

In the end, rationalization may result in significant changes in an industry internationally. These changes, however, can bring new opportunities and challenges for firms in that industry. As Michael E. Porter (1990, p. 48) states, “every significant structural
change in an industry creates opportunities for new early movers”. From a strategic standpoint, rationalization will require an assessment of product and market segments. In such an environment, a cross-border acquisition may need to be undertaken.

Maximize advantages

The search for competitive advantage takes on heightened significance in an environment of trade liberalization. Greater competition and market opportunities mean that a firm will increasingly need to focus on firm-specific advantages — both its own and those of a “target”. Research and theory suggest that these advantages — resources and capabilities — are an important source of competitive advantage (Collis, 1991; Mahoney and Pandian, 1992; Peteraf, 1993; Wernerfelt, 1984). Rajneesh Narula (1996) suggests that many of these assets have mobility. He also indicates that, in today’s environment, “created assets” (those that depend on learning) are often the ones that generate the most value for a firm. The firm will also need to maximize advantages that are location-specific — both those of the base country and those of a host country. The immobility of these assets suggests that a cross-border acquisition may be the requisite choice (Narula, 1996). Exploitation (capitalizing on existing advantage) and exploration (increasing or building new advantage) represent distinct motives. Either or both may indicate acquisition as the requisite mode of entry.

A cross-border acquisition may be necessary due to the nature of resources and capabilities. In many cases, these assets are intangible; in many cases they are inimitable. As Jay B. Barney (1988) proposes, value is created for the acquirer when unique inimitable synergies exist between the acquirer and target. Based on the nature of these assets, the best way or perhaps the only way to obtain them is with an acquisition. The immobility of certain assets across borders and the mobility of still other assets only though the internal structure (hierarchy) of a TNC may explain the uniqueness of value creation in international acquisitions.

Dunning (1993) indicates that advantages may be gained through firm-specific resources and capabilities associated with organization, location and internalization. A cross-border acquisition may be desirable because many of a firm’s own competences and abilities can effectively be spread internationally with minimal additional cost. There are also many advantages...
that are generated simply because of a firm’s international activity. A cross-border acquisition permits the advantages due to internationalization of firm resources to be spread out over a region.

If a firm chooses to respond to new market opportunities resulting from trade liberalization, the best way to serve the market may be to acquire locally resident assets. Advantages may be gained by acquiring resources in distribution or sales that a target has built up in its own market. In an environment of heightened competition, it may be necessary to gain a local presence in a market already being served.

**Minimize disadvantages**

The counterpart to maximizing advantages is limiting the impact of disadvantages. In the decision-making process, such considerations not only involve assessing one’s own firm-specific and location-specific disadvantages but should include an assessment of the external environment as well. In the search for competitive advantage during trade liberalization, a firm must undertake a thorough assessment since there may be some way to minimize weaknesses with a cross-border acquisition.

The key to regulating possible harm from disadvantages is identification of current and prospective problems. Consequences due to a lack of experience or knowledge can be reduced through foresight and planning; learning will occur and information can be gathered by operating internationally. In many ways, greenfield entry involves starting from nothing whereas this need not be the case through acquisitions. Issues of control may also give rise to acquisitions, that is, if maintaining control is crucial then acquisitions may be the single feasible solution. The need for product/market diversification, as well as the need to overcome cultural or physical distance, may point to a cross-border acquisition.

**Drivers of cross-border acquisitions during bilateral/regional trade liberalization**

The drivers identified in this study are reasons why cross-border acquisitions are necessary in an environment of bilateral/regional trade liberalization. They explain why such acquisitions are a superior mode of FDI. They delineate the attributes that enable firms to capitalize on existing or capture new competitive
advantage through cross-border acquisitions. These drivers are shown in figure 2. As with the previous diagram, they are discussed separately for purposes of illumination. Although it is correct to draw the conclusion that there is merit in giving attention to these as individual considerations, ending there without a collective consideration of the four drivers would not be prudent. The firm may generate its greatest strength not in identifying these as distinct drivers but in making connections between them. That is, the individual drivers provide advantage but it is in combination that they may give the firm its optimal competitive advantage.

Figure 2. Drivers of cross-border acquisitions during trade liberalization

Market share/market power

An environment of economic integration — with the accompanying increase in competition and expansion of markets — will put pressure on firms to examine their strategic position relative to rivals. This means that a firm's response may include adjustments to improve that position. Growth and expansion strategies will probably include some way to capture more of the market at home and abroad. At a minimum, reinforcing market position will be desirable.
Market share and market power considerations can be a powerful driver during bilateral/regional trade liberalization. Depending upon what factors characterize a firm’s industry, cross-border acquisitions can be the means of increasing market share and improving market power. There are a number of significant factors that influence the need for adjustment through cross-border acquisitions. First, there may be a significant amount of rivalry among firms. This will result in competition for market share (Chesnais, 1993). Second, a firm may be faced with a saturated or tight market. There may be no way to increase position without an acquisition. If a firm is entering such a market for the first time, there may be little choice from among the direct investment options. If there is no room for additional competitors (i.e. greenfield investment) and partnering is not suitable, the firm will have to acquire assets already serving that market. Third, a concentrated market structure in a firm’s home country may dictate a cross-border acquisition as the only viable option (see, Barton and Sherman, 1984). Fourth, if there is excess capacity, a firm may need to buy a competitor’s market share to consolidate the market/industry. Consolidation, the buying up of excess capacity, may result in changing the industry context generating oligopolistic conditions. There may also be other factors such as entry barriers that can best be overcome through an acquisition (Chesnais, 1993). In general, cross-border acquisitions for market reasons — to compete via market share and market power — will be acquisitions that are either horizontal or vertical; and, if vertical, then usually downstream assets.10

In addition to gaining market share abroad, cross-border acquisitions may be undertaken to improve a firm’s position in the home market. Such an acquisition may help a firm gain new insight for revitalizing products that are failing at home. Buying ideas, technology etc. to obtain unique assets or resources such as brands or distribution channels may help a firm maintain or increase its market share and market power at home. Sometimes these benefits are indirect but ultimately they may help a firm in its search for competitive advantage. As Porter (1990) suggests, just being in an environment of rivalry can enhance a firm’s performance.

In an environment of heightened competition during trade liberalization, acquisitions may be a primary means of realizing a growth or expansion strategy. Industry and market conditions,

10 See Delios (1998) for a discussion of the importance of accessing downstream assets when entering new markets.
however, will dictate the influence that this driver — market share and market power — has on a firm’s response. Issues of timing and speed will also influence the choice of mode. In some cases, cross-border acquisitions may be the only route to quickly seize opportunities that arise in the host market.

Intra-firm linkages and inter-firm linkages

Another very powerful driver of cross-border acquisitions during bilateral/regional trade liberalization is linkages. This includes two kinds of linkages: intra-firm linkages and inter-firm linkages. In an environment of bilateral/regional trade liberalization, the need for both types of linkages is clearly evident. The need to respond to increased competition and a larger market suggest why the benefits of linkages are a driver of cross-border acquisitions. In contemplating cross-border acquisitions, the calculus of build vs. buy includes issues of speed, availability of linkages, price, and probability of returns.

Intra-firm linkages. Transnational network linkages describe the way a firm’s operations are organized. Although a TNC has separate affiliates located in different geographical locations, it can achieve benefits from the management of these units as a coordinated transnational network (Ensign, 1999). The benefits from such an organizational network — an internal network — have been supported by both theory and research. The work of Christopher A. Bartlett and Sumanta Ghoshal (1989), Bruce Kogut (1983) and others has provided strong support for the advantages of having transnational operations. Kogut (1983) describes the sequential advantages of these “options” that are unique to the TNC. Benefits are gained when a firm exercises such “options”. Numerous other studies related to internalization theory, intra-firm trade, retaining proprietary knowledge etc. support the argument that intra-firm linkages are a powerful driver of cross-border acquisitions.11

Inter-firm linkages. Understanding network theory can help to understand the need for inter-firm linkages during trade liberalization. Network theory stresses the importance of bridging strategies and forging connections and resource exchange with other firms in the task environment. It suggests an industrial network of “suppliers, producers, innovators, users, and others,

involved in developing, producing, and marketing a special product” (Forsgren, 1989, p. 145).

Cross-border acquisitions can be used to internalize linkages that build on already existing relationships or can be used to establish new relationships. As Peter McKiernan (1992, p. 106) states, “the strength of the individual organization depends, not on specific advantages as in the market-imperfection theories but on links, with customers, suppliers, distributors, competitors and so on”. For example: “Productive and marketing capacities of organizations are adjusted to match those of others in the network by an investment in physical and human assets which reinforces the bonding of the industrial network” (McKiernan, 1992, p. 106).

Technology/innovation

Technology has a powerful influence on today’s economic environment. Technology has a major impact on competition. Firms compete on the basis of technological progress. Technology also influences trade and investment (Clement et al., 1999). According to Robert Stobaugh and Louis T. Wells (1984, p. 12): “Just as extent of competition influences the choice of technology, it also affects the choice of the channel through which technology is transferred”. Growth in TNCs and trade is related to technological advances in communication and information gathering processes. Technology even exerts force on trade liberalization. To combat increasing competition — such as that owing to economic integration — firms focus on acquisition of technology in an effort to maintain or enhance their competitive position. In an environment that is changing rapidly, firms can be expected to undertake cross-border acquisitions to acquire technology, exploit the advantages of having superior technology, or both.

To maintain or gain competitive advantage requires constant attention to technological changes and innovation. In some cases, firms may not have a technological advantage or may not have the right one. It may not be possible to generate the necessary technological improvements within the firm. In this case, the firm will need to obtain these assets or capabilities outside the firm (exploration). Technology — like a commodity — may be purchased. But unlike a commodity, technology may not be

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12 It has been suggested that rising technology would create a climate of greater economic integration even without the major changes in economic policy that result in trade liberalization.
suitably purchased as an end product, an output, a one-off transaction. A co-mingling with or internalization of the technology producing assets becomes necessary. Again, if an alliance is inferior or not viable then acquisition becomes the sole means for a firm to obtain access to innovative activity. If a firm is unable to acquire the necessary technology at home, it will need to look internationally. Even firms that compete exclusively in a domestic market may be forced to look beyond their own borders.

At times, technology can only be obtained through an acquisition. This may come as a direct purchase (e.g. patents, research scientists, specialists in engineering or software) or through buying into a network (e.g. acquiring a firm for trade knowledge, cross-licensing, proximity to suppliers and buyers). Acquisition of technology can also result from location, spillover, and agglomeration effects (Dunning, 1995; Porter, 1990). Simply being near the action — being a local player — may provide positive benefits and an increased awareness of competitors and their behaviours. Although there is no shortcut to involvement, a shortcut to gaining expertise may be through acquisition. In contrast, a firm may already have a technological advantage it wishes to utilize further. It may favour a cross-border acquisition to protect its technology, choosing to conduct trade within the firm rather than through the market. In either case, acquiring or transferring technology is an extremely powerful driver of cross-border acquisitions during economic integration.¹³

Cost/efficiency

In an environment of regional economic integration, a firm will face increased pressure to be competitive. To do so will require attention to cost and improving efficiency. How a firm uses its resources will take on increased significance. Cost and efficiency can be powerful drivers of cross-border acquisitions during trade liberalization.

¹³ An insight provided by one of the referees is that technology/innovation seeking may follow from market share/market power seeking or cost/efficiency seeking. The degree to which the motives build off one another (or are independent or sequential) may be resolved empirically. Inkpen, Sundaram and Rockwood (2000, p. 50) provide evidence that some firms undertake acquisitions primarily for reasons of technology access — technology acquisitions in the United States accounted for over 20 per cent by number, 40 per cent by value, and during the 1990s non-United States firms made $250 billion worth of technology acquisitions in the United States.
Firms seeking cost and efficiency benefits may be able to rationalize the structure of established resource-based or market-based investments. In order to benefit, however, a firm will need geographically dispersed activities that are under its control — that is, transnational operations (Bishop and Crookell, 1986). For a domestic firm, this will require a cross-border acquisition. The benefits are essentially those of economies of scale and scope and risk diversification. These benefits are derived from cross-border product or process specialization, learning experiences that result from producing in a different location, and the options of arbitraging cost and price differentials across borders (markets) (McFetridge, 1986). As Dunning (1992, p. 59) states: “In order for ... rationalized foreign production to take place, cross-border markets must be both well developed and open. This is why it flourishes in regionally integrated markets”.

Firms may obtain cost and efficiency benefits by selectively picking locations based on factor endowments, institutional arrangements, financial systems and policies, and market structures that are country-specific (Dunning, 1993). Firms can arrange operations in a way that provides the best use of resources. To take advantage of differences in factors, a firm generally has two options. First, it may make a cross-border acquisition to take advantage of differences in the availability and cost of traditional factor endowments in different countries. As Ali M. Fatemi and Eugene P. Furtado (1987) note, factor markets and therefore costs are segmented internationally. In general, production that depends on capital, technology and information intensive value-added activities will be located in developed countries. Production that depends on cheaper labour and natural resource intensive activities, for example, may be located in developing countries (McFetridge, 1986). Second, a firm may make a cross-border acquisition in a country to take advantage of similarities in economic structure and income levels. In this case, an acquisition is utilized to take advantage of economies of scale and scope, supply capabilities, or perhaps differences in consumer tastes and supply capabilities. Crookell (1990) finds that cross-border acquisitions are ideally suited to take advantage of “created” competences and capabilities, the availability and quality of supporting industries, the characteristics of the local competition, the nature of consumer demand, and the macro and micro-policies of governments.

