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The special issue on FDI and multinational corporations: an introduction

Philipp Harms and Konstantin M. Wacker

Abstract

This paper offers an introduction to the special issue on FDI and multinational corporations. It summarizes the contents of the five papers included, and relates them to the recent literature on the subject.

(Published in Special Issue [FDI and multinational corporations](#))

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Foreign direct investment (FDI) is a key category of international capital flows that largely reflects investments of multinational corporations. According to the most recent vintage of Lane and Milesi-Ferretti's (2017) dataset on the "external wealth of nations", FDI stocks accounted for 29 percent of global cross-border liabilities in 2015. In more than a third of countries, FDI is the source of over 50 percent of foreign financing. According to UNCTAD data, global FDI flows roughly quadrupled from about half a percentage point of world GDP in the 1980s to about 2 percent of world GDP in recent years. The number of academic articles on the subject even increased at a faster pace than actual FDI flows (Wacker, 2013).

However, it is not only its quantitative importance, which makes the study of FDI relevant for both researchers and policymakers. It is also the multifaceted and potentially inter-disciplinary nature of the topic. This insight induced us to organize the *Mainz Workshop on FDI and Multinational Corporations*, which has been taking place annually at Johannes Gutenberg University Mainz since 2015, and it is the motivation for this special issue of *Economics*. Without claiming to be comprehensive, this introduction will provide a short overview of the special issue, relating its contributions to the overall research on FDI and multinational corporations.

Historically, the theory of FDI is deeply rooted in the theory of industrial organization (see Antràs and Yeaple, 2014 for a recent survey). The contribution of **Onur Koska** (2019) to this special issue can be seen in the context of this literature. Koska analyzes how government regulation in the form of a minimum output requirement affects foreign companies' choice of market entry – in particular, the choice between acquiring a domestic firm and serving the domestic market through exports. Explicitly modeling firms' strategic interaction, the author demonstrates that an appropriate use of the regulatory tool tilts foreign companies' decision towards acquisition and raises domestic welfare. The latter result may seem counter-intuitive at first, since foreign acquisition is likely to reduce competition on the domestic market, lowering consumer surplus in a Cournot oligopoly. However, the minimum output requirement catches two birds with a stone: it avoids a decline in supply, and it positively affects the price that foreign companies offer in order to acquire the domestic firm. As a consequence, an "acquisition-cum-regulation package" is preferable to unregulated market entry or to completely protecting the domestic market from foreign competition. The theoretical analysis of Koska's paper contributes to a strand of literature that focuses on the organizational arrangements chosen by firms to enter foreign markets: exports vs. arms-length interaction with other firms vs. greenfield FDI vs. foreign acquisition. The paper

abstracts from information asymmetries and enforcement problems, which are likely to be much bigger for cross-border transactions than in a purely national context. Combined with the strategic interaction modeled by Koska, these features raise the complexity of firms' decisions and demonstrate the necessity of thoroughly analyzing the effects that any policy intervention might have.¹

While the microeconomic perspective on FDI highlights individual companies' strategic choices and the interaction between different firms, a large part of the macroeconomic literature considers FDI an international investment: as such, the activities of multinational corporations potentially raise host countries' per-capita income by raising the capital stock and total factor productivity.² Sure, the recent literature in this field has increasingly moved towards studies using firm-level data, mostly investigating ownership effects on productivity (e.g. Javorcik and Poelhekke, 2017) and their spillover to local firms (e.g. Fons-Rosen et al., 2018). But as Alfaro (2017) stresses in a recent policy survey, complementary macro studies are still important to highlight effects that may be beyond the firm level. The contribution of **Nouha Bougharriou, Walid Benayed and Foued Badr Gabsi** (2019) to this special issue follows this line of thought: while the main focus of their empirical analysis is on the growth effects of democracy in Arab countries over recent years, FDI plays an important role in their argument. More specifically, the authors argue and provide evidence that democracy had an ambiguous influence on growth for this group of countries between the years 2002 to 2013: on the one hand, it dampened growth by raising public consumption. On the other hand, however, it made countries more attractive for foreign companies, and the resulting FDI inflows had a positive effect on growth.

