

***THE HOME COUNTRY EFFECTS OF FDI
IN DEVELOPED ECONOMIES***

by
Ari Kokko

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Postal address: P.O. Box 6501, S-113 83 Stockholm, Sweden. Office address: Sveavägen 65
Telephone: +46 8 736 93 60 Telefax: +46 8 31 30 17 E-mail: japan@hhs.se Internet: <http://www.hhs.se/eijs>

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Ari Kokko
European Institute of Japanese Studies
Stockholm School of Economics
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Abstract

This paper surveys the effects of outward foreign direct investment on the developed home countries of multinational corporations. The focus is on the production interactions arising from outward investment – what is the impact on home country exports and production structure – but the paper also discusses effects on investment, the balance-of-payments, technology and knowledge, and political decision-making in the home country. The main conclusion is that outward FDI is beneficial to the investing firm, but that the effects on the home country vary depending on the characteristics of the investment project and the business environment in the home and host countries. In most cases, there is only a small impact on total exports and production in the developed home countries, but the net effect on employment may be mildly negative. This is related to a shift in production structure, whereby labor intensive activities are outsourced to host countries with lower wage levels, and more advanced operations are kept at home. Most home countries encourage outward investment, but the fear for negative effects (particularly on the balance-of-payments) has at times motivated restrictions on FDI. The final part of the paper discusses effects on developing home countries, and notes that these are likely to coincide with the effects on developed home countries. One exception is technology-sourcing investments, which may be more important than in developed home countries, and which may, at least in theory, provide an alternative to inward FDI as a source of technology for the more advanced developing economies.

Key Words: FDI, MNCs, home country effects

JEL Codes: F23, F10

1. Introduction

The discussion about the effects of foreign direct investment (FDI) on the home countries of multinational corporations (MNCs) has re-emerged in the international debate during the past decade. The global liberalization of trade and investment after the completion of the Uruguay round – not least the Chinese membership in the WTO – and the regional integration processes in Europe, the Americas, and the Asia-Pacific region are important reasons for this resurgence of interest. The reduction of trade and investment barriers has created new, large markets and removed restrictions on where plants can be located. The response has been a global boom in FDI that was only temporarily interrupted by a reduction in investment flows to emerging markets in connection with the Asian crisis in 1997-1999. The annual number of cross-border investments in Europe exceeds 10,000, and both China and the US attract thousands of FDI projects every year. After a turbulent period following the collapse of the Soviet Union, inflows to Russia have accelerated. In recent years, India has become an important destination for FDI, and several other Asian countries record substantial inflows. Both West Asian and African countries can be found among the economies with the fastest increases in inward FDI (UNCTAD 2006).

In contrast to the situation a decade ago, several developing countries have now appeared among the foreign investors. Brazil, China, India, South Africa, and Malaysia are only some examples of developing countries where local companies have created sufficient intangible assets to become multinational. However, while developing countries have been the subject of numerous studies focusing on the effects of inward FDI, there is little evidence on how they are affected by outward investment. The purpose of this paper is therefore to provide a selective overview of the home country effects of foreign direct investment in developed economies and to discuss how the effects in developing home countries are likely to differ from this. The focus will be on production interactions between the foreign and domestic operations of multinational firms, although some other effects will be discussed as well. These interactions occur because FDI typically affects the MNC's home country operations. The most common question in this context has concerned the impact of outward investment on home country exports: does the establishment of a foreign affiliate substitute for home exports and jobs in the home country? Another question that has received some attention in recent years is how FDI affects the structure of home country production.

A large part of the discussion draws on evidence from the US and Sweden, for good reasons. Both countries have systematically collected data on the outward investments by national corporations since the 1970s, facilitating detailed analysis at the macro level. Moreover, MNCs occupy dominant positions in both economies, accounting for most of manufacturing employment, exports, and research and development (R&D) outlays.¹ Section 2 starts with a discussion regarding the motives for outward investment, to identify some of the expected effects on the investing company (the parent company) and the home country. Section 3 looks at the evidence regarding the effects of FDI on home country exports, Section 4 examines the effects of FDI on industry structure in the home country, Section 5 discusses some other home country effects of FDI, Section 6 summarizes some of the policy responses to outward FDI, and Section 7 concludes by discussing whether the effects on developing home countries can be expected to be similar.