Efficiency may also be gained when a firm that makes a cross-border acquisition is able to use excess resources in multiple markets — i.e. home and host markets. Although Edith T. Penrose
(1995) observed that some resources are indivisible, value may be created because some resources can be transferred or used in another setting (exploitation). The recent emphasis on resources and capabilities helps to understand the importance of cost and efficiency as drivers of cross-border acquisition.

Conclusions, implications and suggestions for further study

This note is based on the premise that there is a relationship between corporate integration — the international integration of firm activities resulting from cross-border acquisitions — and economic integration of countries within a region. However, as John H. Dunning and Peter Robson (1988, p. 1) state, "so far there have been few attempts to analyze the interaction between the two kinds of integration ... or ... collect empirical data bearing specifically on this issue". Very little attention has been focused on the behaviour of the firm in response to regional integration. This study has been a step toward understanding this relationship. Green (1990, p. 3) indicates that acquisition activity represents a "substantial transfer of assets and economic power across geographic areas and industries". He admonishes that cross-border acquisitions do not represent an aspatial occurrence; as such, structural attributes (e.g. elements of physical location) and implications (e.g. adjustments in organization) should be considered. Future research must pick up where others have left off. Country of origin predicts entry mode; United States firms favour acquisitions whereas Japanese firms favour joint ventures, and both countries avoid greenfield (Delios and Ensign, 2000; Mansumitrchai, Minor and Prasad, 1999). Such future study might also consider the motive of the administrator charged with the acquisition decision (Seth, Song and Pettit, 2000).

This study discussed why cross-border acquisitions may be required in response to bilateral/regional trade liberalization. It was suggested that there are specific reasons or drivers that make such an adjustment — international restructuring or integration of a TNC’s operations — essential in an environment of regional economic integration. What is different in this new environment is that cross-border acquisitions can be used for regional competitive advantage. A firm’s response may help it become more competitive within its own trading bloc. This regional advantage can be used to disadvantage outsiders and other insiders. Regional integration will also result in a different type of FDI, new trading patterns and an altered form of trade (managed trade) (Michalak, 1994). Finally, and perhaps most
importantly, firms will have a greater awareness of regional opportunities and threats that require a proactive response. Firms can no longer view their activities as independent and confined to a single nation. As a result of regional integration, their operations will be regional at the least, perhaps global. In terms of Canadian firms response to NAFTA, Alan Nymark and Emmy Verdun (1994, p. 139) report evidence of this logic for cross-border acquisitions: “market penetration and market access, geographic expansion and diversification, and economies of scale were mentioned by the respondent firms as the major reasons”.

As a follow up to this note, research is needed to examine firm behaviour during bilateral/regional trade liberalization. In addition to the response by firms within a region, such investigation might also consider the behaviour of firms from outside a region of trade liberalization. An empirical study could be conducted to test whether the four drivers identified in this study are valid. It would help determine if firms that make cross-border acquisitions during regional integration are motivated by: market share and market power; linkages — both intra-firm and inter-firm; technology/innovation; and cost/efficiency. As proposed in this note, these are the four specific drivers that push a firm to respond with a cross-border acquisition during bilateral/regional trade liberalization. Such an empirical investigation could provide an understanding of how firms respond to a changing external environment.

References


Changing receptivity towards TNCs in the Republic of Korea: survey results and policy implications

Bang Nam Jeon* and Se Young Ahn**

During the past several years, an improved investment environment and active foreign direct investment liberalization measures have enabled the Republic of Korea to attract sharply increased flows of foreign direct investment. Receptivity towards foreign capital has also benefited greatly from significant and positive changes in attitudes towards foreign direct investment among local people. This note reports the results of a survey on recent changes in attitudes towards transnational corporations held by government officials and business leaders in the Republic of Korea and investigates the major determinants of changes in their assessment of transnational corporations, using econometric tools. It then discusses policy implications of these findings for host-country foreign direct investment policy makers and for the international business community.

Introduction

During the past several years, an improved investment environment and active foreign direct investment (FDI) liberalization measures in the Republic of Korea have enabled the country to obtain sharply increased FDI inflows. These have grown at such a rapid pace, especially since the 1997 financial crisis, that transnational corporations (TNCs) play an increasingly...
important role in the domestic economy. When the Republic of Korea joined the Organisation for Economic Co-operation and Development (OECD) in 1996, restrictions on business and FDI were further liberalized. Since then, the manufacturing sector has been almost completely opened to foreign investors. Friendly mergers and acquisitions (M&As) have been allowed since January 1997.

According to the Ministry of Commerce, Industry and Energy, FDI inflows increased from $3.2 billion in 1996 to $7.0 billion in 1997. In 1998, inflows reached $8.9 billion, despite the financial crisis. In 1999, inward FDI totaled $15.5 billion, a 75 per cent increase over the previous year (table 1).

Foreign affiliates are deeply involved in the domestic economy, with FDI flows accounting for almost 4 per cent of gross domestic product (GDP) and FDI stocks accounting for more than 8 per cent. According to the Ministry of Commerce, Industry and Energy, the number of companies in which foreign ownership exceeded 10 per cent came to just 3,877 in 1996, but rose to 9,423 at the end of 2000. Moreover, combined FDI for 1998 and 1999 was $24.4 billion, almost equivalent to the $24.6 billion worth of FDI in the 35 years from 1962 until 1997. FDI was reported to have hit an all-time high of $15.7 billion in 2000 (figure 1). That figure marks the twelfth highest level in the world and the second highest in Asia after China, a substantial enhancement from its previous position outside the top 40 countries.¹

Several factors have contributed to the recent remarkable growth of FDI inflows into the Republic of Korea. First, the Government of the Republic of Korea, which recognized the importance of FDI and the presence of foreign firms as an effective vehicle of technology transfer and its complementary relationship with export activities, took the initiative in creating and maintaining a favourable environment for attracting FDI. Among others, the Government introduced the Foreign Investment Promotion Act in November 1998 to attract FDI and regain the confidence of foreign investors. The Act allowed overseas companies to take over domestic firms via M&As, making foreign firms more visible in the Republic of Korea.² In 1998, the Korea

¹ Donga Daily and Chosun Ilbo, 7 February 2001; UNCTAD’s World Investment Report (various years).
² For a review of the history of foreign capital inflows into the Republic of Korea and the evolution of government policy on inducing foreign capital, see Jeon (2001). For the theoretical rationales and roles of FDI on economic development in the Republic of Korea, see Ahn (1986).
Table 1. FDI flows into the Republic of Korea (notification basis), 1990-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Amount (Millions of dollars)</th>
<th>Total Number of cases</th>
<th>FDI/GDP</th>
<th>Manufacturing Amount (Millions of dollars)</th>
<th>Share (Per cent)</th>
<th>Services Amount (Millions of dollars)</th>
<th>Share (Per cent)</th>
<th>Divestment Amount (Millions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>803</td>
<td>482</td>
<td>1.67</td>
<td>583</td>
<td>72.6</td>
<td>220</td>
<td>27.4</td>
<td>..</td>
</tr>
<tr>
<td>1991</td>
<td>1 396</td>
<td>509</td>
<td>2.74</td>
<td>1 069</td>
<td>76.6</td>
<td>327</td>
<td>23.4</td>
<td>47.3</td>
</tr>
<tr>
<td>1992</td>
<td>895</td>
<td>444</td>
<td>2.02</td>
<td>648</td>
<td>72.4</td>
<td>247</td>
<td>27.6</td>
<td>240.2</td>
</tr>
<tr>
<td>1993</td>
<td>1 044</td>
<td>458</td>
<td>2.28</td>
<td>527</td>
<td>50.5</td>
<td>517</td>
<td>49.5</td>
<td>193.1</td>
</tr>
<tr>
<td>1994</td>
<td>1 317</td>
<td>646</td>
<td>2.04</td>
<td>402</td>
<td>30.5</td>
<td>915</td>
<td>69.5</td>
<td>205.0</td>
</tr>
<tr>
<td>1995</td>
<td>1 941</td>
<td>872</td>
<td>2.23</td>
<td>884</td>
<td>45.5</td>
<td>1 057</td>
<td>54.5</td>
<td>114.2</td>
</tr>
<tr>
<td>1996</td>
<td>3 203</td>
<td>968</td>
<td>3.31</td>
<td>1 930</td>
<td>60.3</td>
<td>1 273</td>
<td>39.7</td>
<td>308.5</td>
</tr>
<tr>
<td>1997</td>
<td>6 971</td>
<td>1 055</td>
<td>6.61</td>
<td>2 348</td>
<td>33.7</td>
<td>4 623</td>
<td>66.3</td>
<td>449.9</td>
</tr>
<tr>
<td>1998</td>
<td>8 852</td>
<td>1 398</td>
<td>6.33</td>
<td>5 735</td>
<td>64.8</td>
<td>3 117</td>
<td>35.2</td>
<td>250.3</td>
</tr>
<tr>
<td>1999</td>
<td>15 500</td>
<td>..</td>
<td>..</td>
<td>9 238</td>
<td>59.6</td>
<td>6 262</td>
<td>39.7</td>
<td>193.8$^a$</td>
</tr>
<tr>
<td>2000</td>
<td>15 700</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Total</td>
<td>64 691</td>
<td>11 686</td>
<td>2.87</td>
<td>27 931</td>
<td>57.0</td>
<td>21 060</td>
<td>43.0</td>
<td>2 002.3</td>
</tr>
</tbody>
</table>

Sources: Republic of Korea, Ministry of Commerce, Industry and Energy; Republic of Korea, Ministry of Finance and Economy.

$^a$ Up to June 1999.
Investment Service Center (KISC) was set up under the Korea Trade-Investment Promotion Agency (KOTRA) to provide one-stop services for foreign investors. The Government has recently reaffirmed its commitment to improve the business climate for foreign investors.3

Second, receptivity towards foreign capital has increased greatly through significant changes in attitudes towards TNCs among the local people. Government leaders, the business community and the public have had a fundamental change in attitude with respect to the conduct of business by both domestic and foreign companies and the acceptability of foreign participation in the domestic market (Jones, 1999, p. 52).

However, there have been various contradictory observations about these attitude changes. It has been reported that many foreign investors in the Republic of Korea complained that the nationalistic perspective of the people has changed little. A lack of cooperation and support from the Government was cited as a reason for United States companies deciding against investing in the Republic of Korea.4 Foreign investors were also concerned

4 For example, The Wall Street Journal (“Foreigners worry Korea remains cold to outsiders”, 17 February 1998, p. A19) reported that Dow Corning Corp. (United States) decided against investing billions of dollars to build a plant in the South-western part of the Republic of Korea for this reason.
about a hostile public view towards their products. The Republic of Korea seems to be in a transition period moving away from its old habits of blocking FDI to recent attempts of enticing such investments. The domestic market has become more favourable to FDI due to sweeping reforms introduced since the International Monetary Fund (IMF) stepped in to bail the country out of the currency crisis in November 1997. Attracting foreign investment is now a policy priority, especially in the form of FDI, M&As and investments accompanied by technology transfer.

The recent changes in attitudes towards TNCs in the Republic of Korea, which have been dramatic, but have been perceived differently by different groups of people, provide a unique opportunity of looking into the major determinants of perceptions of foreign firms and the main factors for changing these perceptions in one of the most dynamic newly industrializing economies (NIEs). Since the seminal work on national attitudes towards TNCs done by John Fayerweather (1982), little research has been done in this area, especially in identifying the major personal attribute determinants of attitudes towards foreign affiliates from the perspective of developing countries.

This note reports the survey results of the recently changing attitudes of government and business leaders in the Republic of Korea towards TNCs and investigates the major individual attribute determinants of these attitude changes. Using the ordinary least square (OLS) model and the probit model, the major determinants of perceptions on foreign affiliates by two main leader groups are investigated, using recent survey data. Policy implications on the enhancement of the receptivity towards TNCs and host country policies of FDI in the Republic of Korea are also discussed.

**FDI inducement policies in the Republic of Korea**

Foreign capital has been welcomed in the Republic of Korea since the early 1960s for its significant contributions to investment, exports, growth and technology transfer. Various forms and types of foreign capital have enabled the country to grow by an estimated 7-10 per cent (real GDP) annually. The rapid growth of the economy would not have been possible if the country had to fund investment out of domestic savings alone. High domestic savings, between 30 and 40 per cent of national income, and large foreign capital inflows, as large as one third of
the total investment in the Republic of Korea, contributed significantly to faster economic growth during the last four decades. In recognition of the essential role of foreign capital in its economic development, the Republic of Korea made efforts to improve the environment for TNCs and open the door for foreign investors.