The important influence of the constitutional framework identified by Bougharriou et al. is reminiscent of previous results by Harms and Ursprung (2002), Busse and Hefeker (2007), Asiedu and Lien (2011) as well as Wisniewski and Pathan (2014), and indicates that institutional and political features of host countries are no less important in attracting multinational corporations than purely economic factors. This, in turn, illustrates that the analysis of FDI often requires an interdisciplinary approach, both when it comes to understanding the forces that enhance or dampen investment flows, and when it is about the

¹ Breinlich et al. (2017) provide a recent survey of the issues involved in merger policy.

² Borensztein et al. (1998), Alfaro et al. (2004), Herzer et al. (2008) and Harms and Méon (2018) analyze the empirical effects of FDI on economic growth. See also Blonigen, (2005) for a survey, and Iamsiraroj and Ulubaşoğlu (2015) for a meta-study on the FDI/growth-nexus.

aggregate, distributional, and social consequences of foreign direct investment.³

The paper by **Abeliansky and Martinez-Zarzoso** (2019) also adopts a macroeconomic perspective on FDI's effects, addressing a highly relevant policy aspect: China's "Going Out" strategy that intended to promote Chinese FDI abroad. What effect does this increased outward FDI have on China's trade with the respective FDI host economies? This question concerns the fundamental question of the interaction between FDI, strategies of multinational firms, and the structure of trade. The authors find evidence of Chinese FDI being positively related to trade with the respective host economies, at odds with the predominant view that FDI is mostly horizontal in nature and hence a *substitute* for trade. How much of that is specific to the fact that China is one of those emerging economies that have become an increasingly important source of FDI in the world economy? Is FDI of these countries particularly vertical in nature? Does it simply reflect political priorities of China's economic diplomacy?⁴ Or could a complementarity of trade and FDI also arise in a horizontal model with informational frictions, where one mode of entry lowers the information costs for another?⁵ The variety of questions arising from the findings of Abeliansky and Martinez-Zarzoso once more highlights the multi-faceted nature of FDI research.

Another policy-related aspect that is gaining a lot of public attention is the taxation of multinational firms. The paper by **Castillo-Murciego and López-Laborda** (2019) in this issue focuses on the role of double taxation treaties (DTTs) and investigates how such treaties have influenced Spain's inward and outward FDI over two decades. They find a positive relation between DTTs and FDI from and to Spain. But probably even more interestingly, their detailed analysis reveals quite some heterogeneity and sensitivity to the sample investigated. The authors conclude that "a further investigation of the content of DTTs and that of the internal law of countries is needed". This echoes recent findings in Davies et al. (2018) that there is a difference between the effects of a (quantifiable) corporate tax rate and the (rather qualitative) effects of being a tax haven on FDI. The new Electronic Database of Investment Treaties provided by Polanco Lazo et al. (2018) at WTI may provide a promising tool for further research on those aspects.

³ In a recent analysis of responses given within the International Social Survey Programme (ISSP), Harms and Schwab (2018) identify the individual and country-specific factors that determine individuals' attitudes towards multinational enterprises.

⁴ See Dreher et al. (2018) and Fuchs (2018) on this issue.

⁵ For the role of information frictions for FDI see especially Harding and Javorcik (2011) and Hashimoto and Wacker (2016).

Certainly, this special issue cannot provide a comprehensive picture of recent developments in the FDI literature. Apart from the absence of firm-level studies mentioned above, there are many other strands of literature that have bloomed in recent years and that we do not cover, including the financing aspects of multinationals (Foley and Manova, 2014; Manova et al., 2015), the labor market effects of offshoring (Baumgarten et al., 2018), the role of cultural distance for firm internalization strategies (Beugelsdijk et al., 2018), or the role of FDI in international diversification (Albuquerque, 2003; Fillat et al., 2015) and business cycle transmission (Cravino and Levchenko, 2017).

Is all this research enthusiasm and effort worth it? Is FDI a phenomenon that will still be around in the years to come, or do multinational corporations follow a business model whose time has come? In a recent cover story, *The Economist* (2017) painted a rather gloomy picture, documenting the worsening performance of firms operating in different countries and diagnosing the demise of the multinational corporation. In his contribution to this special issue, **Ron Davies** (2019) addresses this question, arguing that, while the volume, composition, and character of FDI may change, cross-border investment will play an important role for the foreseeable future. This, in turn, guarantees that the topic will keep its relevance both for research and for policymaking.

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