

## Changing Nature of FDI: Need to Re-examine the Productivity Spillovers

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This note argues that the nature of foreign direct investment (FDI) flows have changed drastically in recent decades and consequently the theories developed earlier during the second half of the 20<sup>th</sup> century and the testing procedures adopted to analyse productivity and technology spillovers from FDI needs to be re-examined.

Literature on FDI spillovers were developed in an era when multinational enterprises (MNEs) invested mainly in manufacturing. It was assumed that MNEs enjoyed huge productivity advantages compared to host country firms and the MNEs enjoyed higher productivity levels. The host country firms enjoyed productivity spillovers from MNEs depending on the firm characteristics. The literature was also mainly developed in the pre-WTO regime and before the advent of the information technology (IT) revolution. During that period transaction costs in transferring intangible assets like technology and knowledge were very high due to lack of intellectual property protection and information about the host country firms were difficult and time consuming to obtain. This resulted in huge internalisation advantages. In the last few decades transaction costs have come down drastically due to better intellectual property rights (IPR) protection and the web revolution has reduced the cost of obtaining information about the host country firms. This has opened out the options of outsourcing of designing and production and technology licensing (Chen 2010). FDI would take place only if the transaction cost of using market for both R&D and production of output is high.

Furthermore, in recent times the share of manufacturing in FDI flows has come down drastically. Currently most FDI is in services. It is not clear whether theories developed for the manufacturing sector could be used for services. It is difficult to identify intangible assets, ownership advantages and internalisation advantage in the case of services in general and non-financial services in particular. Some studies argue that for sophisticated financial services the Ownership-Location-Internalisation (OLI) paradigm could be used (Ramasamy and Yeung 2010). They certainly cannot be used for other services. Currently other services have an important place in FDI flows. Some studies also show (Dytch and Uctum 2011) that FDI in services in general and non financial services in particular harm the manufacturing sector and likely to lead to deindustrialisation.

The share of technologically advanced countries in FDI has also come down. For countries like China and India the share of tax heavens in FDI inflows has been substantial indicating round tripping. Studies show (Rao and Dhar 2011), that for India more than 70 per cent of FDI inflows were from tax heavens and their share in manufacturing is insignificant. They were mostly in non financial services like real estate and construction.

The manufacturing base has shifted to Asia from Europe and the US. In several Asian countries and in many manufacturing sectors the host country (Asian) firms are in the productivity frontier enjoying higher level of productivities compared to MNEs. Earlier, mostly developed country MNEs were on the frontier. In the changed circumstances the spillovers from MNEs to host firms does not make sense when the MNEs are not in the productivity frontier. Hence, there is a need for re-examination of the theory and methodology.

The developed countries MNEs still enjoy enormous advantage in R&D and designing but not in actual production. They outsource manufacturing.

In the long-run innovative firms from developing countries cannot depend only on spillovers to emerge globally competitive. Instead they should evolve strategies to emerge as global leaders in their own right. For example, successful Indian firms did not wait for spillovers to take place. They had a positive strategy to tackle the entry of foreign firms with advanced technology. Some Indian firms entered into a series of non-equity strategic alliances with several MNEs and Indian firms. Such strategic alliances seem to have enabled these Indian firms to enhance their productivity and emerge competitive in several sectors like IT, automobiles, electronics, drugs and pharmaceuticals. Several of the Chinese and Indian firms have graduated to be MNEs.

Currently several developed country MNEs have their presence in Asian countries not only to exploit their home based intangible assets but also to benefit from the environment of countries that have become important manufacturing hubs. For example, during late 20<sup>th</sup> century, several US firms adopted the Toyota practices in particular, just-in-time delivery practices. In the literature on FDI in R&D, the concept of home based exploitation (HBE) strategy and home base augmentation (HBA) strategy has been developed and used successfully (Ito and Wakasugi 2007, Kummerle 1999, Kurokawa et al. 2007). It would be useful to employ some of these concepts in analysing productivity spillovers.

**In sum**, the hypothesis based on superior productivity performance of MNEs spilling over to host country firms needs re-examination as

- Currently manufacturing sector does not dominate FDI flows
- In Asia several Asian (host country) firms enjoy higher productivities compared to MNEs
- In many countries FDI inflows are dominated by flows from tax heavens perhaps due to round tripping
- Due to drastic reduction in transaction costs enterprises tend to outsource different stages of product development like R&D, designs, fabrication of components and assembling of components to different firms in different countries.

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