In the early 1960s, the Government introduced a series of basic laws and regulations on foreign borrowing and set up the “Basic Principles for Foreign Capital Inducement”. The Government announced that it aimed at securing an adequate amount of foreign capital by permitting foreign investment inflows, regardless of amount or type, as long as the purpose of the investment was appropriate and in good faith. The Foreign Capital Inducement Promotion Act was introduced in 1960 to attract foreign capital by providing tax and tariff benefits for foreign investors, eliminating discriminatory measures aimed at foreign investors and guaranteeing investors’ remittances of their principal and earnings. Since the late 1960s, furthermore, the Government has encouraged FDI actively. To this end, the Masan Free Trade Zone was established in 1970, which was intended to reduce the administrative barriers and extend tax incentives to FDI. After the early 1970s, a special law was also introduced to prevent labour union activities in foreign affiliates. United States sources provided most of the public and commercial loans and FDI, while Japan provided technology transfer to the Republic of Korea during the early 1970s. Between 1973 and 1978, the total amount of FDI inflows to the Republic of Korea rose to more than $700 million, an amount three times higher than the inflow of $227 million during the period 1966-1972.

During the 1970s, the Government faced new problems in foreign capital inducement. First, overlapping investments were done in heavy and chemical industries. Second, there was a rapid increase in short-term, high interest rate commercial loans to finance huge current account deficits caused by oil crises and the worldwide recession. To deal with these problems, as well as with the drastic increase in foreign borrowing in the aftermath of the second oil shock of 1979-1982, the Government restructured laws and regulations on foreign borrowing. In 1983, for example, the Public Loan Inducement and Supervision Law and the Foreign Capital Supervision Law were integrated into the new Foreign Capital Inducement Law. Most importantly, under the new law, a significant change in the FDI policy of the Government took place. A negative list system for FDI approval was introduced in
1983, replacing the positive list system. Under that system, any industry not specified in the list became open and unrestricted to foreign investment. This measure allowed virtually all of the manufacturing sector to become open to FDI; there were only a few exceptions, such as public utilities.

Multilateral negotiations on the General Agreement on Tariffs and Trade and the policy of introducing greater competition into the domestic market allowed foreign investors to invest more freely in the services sector, including in financial services. In 1992, the Government amended the Foreign Capital Inducement Law, which allowed foreign investment to be approved automatically by simply filing an investment report. The FDI liberalization policy and the Republic of Korea’s improved investment environment led to increased FDI inflows by more than five times, to $5.6 billion during the period 1986-1992, compared with $1.1 billion during 1975-1985. The major industries that benefited from the huge influx of FDI included electric and electronics, transportation equipment, chemicals, finance and insurance. Restrictions on business categories open to FDI were further liberalized when the Republic of Korea joined the OECD in 1996.

The currency and financial crisis that began in late 1997 weakened the favourable environment for foreign investment in the Republic of Korea. With a strong commitment to improving the business environment for foreign investors, the Government established, in 1999, a national committee on FDI to review FDI policies and systems on a continuous basis. For example, conflicts between the central Government and local authorities were to be resolved in this committee. As a result of the crisis, the domestic economy has been undergoing significant structural adjustments in the financial and industrial sectors. The receptivity of foreign capital in the Republic of Korea has been enhanced significantly through continuous and steady efforts made by the Government. The country still has many obstacles to overcome in attracting FDI. These include a high cost and low efficiency economic structure, an uncompetitive banking and financial industry and a lack of transparency in policy-making and information. High wages, high rents and high interest rates have also been key impediments to FDI. The Government needs to work on enhancing the flexibility in the labour market. Further deregulation, transparent policy-making mechanisms and effective services to foreign investors will be vital to regain their confidence.
Survey design

The two groups in the Republic of Korea covered here are government officials (public sector) and high-level decision makers in businesses (private sector). These groups were chosen because of their role in shaping national attitudes and host-country policies towards business activities of TNCs in the Republic of Korea. To maximize the response rates and obtain reliable data, field survey coordinators were hired with assistance from the Ministry of Commerce, Industry and Energy, who conducted the stratified sampling, distributed questionnaires, conducted interviews when necessary and collected the responses for each group.

The survey was administered in 1998 and 1999. Although the response rates varied for each group, the average rate was higher than 80 per cent. A total of 208 people, 97 government officials and 111 business leaders with different levels of job hierarchy and responsibility, completed the questionnaires. Among the 97 government officials who responded, 17 of them were in grades 3 and 4 (directors or higher), 40 were in the grade 5 (assistant directors) and 40 were in grades 6 and 7 (department managers or section managers). In the business sector, there were 24 chief executive officers who responded, 33 vice presidents or directors and 54 managers, totaling 111 business leaders. The questionnaire contained 15 questions aimed at eliciting attitudes towards foreign affiliates in the Republic of Korea in general, and at indicating and ranking any positive and negative impacts of foreign affiliates on the economy, finance, management control, culture, and politics. The survey also contained a series of questions on personal attributes of the respondents, such as gender, age, education, job responsibilities, job level, the size of the firm, the nature of the job (international affairs or domestic affairs) and the location of job. There were also several questions on the overseas experience of the respondents.

Survey results and analysis

Overall attitudes towards TNCs

To examine the overall attitudes towards TNCs, a series of questions was posed in the questionnaire. The summary results of the responses of government officials and business leaders to a question on the overall evaluation of TNCs in the Republic of Korea are reported in table 2. Both government officials and business leaders gave a favourable appraisal of TNCs in the
Republic of Korea, with average scores of 4.02 and 4.01 on a 5-point scale, respectively. Favourable responses were received from 90.7 per cent of government officials and 88.5 per cent of the business managers, which are much higher than corresponding figures reported by other countries. High-ranking policy makers had a more favourable assessment of the role of TNCs on the domestic economy (table 2).

The pattern of responses by the two groups was reflected in the responses to question: “Do you think that a foreign firm in the Republic of Korea established and invested by foreign investors should be treated in the same manner as a domestic firm in terms of government regulations, support, benefits and, at the same time, responsibility?” Government officials provided a more favourable assessment of TNCs with a 72.2 per cent affirmative response rate than business leaders, who showed an affirmative response rate of 62.2 per cent (table 3). Similar patterns of responses were also found as regards past and future attitudes towards TNCs. Many government officials and business leaders, however, responded that they have changed or plan to change their assessment of foreign affiliates to make it more favourable.

To identify specific reasons for the diversity of attitudes towards TNCs by government officials and business leaders, the survey asked the respondents to rank a wide variety of positive and negative impacts that TNCs can have on economics, politics, management control, social issues and culture. Both elite groups responded that bringing foreign capital from abroad to the country is the most important positive impact of foreign affiliates (table 4). The creation of employment opportunities and technology transfer had the next highest ranking, followed by improvement in competitiveness and efficiency of local firms, the globalization of domestic economic systems and improvements in the balance of trade. All the respondents, government officials and businesspeople alike, seemed to be somewhat skeptical of the notion that TNCs could help to improve relations between the Democratic People’s Republic of Korea and the Republic of Korea.

5 Using similar questions in their surveys, several authors reported the percentage of the respondents who had positive attitudes towards foreign affiliates or had investments in a variety of countries: 57-78 per cent for legislators, government officials and businessmen in the United States (Fayerweather, 1982), 62 per cent of legislators and 94 per cent of civil servants in the United Kingdom (Graham, 1982), 26 per cent of legislators and 30 per cent of civil servants for France (Graham, 1982), 78 per cent and 69 per cent of government, business, and academics in Chile and Venezuela, respectively (Truitt and Blake, 1982). All figures are reported in Fayerweather (1982).
Table 2. Assessment of the impact of TNCs on the domestic economy by government and business leaders in the Republic of Korea

<table>
<thead>
<tr>
<th>Ranking scale</th>
<th>Government officials</th>
<th>Business leaders</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Grades 3,4</td>
<td>Grade 5</td>
</tr>
<tr>
<td>1 (strongly negative)</td>
<td>0 (0%)</td>
<td>1 (2.6%)</td>
</tr>
<tr>
<td>2 (negative)</td>
<td>1 (5.0%)</td>
<td>1 (2.6%)</td>
</tr>
<tr>
<td>3 (neutral)</td>
<td>0 (0%)</td>
<td>2 (5.1%)</td>
</tr>
<tr>
<td>4 (positive)</td>
<td>14 (70.0%)</td>
<td>26 (66.7%)</td>
</tr>
<tr>
<td>5 (strongly positive)</td>
<td>5 (25.0%)</td>
<td>9 (23.1%)</td>
</tr>
</tbody>
</table>

Average scale of responses: 4.15 (Government officials) vs. 4.01 (Business leaders)

Total observations: 20 (Government officials) vs. 111 (Business leaders)

The summary results reported in this table are based on the frequency of responses to the survey question: “How do you evaluate the overall impact of TNCs in the Republic of Korea on the domestic economy?” The numbers in parentheses denote the ratios of the frequency of each response to the above question to the total number of responses obtained from each group.
<table>
<thead>
<tr>
<th>Q: Did you consider a foreign firm in the Republic of Korea to be a local firm in the past?</th>
<th>Government officials</th>
<th>Business leaders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year/No</td>
<td>Grades 3,4</td>
<td>Grades 5</td>
</tr>
<tr>
<td>Yes/No</td>
<td>9/8</td>
<td>12/28</td>
</tr>
<tr>
<td></td>
<td>(52.9%)</td>
<td>(30.0%)</td>
</tr>
</tbody>
</table>

| Q: Do you think that a foreign firm in the Republic of Korea established and invested by foreign investors should be treated in the same manner as a domestic firm in terms of government regulations, support, benefits and, at the same time, responsibility? |
|----------------------------------------|----------------------|------------------|
| Year/No | Grades 3,4 | Grades 5 | Grades 6,7 | Total | CEO | VP/director | Manager | Total | Total |
| Yes/No | 14/3 | 27/13 | 29/11 | 70/27 | 13/11 | 21/12 | 35/19 | 69/42 | 139/69 |
| | (82.3%) | (67.5%) | (72.2%) | (72.2%) | (54.2%) | (63.6%) | (64.8%) | (62.2%) | (66.8%) |

| Q: Do you think that a foreign firm in the Republic of Korea established and invested by foreign investors should be treated in the same manner as a local firm in the future? |
|----------------------------------------|----------------------|------------------|
| Year/No | Grades 3,4 | Grades 5 | Grades 6,7 | Total | CEO | VP/director | Manager | Total | Total |
| Yes/No | 17/0 | 37/3 | 38/2 | 92/5 | 20/4 | 26/7 | 42/12 | 88/23 | 180/28 |
| | (100%) | (92.5%) | (95.0%) | (94.8%) | (83.3%) | (78.8%) | (77.8%) | (79.3%) | (86.5%) |

The summary results reported in this table are based on the frequency of responses to the above three questions. The numbers in parentheses denote the ratios of the number of the positive responses (“yes”) to each question to the total number of responses obtained from each group.
**Table 4. Evaluation of the positive and negative roles of TNCs in the Republic of Korea by government officials and business leaders**

<table>
<thead>
<tr>
<th>Positive/negative roles</th>
<th>Government officials</th>
<th>Business leaders</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. People’s perception of the positive roles of foreign firms in the Republic of Korea</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Q: What do you think are the positive impacts of foreign firms doing business in the Republic of Korea? [Please rank the following seven points in the order of importance to you: 1 (most important) through 7 (least important)]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. To attract foreign capital from abroad.</td>
<td>2.51 (1.39)</td>
<td>2.62 (1.51)</td>
<td>2.57 (1.46)</td>
</tr>
<tr>
<td>2. To improve the competitiveness and efficiency of domestic firms.</td>
<td>3.53 (1.75)</td>
<td>3.62 (1.97)</td>
<td>3.58 (1.86)</td>
</tr>
<tr>
<td>3. To obtain advanced technology from abroad.</td>
<td>3.32 (1.69)</td>
<td>3.21 (1.61)</td>
<td>3.26 (1.65)</td>
</tr>
<tr>
<td>4. To create employment opportunities.</td>
<td>3.04 (1.54)</td>
<td>2.95 (1.72)</td>
<td>3.01 (1.63)</td>
</tr>
<tr>
<td>5. To reduce the hostility from the Democratic People’s Republic of Korea towards the Republic of Korea.</td>
<td>6.77 (8.26)</td>
<td>6.80 (11.6)</td>
<td>6.79 (9.70)</td>
</tr>
<tr>
<td>6. To increase exports and improve the balance of trade.</td>
<td>5.24 (3.30)</td>
<td>5.30 (3.66)</td>
<td>5.28 (3.50)</td>
</tr>
<tr>
<td>7. To upgrade and globalize the domestic economic system and business customs.</td>
<td>4.79 (2.74)</td>
<td>4.81 (2.67)</td>
<td>4.80 (2.71)</td>
</tr>
<tr>
<td><strong>II. People’s perception of the negative aspects of foreign firms in the Republic of Korea</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Q: What do you think are the negative impacts of foreign firms doing business in the Republic of Korea? [Please rank the following seven points in the order of importance to you: 1 (most important) through 7 (least important)]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Less contribution on technology advancement than domestic firms.</td>
<td>6.23 (2.89)</td>
<td>5.37 (2.25)</td>
<td>5.76 (2.48)</td>
</tr>
<tr>
<td>2. Possibility of pulling out investments during economic crisis or confrontation with the Democratic People’s Republic of Korea.</td>
<td>6.40 (3.08)</td>
<td>6.30 (2.73)</td>
<td>6.34 (2.87)</td>
</tr>
<tr>
<td>3. Unwillingness to cooperate with the Government of the Republic of Korea and policies.</td>
<td>5.71 (2.49)</td>
<td>5.21 (2.34)</td>
<td>5.44 (2.40)</td>
</tr>
<tr>
<td>4. Drainage of wealth and profit to home countries and abroad.</td>
<td>3.09 (1.28)</td>
<td>3.22 (1.48)</td>
<td>3.16 (1.39)</td>
</tr>
<tr>
<td>5. Subordination of the domestic economy through monopoly and taking over management.</td>
<td>3.41 (1.52)</td>
<td>3.64 (1.58)</td>
<td>3.64 (1.55)</td>
</tr>
<tr>
<td>6. Influencing domestic trade policies with the aid of its home country.</td>
<td>4.75 (2.07)</td>
<td>5.24 (2.50)</td>
<td>5.02 (2.28)</td>
</tr>
<tr>
<td>7. Bad influence on culture due to the indiscreet influx of foreign cultures.</td>
<td>6.52 (3.15)</td>
<td>6.21 (3.01)</td>
<td>6.35 (3.07)</td>
</tr>
<tr>
<td>8. Pursuing management strategies for the interest of the home country rather than domestic interests.</td>
<td>2.71 (1.43)</td>
<td>2.97 (1.39)</td>
<td>2.85 (1.40)</td>
</tr>
<tr>
<td>Total observations</td>
<td>97</td>
<td>111</td>
<td>208</td>
</tr>
</tbody>
</table>

*a The numbers in parentheses denote t-statistics. The critical values of the t-statistics for the 5 per cent and 10 per cent significance levels are 1.64 and 1.28, respectively.

Participants were also asked to rank possible negative impacts of foreign affiliates in the Republic of Korea. Government officials and business leaders indicated that the TNCs’ pursuit of management strategies in the interests of the home country,
rather than the interests of the host country, was the most serious concern. The elite groups also showed serious concern for the drainage of wealth and profits repatriated to home countries, and the possibility of subordination of the domestic economy through TNC-led monopolies and takeovers of domestic firms. Overall, the elite groups in the public and private sectors seemed to have confidence in the behaviour of TNCs regarding the withdrawal of their investments during a period of economic crisis or confrontation with the Democratic People's Republic of Korea.

One of the limitations of studying overall attitudes is that it is difficult to tell exactly what are the main driving factors contributing to the divergence in attitudes towards TNCs among different groups. More formal empirical tests controlling for the effects of demographic differences would need to be conducted to identify the specific underlying forces that have contributed to the formation of differences in receptivity towards TNCs by government officials and business leaders.

**Individual attribute determinants of changes in attitudes towards TNCs**

Empirical tests were conducted to identify the major contributing factors to the changes in attitudes towards TNCs in the Republic of Korea. Thirty-nine government officials out of 97 and 48 business leaders out of 111 reported significant changes towards a more favourable attitude towards TNCs. The regression form using multiple regression analysis is:

\[ Z_{ij} = F^{-1}(P_i) = \alpha_j + \beta_j X_{ij} + \varepsilon_j \]

where:

\[ X_{i1} = \text{[AGE, GNDR, SCHL, JBLV, DUMJOB, EXPR, DUMTRNG, DUMGOVT]}; \]
\[ X_{i2} = \text{[AGE, SCHL, JBLV, DUMJOB, EXPR, DUMTRNG, DUMSIZE]}; \] and
\[ X_{i3} = \text{[AGE, GNDR, SCHL, JBLV, DUMJOB, EXPR, DUMTRNG, DUMBSMT]}. \]

The dependent variable \( Z_{ij} \) is a binary choice variable of 1 or 0 for a respondent \( i \) in a group \( j \), assuming the value of one when respondents admitted that they changed their assessment of TNCs from negative in the past to positive at present, and the value of zero otherwise. Several questions were asked to evaluate respondents' attitudes towards foreign affiliates. For example: "Do you think that a foreign firm in the Republic of Korea established and invested by foreign investors should be treated in the same manner as a domestic firm in terms of government
regulations, support, benefits and, at the same time, responsibility?” was one of these questions. The value of the group identification goes from 1 to 3: 1 is for government officials, 2 for business management and 3 for the combined group.

A vector of $X_{ij}$ consists of a set of explanatory variables describing the personal attributes of an individual $i$ in group $j$. Of all information received and coded on a variety of personal attributes of each respondent, the following set of explanatory variables was selected: Age [AGE], gender [GNDR], schooling [SCHL], job hierarchical level [JBLV], the nature of job responsibility (international versus domestic affairs) [DUMJOB], short-term overseas travel experience [EXPR], long-term overseas training experience [DUMTRNG], the type of government agency that government officials work for (national versus local) [DUMGOVT], and the size of firm in which business leaders work [DUMSIZE].

Specific scales were adopted to measure the explanatory variables. The job hierarchical level [JBLV], for example, had a value of 1 for government employee position grades 6 and 7 (managers), 2 for grade 5 (assistant or deputy directors), and 3 for grades 3 and 4 (directors or higher) and a value of 1 for managers, 2 for vice presidents and directors, and 3 for presidents or chief executive officers. Two different measurements for overseas experiences [EXPR] were used: the frequency of foreign trips and the number of countries visited. The explanatory variables whose identification starts with DUM all entered the model as dummy variables. For example, the nature-of-job dummy [DUMJOB] had a value of 1 if the respondent was responsible mainly for international affairs and 0 for domestic affairs. The estimation for the combined group also includes a group dummy variable [DUMBSMT] in the explanatory variable set to capture if there are any differences between government officials and business leaders in determining attitudes towards TNCs in the Republic of Korea. $\epsilon_j$ is an independently distributed random error variable with 0 mean. In the above regression equation, the probability $P_i$, resulting from the probit model, where $F$ is a cumulative probability function and $X_i$ is a vector of stochastic explanatory variables for individual $i$, can be interpreted as an estimate of the conditional probability that a respondent will respond affirmatively to the above question, given that the respondent’s attribute is $X_i$.

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6 The investigation of the correlation matrix and the F-tests using the partial correlation coefficients did not show the presence of multicollinearity among the explanatory variables.
To find the relationship between the set of attributes describing an individual in each group and the probability that the individual will form and change his or her assessment of TNCs, the linear probability (OLS) and probit models were estimated. The former model, which was estimated using the OLS method, can be interpreted as describing the change in the probability of having a positive view of foreign affiliates associated with a unit change in the individual’s personal attributes. The probit model, which was estimated using the non-linear maximum likelihood estimation method, measures the impact of explanatory variables on the probability of an individual choosing from a pair of discrete outcomes, such as whether or not to have a positive attitudes. It is useful for the purpose of predicting the probability for an individual with a given set of personal attributes having a favourable attitude towards TNCs.\footnote{Since the probit model transforms the original OLS model in such a way that predictions will lie in the (0, 1) interval for all $Z_{ij}$, which generally leads to coefficients of an arbitrary scale, the two models can give substantially different results. An upper bound of $R^2$ as a measure of goodness of fit in the linear probability model is also likely to be substantially less than 1.}

The results of the sub-group sample estimations of the linear probability (OLS) and probit models are found in table 5. The model suggests that individual attributes are important influences, with varying degrees for different leader groups, on changes in attitudes towards TNCs in the Republic of Korea. First of all, government officials in low job levels appeared to have changed their attitudes towards the positive side more so than those in high levels. Younger business leaders working for smaller firms were shown to have changed their attitudes towards foreign affiliates more conspicuously. Age was a major contributing factor to attitude changes by business leaders — the younger the leaders, the more positive the change.

Business leaders working for small and medium-sized firms seemed to be more ready to change their attitudes favourably than those working for large firms, like chaebols. Overseas (short-term) experience and familiarity with foreign affairs seemed to have been helpful in the more favourable change of attitudes for both groups. The statistically insignificant coefficients of the group dummy variable implies that both elite groups in the public and private sectors, government officials and business leaders alike, seem to have similar patterns of shifting attitudes towards TNCs, which is consistent with the findings of the study of overall attitudes towards foreign affiliates reported earlier.
Table 5. Individual attributes contributing to the changes in the attitudes towards TNCs by government officials and business leaders

<table>
<thead>
<tr>
<th>Explanatory variables</th>
<th>Government officials</th>
<th>Business leaders</th>
<th>All groups</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CLS</td>
<td>Probit 1</td>
<td>Probit 2</td>
</tr>
<tr>
<td>Constant</td>
<td>-0.04</td>
<td>-2.05</td>
<td>-2.60</td>
</tr>
<tr>
<td></td>
<td>(0.42)</td>
<td>(1.95)</td>
<td>(1.98)</td>
</tr>
<tr>
<td>Age</td>
<td>0.06</td>
<td>0.13</td>
<td>0.17</td>
</tr>
<tr>
<td>[AGE]</td>
<td>(0.07)</td>
<td>(0.22)</td>
<td>(0.22)</td>
</tr>
<tr>
<td>Gender</td>
<td>0.46**</td>
<td>2.33</td>
<td>2.35+</td>
</tr>
<tr>
<td>[GNDR]</td>
<td>(0.13)</td>
<td>(1.66)</td>
<td>(1.43)</td>
</tr>
<tr>
<td>Schooling</td>
<td>-0.05</td>
<td>-0.12</td>
<td>-0.14</td>
</tr>
<tr>
<td>[SCHL]</td>
<td>(0.10)</td>
<td>(0.28)</td>
<td>(0.27)</td>
</tr>
<tr>
<td>Job hierarchy level</td>
<td>-0.21**</td>
<td>-0.40+</td>
<td>-0.56*</td>
</tr>
<tr>
<td>[JBLV]</td>
<td>(0.09)</td>
<td>(0.24)</td>
<td>(0.25)</td>
</tr>
<tr>
<td>Job nature</td>
<td>-0.05</td>
<td>-0.01</td>
<td>-0.12</td>
</tr>
<tr>
<td>[DUMJOB]</td>
<td>(0.11)</td>
<td>(0.29)</td>
<td>(0.29)</td>
</tr>
<tr>
<td>Overseas experience</td>
<td>0.12+</td>
<td>0.06</td>
<td>0.31+</td>
</tr>
<tr>
<td>[EXPR]</td>
<td>(0.06)</td>
<td>(0.22)</td>
<td>(0.17)</td>
</tr>
<tr>
<td>Training</td>
<td>0.07</td>
<td>0.36</td>
<td>0.21</td>
</tr>
<tr>
<td>[DUMTRNG]</td>
<td>(0.15)</td>
<td>(0.31)</td>
<td>(0.41)</td>
</tr>
<tr>
<td>The type of government</td>
<td>0.02</td>
<td>-0.09</td>
<td>-0.04</td>
</tr>
<tr>
<td>[DUMGOVT]</td>
<td>(0.14)</td>
<td>(0.36)</td>
<td>(0.37)</td>
</tr>
</tbody>
</table>

The size of firm

<table>
<thead>
<tr>
<th>DUMSIZE</th>
<th>0.01</th>
<th>0.05</th>
<th>0.29</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(0.09)</td>
<td>(0.23)</td>
<td>(0.22)</td>
</tr>
</tbody>
</table>

Number of Observations

<table>
<thead>
<tr>
<th>97</th>
<th>97</th>
<th>97</th>
<th>111</th>
<th>111</th>
<th>111</th>
<th>208</th>
<th>208</th>
<th>208</th>
</tr>
</thead>
<tbody>
<tr>
<td>Log likelihood</td>
<td>-62.6</td>
<td>61.0</td>
<td>111</td>
<td>68.9</td>
<td>68.5</td>
<td>138.5</td>
<td>117.68</td>
<td></td>
</tr>
<tr>
<td>The ratio of the number of correctly predicted cases</td>
<td>59/97</td>
<td>61/97</td>
<td>72/111</td>
<td>70/111</td>
<td>126/208</td>
<td>128/208</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prediction ratio</td>
<td>60.8%</td>
<td>62.9%</td>
<td>64.9%</td>
<td>63.5%</td>
<td>60.6%</td>
<td>61.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residual</td>
<td>0.09</td>
<td>0.13</td>
<td>0.04</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Source: authors &amp; data from the survey mentioned in the text.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Probit 1 uses the number of trips as the measurement of overseas experiences [EXPR], and probit 2 uses the number of countries visited as the measurement of overseas experiences. Numbers in parentheses are standard errors, which were computed using the consistent covariance matrices allowing for heteroskedasticity. The prediction ratio is the percentage of cases predicted correctly by the regression estimation. Coefficients obtained from the ordinary least squares (OLS) and probit models estimate the individual attribute determinants of changes in attitudes toward incoming TNCs by the government and business leader groups in the Republic of Korea.

+ Significant at the 0.10 level.
* Significant at the 0.05 level.
** Significant at the 0.01 level.

Transnational Corporations, vol. 10, no. 1 (April 2001)
Conclusion and policy implications

The purpose of this note was to investigate the major determinants of attitudes and changes in attitudes towards TNCs in the Republic of Korea. Survey data showed that government officials and business leaders were generally favourable towards TNCs. The estimation results based on the linear probability (OLS) and probit models showed that gender (male), job hierarchical level, education and overseas experience were positively correlated with changes in attitudes towards foreign affiliates, while age and the size of firm were negatively correlated. Overall, the findings suggest that individual attributes, among others, are important influences on forming attitudes towards foreign affiliates by leader groups.

Several policy implications can be drawn. First, elite groups in the public and private sectors, such as government officials and business managers who were shown to have the most favourable attitudes towards foreign affiliates, are expected to play a leading role in continuously nurturing a more favourable environment for foreign investors. Progressively positive appraisals of foreign affiliates by government officials are especially worth noting. More than 90 per cent of the government officials who participated in the survey assessed the impact of foreign affiliates on the domestic economy to be positive. More than 70 per cent of the government officials surveyed thought that a foreign affiliate should be treated in the same manner as a domestic firm. Interestingly, more than 80 per cent of the government officials with attitudes unfavourable to TNCs indicated that they would change their attitudes in the direction of equal treatment in the future (table 3). Although the development paradigm of the Republic of Korea's economy has been gradually transformed from government-led industrialization to private sector-led market liberalization, government officials, along with business leaders, are expected to continue to take the initiative in providing a more attractive environment for FDI.

Second, it appears that one of the most common individual attributes in determining and changing the attitudes held by government officials and business leaders is overseas experience. Since the Republic of Korea has been in the process of learning the benefits and costs of market liberalization and globalization and acquiring better knowledge of, and familiarity with, global business environments, short-term overseas experience seems to be one of the key factors in enhancing the country's receptivity towards foreign affiliates.
Third, the linear probability and probit models reveal that the most significant changes in attitudes towards TNCs are expected to take place among young business leaders working for small firms and government officials at low hierarchical levels. It appears that younger age and smaller firms have the advantages of greater flexibility and adaptability to attitude changes in a positive direction. Although higher-level government officials were shown to have more favourable attitudes towards TNCs, lower-level government officials with some overseas experience seem to be more ready to change their attitudes towards foreign affiliates from negative to positive. A more active role in enhancing the country’s positive attitudes towards foreign affiliates is expected to be played by the group of business leaders that runs smaller firms, like venture e-commerce businesses, than by those who own or run large industrial conglomerates, like chaebols.

TNCs are already deeply involved in the domestic economy. According to the Republic of Korea Institute of Industrial Economics and Trade, total FDI stock in relation to the country’s GDP was just 1 per cent in 1995, compared to 1.7 per cent in 1997. But that share rose sharply to 5.7 per cent in 1998, and 8.2 per cent in 1999. The large and rapid influx of FDI caused a sense of uneasiness among local people. According to analysts, approximately 10 per cent of publicly listed firms, as of February 2001, are vulnerable to foreign control as foreign stakes exceed that of local shareholders.8 As this note found, an enhancement of knowledge and greater familiarity with the global business environment by both government officials and business leaders is called for to improve national attitudes towards TNCs further and, at the same time, to be better prepared for foreign control of domestic firms and industries in the years to come.

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References


BOOK REVIEWS

World Investment Report 2000: 
Cross-border Mergers and Acquisitions and Development

United Nations Conference on Trade and Development  
(New York and Geneva, United Nations),  
xxvii + 331 pages

The World Investment Report (WIR) has now been published annually for ten years, first by the United Nations Centre on Transnational Corporations and then, subsequent to the merging of this unit into the United Nations Conference on Trade and Development (UNCTAD), by the secretariat of UNCTAD. The first WIR was heralded by the world’s financial press as filling a major vacuum in the international economic literature. This was because the WIR provided information pertaining to foreign direct investment (FDI) and the international operations of transnational corporations (TNCs) created by this investment, the now-dominant vehicle by which international commerce takes place. While numerous sources provided annual information on world trade and international finance, no comparable comprehensive sources of information existed on FDI.

Alas, one problem faced by UNCTAD and its predecessor agency in preparing the WIR is that this preparation must rely on information collected and released by the world’s governments. The fact is that, in spite of the enormous importance of FDI (something like 10 per cent of the world’s GDP originates in foreign affiliates of TNCs and at least another 5 per cent can be indirectly attributed to these affiliates), the data compiled by most governments are neither highly accurate nor, by most criteria, sufficiently wide in scope of coverage to cover fully all aspects of FDI. Indeed, only one Government, that of the United States, prepares data series that provide detailed information of this sort for both inward and outward FDI. UNCTAD staff bravely try to compensate for the narrowness and (and, in many cases, inaccuracy) of data provided by most governments by preparing “educated guesses” for holes in the data series. (On this, the serious researcher should carefully read the section “Definitions and Sources” in Annex B — the data annex — of WIR 2000.) Also,
UNCTAD extrapolates some data that are available only for limited numbers of countries (in some cases, only the United States) to create estimates for the whole world. In addition, WIR presents just about every ordering and breakdown that can be created from the existing data, resulting in dozens of tables, charts and graphs that are based on surprisingly few underlying data series. The results are impressive but, at the end of the day, the available data on FDI and activities of TNCs remain woefully inadequate despite UNCTAD’s efforts to compensate for the inadequacies.

The deficiencies notwithstanding, WIR has become a standard reference for all those who seriously study FDI and the international operations of TNCs. Probably the most useful aspect of WIR has been the statistical annexes that are common to all editions but have been improved over the years.

Beyond the annexes, WIR has in most years been divided into what amount to two parts. The first part largely tends to be informational in nature, and the format of this part has in recent years become fairly standardized. This part is invaluable reading for anyone who wishes to know what are the salient facts and figures pertaining to FDI and what have been the major trends in these facts and figures. There is necessarily a certain amount of repetition from year to year, but the focus each year is on recent trends. A person not familiar with FDI but wishing to learn about the subject might very well wish to begin his or her study by reading the first part of the latest WIR. Even if this person reads no further, she or he can become quite conversant on the subject if the material in these chapters is fully digested.

The second part of WIR in most years has been a detailed treatment of a specific topic that changes each year. For the most recent edition (2000), this topic is “Cross-border Mergers and Acquisitions and Development”. In recent past years, the topics have been “Foreign Direct Investment and the Challenge of Development” (1999), “Transnational Corporations, Market Structure and Competition Policy” (1997), and “Investment, Trade and International Policy Arrangements” (1996). In 1998, there really was no specific topic (the topic of record was “Determinants and Trends” but, as noted above, this is covered in all recent editions).

These specific topics are all of importance and interest, and UNCTAD is to be congratulated for selecting these topics and attempting to treat them comprehensively. My own view, however,
is that the results warrant a mixed review. The relevant chapters have largely been stitched together from reports commissioned from individuals, and the result has been a number of rather lengthy discourses that are comprehensive and informative but not as well organized as one might hope. Also, the prose suffers from inconsistent style that the best efforts of the editors have not been quite able to eliminate. The resulting element of meandering that is thereby introduced can, in fact, make it difficult for the reader to follow the main themes. Perhaps the results would have been improved had UNCTAD sought fewer inputs and simply commissioned a small team, or even a single author, to put together a short treatise on the relevant subject.

In the case of the most recent report, the treatment of cross-border mergers and acquisitions and the implications of these for development, suffers, through no fault of UNCTAD, from the fact that few empirical studies pertaining to this subject have been attempted. Thus, when push comes to shove, the subject is one about which we have limited understanding. However, this limitation has not stopped *WIR 2000* from publishing more than 100 pages on the subject, where each page contains about twice the number of words that would appear on a normal journal or book page. The treatment is divided into three chapters (chapters IV through VI of the *WIR*). In this reviewer’s judgement, the subject could have been treated more satisfactorily with much less text.

This having been said, the three chapters vary greatly in quality, from quite excellent to not quite satisfying. The first chapter, entitled “Trends in Cross-Border M&As”, is my candidate for excellence. The chapter covers exactly what it claims to, and is highly informative. A reader who is entirely unfamiliar with the subject would benefit enormously from reading it. The discussion begins with the basics (e.g. what is a cross-border merger, and how does this differ from a cross-border acquisition) and goes on to present an impressive amount of information and statistics pertaining to the subject. Indeed, the chapter underscores the fact that presentation of the facts as best as they can has been *WIR’s* strong card since the first edition was printed, and this continues to be the case.

Things become somewhat more problematic in the second of the chapters, which covers “Performance, Motivations and Outlook”. The chapter starts out well enough. Part A looks at the performance of corporations that have engaged in M&A, noting that most empirical studies (whether based on stock market
performance or on measures of financial performance) show that neither stockholders nor the corporations themselves would seem to benefit from M&As. At the same time, this section notes that these studies tend to be of domestic mergers and furthermore are somewhat dated — as shown in the previous chapter, the 1990s witnessed an explosion of M&A activity, but most empirical studies are of earlier periods. Hence, what we know about corporate performance in relation to M&A activity is limited, albeit not very reassuring. But one question that arises is: if performance is bad, why do firms engage in mergers and acquisitions at all?

Traditional thinking gives two possible rational answers to this question. The first is that the merging firms seek increase market power, so that the combined firm garners rents that neither of the uncombined firms can achieve on their own. The second is the combined firm might achieve synergies, resulting in greater operating efficiency, or more satisfactory research and development performance, or some other tangible benefit that, again, the uncombined firms cannot achieve on their own and that gives it competitive advantages over rival firms. In either case, the result should be improved performance of the combined firm from a shareholder’s point of view. There also are possible “irrational” answers, e.g. desire of executives to build “corporate empires” that serve little end but aggrandizement of these executives (possibly in connivance with investment bankers, lawyers and accountants who stand to make huge fees from M&A activity).

Given this, what follows in this chapter is not very reassuring either. The next part of the chapter, part B, attempts to use John Dunning’s OLI model to try to explain why cross-border M&A activity is taking place. This seems a bit odd, because this model was developed more to explain “greenfield” FDI than cross-border M&As. But, never mind this, the explanation offered seems to be that M&As can be used by firms to establish a presence in foreign markets faster than could be achieved by going the greenfields route and that, starting in 1995, speed was of the essence.

Is this a satisfactory explanation? Much as this reviewer admires John Dunning’s work, I do not think so. For one thing, a lot of the cross border M&As that have taken place in developing countries are either the result of foreign interests participating in privatizations or, in some cases, of foreign interests buying out the stakes of local shareholders in what previously had been joint
ventures. Somehow, OLI, at least as employed here, just simply seems to be a poor framework to explain these cases. One problem is that an implicit assumption is that greenfields and acquisitions are alternative means by which TNCs achieve the same ends, i.e. that the two modes of entry easily substitute for each other. It is not clear that this is always the case. Moreover, even if these modes are close substitutes, the chapter never quite satisfactorily explains why speed became of the essence all of a sudden in the middle 1990s, so as to cause investors to substitute acquisitions for greenfields entry, whereas speed did not seem of such essence five years earlier. Yes, things happen faster in today’s world than in the world of our grandfathers, but did things really accelerate so abruptly following 1995, and, if so, why?

But maybe the point of this section is that cross-border M&As are fundamentally different than domestic ones, e.g. that issues of market power and/or synergy figure less importantly in cross border deals while simple market access figures more importantly. In this matter, the chapter introduces the intriguing notion that many of these M&As (mostly, in fact, acquisitions) are motivated by strategic considerations, e.g. firm A acquires firm B because B possesses intangible assets needed by A that it cannot readily develop on its own. (In which case, acquisition is not a close substitute for greenfields entry. And, come to think of it, is this not just one way to describe a synergy?) This is, as indicated, a tantalizing possibility but, alas, not much evidence is shown that this is in fact what is actually going on.

The chapter follows with some discussion of changes in the regulatory environment affecting mergers and acquisitions. This discussion is quite fragmented and misses a number of highly important developments; for example, there is little discussion of the regulation of M&As in either the United States or the European Union, although the relevant regulatory agencies of the United States and the European Union perform at least 90 per cent of all the globe’s regulation of M&As, including many transactions that affect developing nations directly or indirectly. M&A regulation invariably involves some tension between the authorities seeking to block transactions that would give the combined firm significantly greater market power but not seeking to block transactions that would yield favourable economic outcomes, e.g. combinations that do in fact create synergies. The WIR discussion of changes in the regulatory environment proceeds almost as though this tension does not exist.
Indeed, one thing that is curiously lacking in the *WIR* is much discussion of the effects of cross border M&As on market structure, e.g. do these transactions increase the market power of the merging entities? This is especially curious given that the literature on TNCs has long (since at least the seminal doctoral dissertation of Stephen Hymer) emphasized that these firms tend to operate in industries that are oligopolistic. Indeed, publications of UNCTAD during the 1970s stressed the market power of these firms and, while many analysts believe that, during that epoch, this stress was somewhat overzealous, the issue of market power has not gone away (or at least certainly the regulatory authorities in the United States and the European Union do not believe so).  

The third chapter attempts to compare cross border M&As with greenfield investments in terms of effects on the host country economy as regards (1) external financial resources (e.g. are domestic savings effectively augmented by a particular transaction); (2) technology transfer and diffusion; and (3) employment and skills of local workers. A quick reading of this chapter reveals that, asking the question “which mode provides the greater benefits”, the answer is almost always “it depends” or, writing this out more completely, “either mode might be better than the other, it depends upon the specifics of the case at hand”. Again, any comparison depends upon the assumption that greenfield entry and entry via M&As are substitutes. As already noted, this might not be the case. This chapter, although thoughtful and informative in places, suffers from the fact that, beyond an “it depends” answer, we really do not have much knowledge of the effects of cross border M&As on developing countries, due to a dearth of empirical data (and to the related fact that, until quite recently, there simply were not a whole lot of cross border M&As affecting developing countries). The chapter suffers from being especially overly long and often repetitive.

Overall then, the *WIR* has become an important reference that researchers have come to rely upon. If one were to summarize its strengths and weaknesses in a nutshell, its main strength is as a source of data and information, while its relative weakness is as an analytic report. In the latter regard, I would not eliminate the

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annual special topic, but I would try to make the treatment of this topic more succinct and to the point. For one thing, if this were to be done, more people would likely read it. And, at the end of the day, one hopes that the WIR will continue to be published for a long time. This implies that, over time, a complete set of WIRs will come to occupy a larger and larger shelf space. Given this, there is no need for each volume to be excessively thick. ■

Edward M. Graham
Senior Fellow
Institute for International Economics
Washington, D.C.
United States
Multinational Corporations in China: Benefiting from Structural Transformation

Yadong Luo

(Copenhagen, Copenhagen Business School Press, 2000), 381 pages

The second largest recipient of foreign direct investment (FDI), yet widely perceived as one of the most difficult business locations, China, continues to attract much attention among both academics and practitioners. One of the foremost scholars in the field of Chinese management, as well as a former senior official in Jiangsu Province handling foreign-invested projects, Yadong Luo, is uniquely qualified to address the interests and concerns of both audiences.

The first chapter of the book provides a balanced account of the current state of FDI in China within the evolving context of its macroeconomic environment, and includes a summary of new policies (conveniently organized per functional areas) and future trends. The second chapter deals with industrial structure and policies, beginning with an overview of deregulation and continuing with an industry analysis of FDI impact and policies. The chapter concludes with an assessment of the likely impact of China’s entry into the World Trade Organization (WTO). Particularly notable here is the even-handed assessment of both advantages and disadvantages to the Chinese economy. The chapter ends with an appendix summarizing the United States-China bilateral WTO agreement.

Chapters 3, 4 and 5 are industry specific, allowing for a level of detail and clarity not seen in many books on the subject. Chapter 3 is focused on technologically intensive industries, such as pharmaceuticals, telecommunications and electronics. Chapter 4 is focused on service industries, from insurance and financial services to tourism and advertising. Chapter 5 deals with infrastructure and service industries, such as energy and transportation, and, most importantly, e-commerce. Each of these chapters offers a gold mine of information to those who need to gain a general understanding of a given industry.

Those who are seeking a more explicit manner in which to assess their firm’s prospects in China will find chapter 6 most
useful. This chapter constitutes an analysis of the structural dynamics involved in the selection of an FDI project in China, and offers many useful insights on how to go about this very promising, yet difficult, investment environment.

The last part of the book is a selection of eight case studies on the operations of foreign firms in China. The cases are highly diverse in terms of industry, investor country and regional location. Especially useful are the longitudinal descriptions of how investments in China by those firms' evolved, and how certain conditions changed, while other did not in their industries.

In sum, this is a very useful book and a rare one in terms of its ability to draw on academic knowledge, yet translate it into practical insights and advice that company executives will appreciate. If you have time to read only one book on FDI in China today, this should be it.

Oded Shenkar
Ford Motor Company Chair in Global Business Management
Fisher College of Business
The Ohio State University
Columbus, Ohio
United States
Integration through Foreign Direct Investment: Making Central European Industries Competitive

Gábor Hunya, editor

(Cheltenham and Northampton MA, Edward Elgar, in association with The Vienna Institute for International Economic Studies, 2000), 256 + xiv pages

Foreign direct investment (FDI) in Central Europe has attracted a great deal of attention by academics and journalists around the world. But there are not too many studies by experts in the field, or from the countries concerned, which would go a long way "towards understanding a host of key issue related to the emerging pattern of MNC-cum-host collaborative growth in central and eastern Europe" (see the foreword by Terutomo Ozawa, p. xiv) as this book by Gábor Hunya and his colleagues.

A distinctive characteristic of this book is that a large database on FDI has been collected not only from the available macroeconomic sources or balance-of-payments statistics, but also from aggregated company balance sheets. The authors have relied extensively on company data, which was necessary when evaluating the role of FDI in strengthening the competitiveness of industries in Central Europe, and in narrowing the gap between transition economies and countries of the European Union (EU). Such a comprehensive empirical research was possible thanks to an ACE (Action for Cooperation in the Field of Economics) project on which this book was based.

Another major contribution of the book is its focus on specific issues that arise when evaluating the impact of FDI on host economies. Among them are the role of FDI in technology transfer, efficiency upgrading within production specialization, productivity convergence, balance of payments, international trade and, lastly, a comparative analysis of the financial performance of business activities of foreign affiliates and domestic firms. By concentrating on competitiveness the book also evaluates the role of FDI in making transition economies compatible with the acquis communautaires, since all of the countries studied are candidates for EU membership.
A distinct characteristic of the book is a comparative evaluation of foreign affiliates and locally owned firms. It has been demonstrated that FDI upgrades the host economy’s comparative advantages by improving allocation efficiency, by macroeconomic restructuring and, through industrial (technical) efficiency, by increasing productivity through microeconomic restructuring and spillover effects. Foreign affiliates show much better performance than domestically owned firms in terms of profitability, value added per employee, export orientation and assets per employee. An important conclusion, therefore, is that restructuring without FDI is generally slower than with it. Although the impact of FDI on structural change has been positive generally, there have been some exceptions. Of special concern is the relationship between FDI and current account deficits that are accumulating in all transition economies. While some analysts have demonstrated that even a large current account deficit should not be a major concern if it reflects strong private investment inflows, this could nevertheless increase inflationary pressures and lead to an appreciation of the domestic currency, which may threaten the competitiveness of domestic producers (p. 5).

One important conclusion of the book is that the long-term effect of FDI on development is critically dependent on the type of FDI, the structure of indigenous resources and capabilities and the macroeconomic policies of the host governments. The effects therefore relate to economic structures and are dependent on policies.

Mark Knell and Slavo Radoševic have contributed an interesting chapter on FDI, technology transfer and growth to the book. Although technology is a major part of the package of FDI, the literature on the technological impact of FDI still has room for new additions. Therefore, a creative combination of the relationship between FDI and endogenous growth theory, as done in that chapter, is welcome.

The book would not be complete without a comparison with other — developed — countries that are major recipients of FDI. Such a comparison shows that there are Central European countries that already have a higher penetration rate of foreign capital than the developed-country average. Hungary stands out in this respect with a share of over 60 per cent of foreign affiliates’ assets in manufacturing.

The contribution of Matija Rojec on restructuring efficiency clearly demonstrates that foreign affiliates are performing much
better than domestically owned enterprises in terms of return on equity, profit margin, total asset turnover and value added per employee. The main reasons for the difference are the larger than average size of foreign affiliates, their higher capital intensity and their more intensive investment and export orientation. The industries that seem to depend more than the average on the growth of EU markets are often characterized by a higher rate of foreign penetration. The differences in privatization methods, too, have influenced the pattern of FDI (p. 170).

Nevertheless, “FIEs [foreign affiliates] may not be the panacea that central Europe is looking for” (Knell, p. 195). Why? FDI does not play an unambiguously leading role in facilitating technical change and technological learning. There is no direct evidence of widespread productivity spillovers from foreign affiliates to domestic firms. This brings again to our attention the higher relevance of the policy framework in host countries, since it is the technological infrastructure and the absorptive capacities of domestic firms that determine whether or not these countries will be able catch up with the EU in the long term.

Given the importance of trade for growth, this book has a large chapter on this topic. Andrea Éltető has concluded, in her analysis of trade, that foreign affiliates play a bigger role in the exports of all four countries than they do in other fields (for example, capital endowment or investment). They also have a high propensity to export, which is related, to a certain degree, to the small size of the countries analyzed. This high propensity to export is mostly the product of efficiency-seeking FDI. But the higher share of exports in total production in foreign affiliates is only partly related to the fact that they operate in more export-oriented sectors. From the macroeconomic perspective, it is important that foreign affiliates have contributed to the substantial shift in the structure of these countries’ trade with the EU, and in the revealed comparative advantages of these countries towards activities based on skilled labour.

Perhaps the most important message of the analysis of the balance-of-payments impact of FDI (Josef Pöschl) is that the mode of covering current account deficits matters. If the net inflow of FDI is a dominant source of financing that deficit, this may be a hint that an upgrading of productive capacities is taking place, thus allowing for a positive assessment (p. 218). Difficulties arise when the net inflow of FDI is not sufficient to cover the current account deficit. Countries may try to attract other types of capital inflows through high interest rates. But high interest rates allow
domestic currencies to appear stronger than markets’ evaluations. A case study of the economy of the Czech Republic between 1996 and 1998 illustrates the problems that can result from such a strategy.

To conclude, in eleven chapters, distinguished scholars have persuasively argued that FDI can make Central European industries more competitive and facilitate their integration both into EU and into a globalized world economy. However, it has been emphasized that FDI is not a panacea, and there are both winners and losers. The impact depends strongly on the policies of host countries, their absorptive capacities, their human capital development and their general development strategies. The major strength of the book is a comparative evaluation of the performance of FDI in four transition economies and of its determining factors that have been instrumental in producing different FDI impacts under different conditions. This book, edited by Hunya, certainly represents a very valuable contribution to the literature on the role of FDI in development in Central and Eastern Europe. It is therefore a must for both scholars and practitioners who are involved in foreign investment in economies in transition.

Marjan Svetlicic

Professor
Faculty of Social Sciences
University of Ljubljana
Ljubljana, Slovenia
Politiques industrielles pour l’Europe

Élie Cohen, Jean Hervé Lorenzi et al.

(Paris, La Documentation française, 2000), 550 pages

This book is the outcome of a collective effort on the part of a group of leading French economists, addressed to Europe’s opinion leaders, policy-makers and all people interested in the fate of European industry. Its aim is to draw attention to a void, namely the absence of a European industrial policy.

It is structured around a core chapter by Elie Cohen and Jean-Hervé Lorenzi entitled “Des politiques industrielles aux politiques de compétitivité en Europe”, which is then commented upon and extended by 15 additional contributions, some of which offer further original research in specialized areas in their own right. These contributions, which sometimes inevitably overlap, call for a significant increase in research and development (R&D) expenditures via the “mobilisation des moyens scientifiques, industriels et politiques” in public/private partnerships and the diffusion of the resulting innovations “dans les grandes structures publiques” (p. 160). If this cannot be achieved at the level of the European Union (EU), the authors suggest that at least the EU should adopt so-called “horizontal policies” to promote a level playing field. The authors call in particular for the harmonization of taxes applied to mobile factors (read: capital), the further liberalization of public utilities, the introduction of a European patent system, the enactment of a European company statute and measures to encourage medium-sized companies (pp.160-161). If neither “horizontal” nor “vertical” measures are enacted at the European level, the authors claim that member States (read: France) will be obliged to take unilateral action to mobilize “des moyens substantiels au profit de la recherche et de l’innovation” and to undertake a drastic reform (“une réforme hardie”) of their own State support to industry.

The core question raised by the authors of this volume is the “European paradox” — the fact that, while Europe more or less manages to keep up with the United States in terms of total R&D expenditure, it massively underperforms in terms of production and trade in high-technology products. Its pattern of trade remains stubbornly that of a middle-ranking economy,
importing high-technology products and exporting “old economy” goods. Its industrial decline relative to the United States is spectacular and irrefutable — and well documented in this book.

Why does Europe get such a poor return on its R&D efforts compared with the United States? Various reasons are suggested in this book. Among the hypotheses explored by Cohen and Lorenzi is the fact that, while the EU forbids member States to subsidize their own national industries (since this would constitute unfair competition), it has yet to develop an industrial policy at the European level. Industrial policy “as we knew it” has virtually disappeared from the scene, leaving European industry to restructure according to market forces unleashed by the single market and globalization. The EU is criticized for developing a poor substitute — its Multi-annual Framework Programme for Research and Technical Development (MFP). According to the authors, the MFP has been too late in coming, is too modest and not focussed enough. As a result, its limited funds are spread too thinly over too many projects and are anyway misdirected towards “precompetitive” projects. The authors make the case for directing funds towards a more limited set of projects, closer to the market place.

Another reason for the “European paradox”, according to the authors of this book, is the rivalry that has developed between the EU’s R&D programmes and the “Eureka” system. The latter extends well beyond EU boundaries and generates support for collaborative, international R&D projects that reach as far as the Russian Federation (but not, for the moment, the United States or Japan), while the EU programmes and their funding are restricted to EU members and associate countries. Furthermore, Eureka projects tend to be more “market-driven” and less “precompetitive”. The contributors criticize this as wasteful rivalry and call for a re-focussing of both programmes.

Several authors provide a modern theoretical justification for industrial policy in terms of market failures. Gone is sectoral aid to “national champions”. The world has become transnational, and firms are global, so an old-fashioned Colbertisme is simply anachronistic. The results are twofold. On the one hand, national industrial policy becomes a policy of support for small and medium-sized enterprises, by default, according to Grégoire Postl-Vinay of the French Ministry of the Economy. On the other, the aim of industrial policy is nowadays to create the “right” environment for attracting and creating R&D-intensive firms. This, according to the panel of economists, involves more direct
aid to R&D (focussed on a few priority industries, and in particularly informatics and telecommunications) at a European level. This approach could be termed “néo-Colbertisme”.

The reader can also appreciate the up-to-date references to agglomeration effects, clustering and economic geography generally, as well as attempts (not always convincing) at suggesting public policies aimed at developing “la dimension territoriale”.

The format of the book is worth noting. It consists of a major piece of research by Cohen and Lorenzi (occupying one-third of the book), followed by two brief commentaries by Michel Didier and François Morin. Then follow the 15 compléments. Members of the French research community and civil servants, combining high-ranking international staff (including Ugur Mulder of the EU Commission) with academics. The result is a 500-page plea for a more active industrial policy at the European level.

The authors, French with one or two exceptions, have produced in many ways a predictable book. They all justify industrial policy in terms of market failures, such as imperfect competition, winner-takes-all situations and economies of scale. The poor showing of European industry is attributed to too little and belated public help in facing overwhelming United States competition. The idea of industrial policy in itself is not questioned, only its poor execution.

Occasionally, some contributors wander off the straight and narrow path set by the panel’s agenda, and begin to discuss wider reasons for the “European paradox”, such as France’s distorting “taxe professionnelle”, the lack of venture capital, educational, fiscal and regulatory issues. However, one has to search the book with care to find references to such issues. They are quickly passed over on the grounds that a deeper discussion would take one too far afield.

Certainly so. Unfortunately, however, one could argue that Europe’s poor growth and industrial performance compared with the United States is surely not due mainly to an inadequate and unfocussed industrial policy, but precisely to more diffuse, deep-rooted factors, such as high taxation, social security regimes that weigh heavily on factor prices, and an overregulation of labour and capital markets. No industrial policy, however well conceived, will have a measurable impact on the “European
paradox” unless European countries do something to correct these problems. If, therefore, one must criticize this otherwise useful, exhaustive and informative work, it would be to say that the authors treat industrial policy as though it were a self-contained issue and, as a result, attribute to it an ability to change things for the better that one fears it does not possess.

Victoria Curzon Price

Department of Economics
University of Geneva
Geneva, Switzerland
This book addresses the question of government interference with the property rights of a foreign investor in the context of contemporary international law. It examines in a systematic manner such matters as international norms governing expropriation, responsibility of a foreign government to an investor, treaties protecting foreign investment, political risk insurance, immunity of States from suits in other States and international arbitration between States and investors. The authors integrate a wealth of material related to international law of expropriation from the perspective of assisting an investor in avoiding confiscation of property located in a host country. Many of the topics covered in this book have been addressed in various law books and journals, but not integrated under the theme of political risk. In this respect, the book is an up-to-date reference attempting to answer such questions as the type of protection against political risk that currently exists under international law; what an investor can do to measure political risk in a developing country prior to an investment; what investors can do to protect themselves against political risk once an investment has taken place; and what an investor can do after an event has materialized and has caused damage.

Political risk is broadly defined as the risk that the laws of a country will change to investors’ detriment after they have invested capital in the country, thus reducing the value of their investment. It does not cover the related and important commercial risk that is involved in foreign direct investment (FDI). Commercial risk is defined as the risk inherent in any business venture, such as the risk of low consumer demand, higher than expected manufacturing costs, insolvency of purchasers and cost overruns in production.

According to the authors, the political risk of expropriation appears to have peaked in 1975, with 83 cases of expropriations in 28 different countries, but declined by 50 per cent the following year. Between 1980 and 1985, the rate of expropriation averaged three per year. Since then, according to the authors, many
developing countries have enacted liberal investment codes and have helped to create a network of bilateral and multilateral investment treaties, all of which give some guarantee to an investor contemplating a direct investment in a developing country.

In fact, since the mid-1980s, an overwhelming majority of developing countries have introduced measures to liberalize FDI frameworks, with positive effects on inward investment (UNCTAD, 1998, p. xxvi). These countries have enacted investment laws allowing for the settlement of disputes in a neutral forum using the facilities and procedural rules of arbitral institutions, such as the International Chamber of Commerce and the International Centre for Settlement of Investment Disputes. There have been a number of incentives offered by developing countries to attract FDI, including tax breaks, inexpensive financing and land at reduced prices (UNCTAD, 2000a, p. 3). Changes in government policies on FDI during the late 1990s confirm and strengthen the trend towards the liberalization, protection and promotion of FDI. Most of the restrictions on the ownership of land, real estate, employment of foreigners and foreign exchange controls have been reduced or has been removed totally. In many countries, legal guarantees on the protection of intellectual property rights and against expropriation have been strengthened (UNCTAD, 2000b, p. 7).

However, despite this change of attitudes towards FDI and the concomitant changes in the behaviour of investors, the authors feel that the current trends can change. The host country that welcomes FDI today can turn inward tomorrow, shunning liberal policies and nationalizing foreign interests. According to them, political risk should be a factor considered by any investor contemplating investing in a developing country. It is worth noting that FDI outflows reached a record of $800 billion in 1999, an increase of 16 per cent over 1998. In the same period, developing countries received $208 billion in FDI, which represents 24 per cent of global FDI inflows (UNCTAD, 2000b, p. xvi).

The book is divided into three parts. The first part of this book focuses on passive methods of minimizing risk, i.e. an awareness of the protections available to an investor under both customary international law and through treaties. The other two parts describe actions (contracts, insurance and arbitration) that can be taken by an investor prior to investing and once the investment is undertaken.
Part I of the book, the largest one, discusses the types of political risk affecting property rights of investors. It addresses the state of international law as it relates to political risk and as developed by case law, commentators, state practice and international organizations, including multilateral and bilateral investment treaties containing promises guaranteeing certain standards of treatment to both investors and investments.

Property rights, as used in the book, refer, in civil law terminology, to ownership of property, which comprises three elements or ingredients: usus (the right to use), fructus (the right to the fruits of the property, such as interest or rentals) and abusus (the right to dispose of, or sell, the property). Similarly the common law regards property rights as a “bundle” of rights, the major components of which are the rights to control, possess, use, exclude, profit and dispose of property. An example is provided as follows: for an investor who owns a manufacturing plant, property rights include: ownership of land, the factory on the land, and the inventory and equipment located in the factory; the right to use the factory to manufacture the goods that the investor deems profitable; the right to manage the business as the investor deems proper; the right to sell goods and capital assets; and the right to receive usable currency and to export the currency. Five types of political risk affecting these rights have been identified: expropriation (including confiscation and nationalization), de facto expropriation (including creeping and indirect expropriation), currency risk, the risk of political violence and the risk of breach of contract by the host State. However, the reader is warned that, while these distinctions are useful in understanding the nature of political risk and the various ways it can manifest itself, the lines between these types of political risk are often blurred in actual situations and usually involve elements from more than one of these five categories.

Whether or not actions of a host country result in expropriation is a matter of degree rather than of kind. Many regulations and taxes imposed by a State are lawful exercises of the power of government, but may nevertheless affect FDI. International law does not consider such measures to constitute expropriation because of the “legitimate” purpose behind such laws. For example, while an imposition of a requirement that 10 per cent of the workers be nationals of the host State would probably not be seen under international law as an expropriation, a requirement that 51 per cent of management be appointed by the host State may be an expropriation. Whether or not actions of a State are expropriatory depends upon the impact of such actions.
on an investor’s right to use the property. The form of expropriation, whether direct through violent seizure of assets or indirect through appointment of a manager to run the investor’s partner in a joint venture, is not relevant. The Iran-United States Claims Tribunal largely ignored the question of the intent of the Government of the Islamic Republic of Iran when determining whether or not the appointment of temporary managers of United States investments should be considered expropriations.

Although the point at which regulatory actions by a host State become expropriatory under international law may not always be clear, an investor can attempt to avoid certain potential regulatory actions of a State in an agreement with the State through the use of “stabilization clauses”. According to the authors, stabilization clauses mean that the law of a host State in effect on the date of the contract is the law that will govern the relationship between the parties, regardless of future changes to that law. Investors may also wish to negotiate more specific assurances from the host State regarding particular regulations that they do not want imposed or increased. If an investor is able to attain such assurances, then regulations imposed later in violation of such provisions would be, if not expropriatory, at least a violation of an “internationalized agreement”, which may give rise to a claim for compensation, according to the authors.

While assumption of control over property by a government does not justify automatically and immediately a conclusion that the property has been taken by the government, thus requiring compensation under international law, such a conclusion is warranted whenever events demonstrate that the owner was deprived of fundamental rights of ownership, and it appears that this deprivation is not merely ephemeral. The intent of the government is less important than the effects of the measures on the owner, and the form of the measures of control or interference is less important than the reality of their impact.

An interesting discussion is related to the legal nature of this type of contract between a national of one State and another sovereign State. In this context, many issues arise concerning international law: Can a sovereign State bind itself by contract to an individual or corporation? May the State later breach that contract if necessary for the “public purpose”? Does the investor then have remedies that can be pursued against the State, or should the investor’s home State pursue remedies? If the investor is a corporation, which State is the “home State” under international law?
Under international law, for a host State to take certain action, such as the expropriation of an investor's property without paying compensation, especially if the State has reinforced its “international obligations” in this regard by entering into a binding treaty or contract, the State will at least be reluctant to perform such an unlawful act. Under international law, a State may bind itself to a contract with a national of another State, and this does not infringe upon the sovereignty of the State. A State may engage its “responsibility” for acts that are considered illegal under international law.

After highlighting the main features of government intervention, the authors discuss the question that arises prior to investing: how an investor can measure all risks associated with an investment. A complete analysis of political risk requires the consideration of a number of factors. Of fundamental importance to investors is any treaty between the host State and the investor's home State regarding the protection of investment. These treaties, discussed in detail, are generally referred to as bilateral investment treaties. They usually cover, among other matters, the circumstances under which each State will allow investors from the other State to establish enterprises; whether there will be restrictions on the export of currency; under what circumstances one State may expropriate property of investors from the other State, and how compensation must be paid; and the manner and method of settlement of investment disputes between a State and investors from the other State.

The existence of multilateral and bilateral investment treaties is strong evidence that a State intended (at least at the time of the execution of the treaty) to treat FDI fairly. Furthermore, a State is less likely to interfere with an investor's property rights if such interference would also violate the terms of a treaty, in addition to possibly violating other principles of customary international law. If such a treaty is violated, the investor's home State would be permitted to bring an action against the offending State in an international forum, such as the International Court of Justice.

To facilitate a discussion of international law concepts in this respect, the authors explain in some detail the role of international law. International law has been defined as the body of rules governing the mutual relations of States, and it is founded on certain underlying principles. The first of these principles is that all States are sovereign in their own territory and that “pari parim non habet imperium”, which means that no State could be expected to submit to the laws of another. This finds expression,
for example, in the claims of certain developing States that they have the absolute right to expropriate property of foreign investors located in their territory, and are not bound by any law external to their own with regard to the compensation to be paid to the investor.

The concept of absolute sovereignty is balanced by a set of rules and norms that are derived from the consent of sovereign States and that are said to bind all States. The sources of these rules are international conventions, such as treaties between States; international custom, as evidence of a general practice accepted as law; general principles of law; and, as subsidiary sources, judicial decisions and teachings of the most highly qualified publicists. One such rule is that a State is obligated to pay compensation to a foreign investor following expropriation pursuant to international standards. The concept of sovereignty is recognized, however, in that a State is not prohibited from expropriating property in its territory, so long as certain rules of international law, discussed earlier, are followed.

Another interesting point examined is conformity of the internationalization of a contract to international law, as referred above. The authors appear to favour the conformity of these contracts to international law. Mention is also made of arguments, which seem to be more prevalent, that these contracts are not covered by international law. Even if it is assumed that a State is “bound” under international law for its promises to investors made in an internationalized contract, it does not mean that the State cannot breach the contract — it merely means that the primary consequence of a breach is that the State is obligated to pay compensation in the amount of the value of the contract to the investor.

Reference is also made to European courts that began to develop the doctrine of “restrictive immunity”, by which a State would not be immune to a suit based primarily on its commercial activities. Under this doctrine, a distinction is made between acta jure imperii, which refers to acts of a public authority for which there would still be immunity, and acta jure gestionis, which refers to commercial acts for which States would not be granted immunity. This is reflected in the European Convention on State Immunity, which, although it has not gained widespread acceptance, represents the views of many European States.

Many commentators draw the following conclusion concerning the international law of expropriation: a State may always expropriate property of investors within its borders;
however, for such an expropriation to be “legal”, it must not be discriminatory against the investor, it must be for a public purpose and it must be accompanied by full compensation, which must be prompt, adequate and effective. Thus, an expropriation that is non-discriminatory and for a public purpose is legal, but the requirement of compensation rule makes this legality conditional. An expropriation not meeting these requirements is illegal. Expropriations that are discriminatory, or not for a public purpose, are considered illegal whether or not compensation is paid. This view of the law of expropriation has received considerable support from State practice and the jurisprudence of international tribunals.

While it is generally agreed under customary international law that an expropriating State must pay full compensation following a taking, there is no similar agreement regarding the method of valuing property to arrive at full compensation. Professor Amerasinghe has been quoted to say that “Full compensation has been arrived at by a variety of methods, depending on a variety of factors, including the nature of the property or interests taken and other circumstances relating to the property taken. No preference has been shown for a particular method, such as the discounted cash flow method .... It would seem that the assessment of full compensation is at the present time filled with variables and is certainly not a very scientific process” (p. 97).

Treaty provisions regarding the protection of investment address existing international laws protecting FDI from political risk. The proliferation of bilateral investment treaties and, to a lesser extent, multilateral investment treaties that generally uphold or bolster customary rules of international law protecting investment, is evidence of this trend. These treaties set forth the rules that affect investment by their nationals in each other’s territory, sometimes merely repeating or clarifying rules of customary international law and sometimes adding to such rules.

Part II of the book describes actions that can be taken by an investor to reduce exposure to political risk prior to investing in a developing country. It analyses the various investment projects often undertaken in developing States and then it discusses both structures that can be used to reduce exposure to political risk and contract terms in investor-State contracts that can reduce further such risk. If an investor is able to negotiate directly with a host State to receive “internationalized” contractual assurances containing, for example, a “choice of law” clause,
Choosing international law as the governing law and an international arbitration clause that provides for arbitration of disputes before neutral tribunals, places the investor in a good position to protect the investment, if loss due to government intervention ever occurs, or becomes a serious threat. There is also the possibility of taking up risk insurance. Such insurance typically provides coverage against non-commercial risks, such as currency inconvertibility, expropriation and war, and is available from a number of sources, including nationally sponsored insurance agencies.

Once an investor has decided to invest in a country where political risk may be faced, the investor should begin looking at methods to minimize that risk. This part of the book focuses on affirmative steps that can be taken by the investor to reduce exposure to political risk. It discusses investment insurance and provisions in investor-State contracts that can reduce political risk.

The purchase of political risk insurance is one of the most direct and simplest steps that an investor can take to reduce exposure to political risk. Political risk insurance is similar in many respects to ordinary business risk insurance. It typically provides coverage against political risks, such as currency inconvertibility, expropriation and political violence. Political risk insurance is available from a number of sources, including State-sponsored insurance agencies, such as the United States Overseas Private Investment Corporation (OPIC), private insurers such as Lloyds of London; and a multilateral agency, the Multilateral Investment Guaranty Agency (MIGA).

Almost all developed States sponsor political risk insurance agencies, most of which are members of the International Union of Credit and Investment Insurers, known as the Berne Union. A list of political risk insurers that are members of the Berne Union is provided in Appendix X of the book. The largest State-sponsored insurance agencies are OPIC, Treuarbeit (Germany) and the Export Insurance Division, Ministry of International Trade and Industry (Japan). Together, they represent over 80 per cent of all outstanding national insurance coverage.

Part III of the book describes what an investor can do when threatened with, or after suffering, loss due to government intervention. It mainly addresses how and when to resort to international arbitration. Several forms of arbitration, such as *ad hoc* arbitration using rules promulgated by the United Nations Commission on International Trade Law (UNCITRAL) and
arbitration conducted by the World Bank’s International Centre for Settlement of Investment Disputes (ICSID), are discussed in detail.

Because international arbitration can be time consuming and costly, even when it is more efficient than litigation before courts, a decision to arbitrate should only be made after careful consideration of all other options, such as negotiation, mediation, or conciliation with a host country, diplomatic pressure, or other actions by an investor’s home country. Two forms of arbitration are described that are of particular interest to an investor transacting business with a State: *ad hoc* arbitration under the rules of the United Nations Commission on International Trade Law and arbitration pursuant to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States.

The authors recognize that international law does not provide a complete solution for investors seeking to reduce the political risks of investing in a developing country. The investment climate, including the regulatory framework of the host country, as well as the investment organizational structure, also play important roles. Indeed, the core enabling framework for FDI consists of rules and regulations governing not only entry, but also operations of foreign investors, standards of treatment of foreign affiliates and the functioning of markets. Thus, the political risk is one of the factors that an investor considers when investing in a developing country. What is the most important is to separate political risk from economic development problems, and to ensure that the process of development is understood and addressed adequately in international law dealing with investment issues.¹ It is right to say that a solid understanding of the international law related to political risk by investors will contribute to reducing such risks and will likely play a role in avoiding misunderstandings between investors and host States. This book is a useful contribution in this regard.

Assad Omer

United Nations Conference on Trade and Development
Geneva
Switzerland

¹ For an in-depth discussion on FDI and development issues, see UNCTAD, 1999, part II.
References


While all of the existing multilateral agreements that liberalize and protect investment contain transfer provisions, the features of these provisions vary, depending on the overall purpose of an agreement and the scope of the other obligations that the agreement establishes. Notwithstanding these variations, all of the multilateral agreements permit countries to impose restrictions on transfers in circumstances in which a member is confronted with a balance-of-payments crisis. In regional and bilateral agreements, transfer obligations are comprehensive and, in many cases, detailed. On the issue of balance-of-payments derogations, this paper concludes that, in certain cases, countries may need to rely on them as a complement to their own adjustment efforts and external financial assistance. The inclusion of a balance-of-payments derogation in the draft text of the OECD’s Multilateral Agreement on Investment — generally regarded as a draft agreement that establishes a high standard of investment protection — demonstrates the degree of consensus that has been achieved with respect to this issue.

Environmental protection and related matters have, to date, been rarely mentioned in international investment agreements. This may not be surprising, because the latter might not be considered as the primary instruments with which to address environmental matters. Yet, linkages between environmental concerns and international investment rules do exist, including where there is intent to ensure that investment rules do not frustrate host
countries’ efforts to protect the environment. Moreover, international investment agreements can provide for a framework to encourage the transfer of clean technology and environmentally sound management practices to host countries, which could contribute to development objectives. A number of options exist with respect to the way in which environmental matters could be dealt with in international investment agreements. Firstly, parties could choose not to address environmental protection issues in them, leaving them to other international legal instruments. Secondly, an international investment agreement may include general, hortatory provisions that stress the importance of environmental preservation. Thirdly, specific clauses that affirm or preserve the regulatory powers of host countries with respect to environmental protection could be included in them. Equally, they might contain carve-out clauses for environmental measures. Fourthly, parties could address environmental protection through provisions that oblige them not to lower standards in order to attract FDI. Finally, international investment agreements could include mandatory legal duties, addressed to FDI actors, to observe certain environmental standards, including those related to environmentally sound technology and management practices, which could be provided for, or incorporated by reference, in the respective international investment agreements.

**World Economic Situation and Prospects 2001**
(Published jointly with the United Nations Department of Economic and Social Affairs)

(Sales No. E.01.II.C.2) ($15)

This is a joint report by UNCTAD and the United Nations Department of Economic and Social Affairs on the performance and short-term prospects of the world economy. It provides an update to the more comprehensive *World Economic and Social Survey* (Sales No. E.00.II.C.1, $55.00), which is published each July, and the *World Investment Report* (Sales No. E.00.II.D.20, $49.00), published each September. Chapter I takes stock of the state of the world economy at the beginning of 2001. Chapter II analyzes recent developments and prospects in international trade and investment. Its section on trends examines the strengthening and broadening expansion in international trade. The section on FDI flows notes the record level ($1.1 trillion) reached in 2000, with developed countries taking the lead in the current surge. The
subsequent section examines the main features of cross-border mergers and acquisitions whose share in total mergers and acquisitions reached a new record (30 per cent) in 1999 and 2000. The last section of this chapter analyzes the impact of the cross-border mergers and acquisitions and the policy options to deal with them. It notes that most of the divergences in impact between cross-border mergers and acquisitions and greenfield FDI are to be observed at the moment of entry. In the longer run, except for the impact on market concentration and competition, these differences tend to disappear. Chapter III describes the main macroeconomic developments in the major regions of the world economy in 2000 and their prospects in 2001.

**Measures of the Transnationalization of Economic Activity**
Current Studies, Series A, No. 31

(Sales No. E.01.II.D.2) ($20)

This study first provides an overview of conceptual issues relating to the measurement of transnationalization and discusses the advantages and drawbacks of different measures. Then, using a variety of such measures, it analyzes trends in transnationalization for a number of economies: Canada, Germany, Japan, Netherlands, Republic of Korea, Singapore, Sweden, Switzerland, Taiwan Province of China, United Kingdom and United States. While the overall degree of transnationalization of the global economy is increasing, there are important differences in the process and phases of transnationalization among the various economies examined. The most notable difference is the decline in the contribution of developed countries to the transnationalization of the global economy, while the importance of developing countries as outward investors is increasing.

**Tax Incentives and Foreign Direct Investment: A Global Survey**
ASIT Advisory Studies No. 16

(Sales No. E.01.II.D.5) ($23)

This study looks at the paradox that, while the efficacy of
incentives in promoting FDI is often questioned, countries increasingly resort to them. It is based on a survey of the tax incentives – one of their most popular forms – in over 45 countries from all regions of the world. Nearly all countries surveyed offer incentives that target specific sectors. Regional incentives aimed at assisting the economic development of rural or underdeveloped areas are also prevalent in nearly 70 per cent of the countries surveyed. Consistent with the aim of increasing foreign currency earnings, there is also a clear trend towards the development of export incentives. The analysis in this book also throws light on other issues such as design considerations, the importance of proper administration of incentives and home-country measures that increase the efficacy of tax incentives offered in host countries. Policy makers will find the study a useful tool in the design, implementation and administration of incentives.

**Investment Policy Review: Mauritius**

(Sales No. E.01.II.D.11) ($22)

The UNCTAD Investment Policy Reviews are intended to help countries improve their investment policies and to familiarize Governments and the international private sector with these countries’ investment environment. FDI has played a small but pivotal role in the economic success story of Mauritius. In 1970, it was the first African country to enact an Export-processing Zone Act. These zones attracted small Asian investors to locate textile and garment manufacturing there, while benefiting from preferential access to European and United States markets. Indeed, Mauritius has been one of the few countries to deploy FDI successfully to maximize the opportunities of preferential trade status, notwithstanding limited supply capacities and remoteness from world markets. FDI is also important in tourism, another pillar of economic prosperity. In the 1990s, Mauritius entered the league of outward investors, following a “flying geese” pattern. Now a middle-income country, Mauritius faces the challenges of a mature developing economy, such as rising labour costs. Whether the country will be able to move to the next stage of development or not will depend on its ability to shift more forcefully into higher value sectors, including financial services, business services and information technology.
The 2000-2001 Annual Report of the World Association of Investment Promotion Agencies (WAIPA) has been prepared as a background document for the WAIPA VI General Assembly Meeting in Geneva, Switzerland. It includes an overview of WAIPA activities, a directory of WAIPA members and a copy of the Association& Statute. In January 2001, WAIPA had a total membership of 113 agencies. According to its Statute, “membership of WAIPA shall be open to all agencies whose primary function is to promote any country or territory for investment”. A limited number of copies is available free of charge upon request.
Books received on foreign direct investment and transnational corporations since December 2000


Bureau of Economic Analysis, *Dvustoronniye soglasheniya Rossiyskoy Federatsii s zarubezhnymi stranami o pooshchenii i vzaimnoy zashchite kapitalovlazheniy* [Bilateral Treaties of the Russian Federation with Foreign Countries for the Promotion and Mutual Protection of Investments] (Moscow: Yuridicheskaya Literatura, 2000), 432 pages.


Submission statistics

Figure 1. *Transnational Corporations*: breakdown of manuscripts as of 31 December 2000

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Figure 2. *Transnational Corporations*: breakdown of manuscripts since inception

![Submission statistics bar chart]
GUIDELINES FOR CONTRIBUTORS

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