2. Motives for foreign direct investment

The earliest theories of FDI, dating to the 1950s, saw cross-border investments mainly as transfers of capital between countries (Macdougall 1960). The main motives for these capital flows were thought to be related to cross-country differences in capital returns. Capital was abundant in rich countries (read the US), the best investment opportunities were already exploited, and the marginal return to capital was therefore low. Poorer countries (read Western Europe) still had unexploited investment opportunities and a higher return to investment. By moving their investments from richer to poorer countries, capital owners could exploit these cross-country differences in returns.. The main impact of FDI on the home country was also believed to be related to capital flows, both in terms of investments (with foreign investment substituting for domestic investment) and balance-of-payments effects (with initial capital outflows to finance the foreign investment project and subsequent inflows of capital in the form of repatriated profits). Similar arguments were made on the basis of differences in the cost of labor and other inputs, as well as differences in returns related to tax rates, tariffs, and other kinds of government interventions (Horst 1971, Caves 1996).

¹ However, as Lipsey (2002) notes, there has been a reduction in the share of locally-owned MNCs and an increase in the share of foreign-owned multinationals in both the US and Europe as a result of internationalization.

One of the weaknesses of the early theories was that they predicted reductions in FDI flows as a result of convergence in capital returns, labor costs, and regulations. However, in reality, FDI flows increased as the European economies converged towards US levels during the 1970s and 1980s. New theories were needed, and these came to focus on organization rather than international capital flows. The main questions were no longer related to factor movements but to why companies wanted to extend their activities across international borders and why they sought to control foreign production or service operations? The answers focused on the exploitation of firm-specific intangible assets (Hymer 1960, Buckley and Casson 1976). Different business activities are linked by flows of intermediate products, embracing not only ordinary semi-processed materials, but also knowledge and information in the form of technological know-how and skills embodied in goods and human capital. Some of the links can be based on market transactions, but external markets are often inefficient, especially with regard to transactions in intermediate products that embody firm-specific intangible assets related to knowledge, technology, organization, management skills, or marketing skills. This is because specification and pricing of these assets is particularly difficult. Moreover, external markets in knowledge intensive products are difficult to organize and usually do not cover the multiple eventualities that transactions in information give rise to. When external markets do not exist, or when the costs of operating in them are higher than the benefits, there are incentives for the MNC to develop its own internal organizational structure to achieve internal coordination of activities. This “internalization” may stretch across international borders, explaining the existence of multinational firms and FDI.

Arguing that internalization alone could probably not explain all cases of foreign direct investment, Dunning (1980) proposed an eclectic approach in order to provide a more comprehensive explanation for the phenomenon. According to Dunning, international production is the outcome of a process in which ownership, internalization and localization advantages work together. The ownership advantages are firm specific in the sense that the firm has control over them. They embrace patents, know-how, labor skills and other forms of superior production technology, control over markets and trade monopolies, scale advantages, managerial capabilities, and so forth. These factors determine the firm’s competitive position in relation to other firms. The internalization advantages arise from the existence of market imperfections, as discussed above. They explain the firm’s reluctance to engage in licensing

agreements or other market-based transactions that involve intangible assets. Location advantages are those associated to the availability of inputs for all firms established in a certain country. They comprise natural resources, location, cultural and political environment, factor prices, transport costs, but also government policies such as trade barriers (quotas, tariffs) and local content requirements. These circumstances explain why a firm may decide to undertake production abroad instead of producing for export from the home country.

Thus, the dominant view in theory is that in order to compete successfully in a foreign market, a firm must possess some ownership-specific assets. These assets allow the firm to bear the extra costs of operating in foreign countries, where local firms typically benefit from better market knowledge and contacts with local decision makers. Since they also distinguish multinational firms from non-multinational companies, they are likely influence some of the effects of FDI on home as well as host countries. Unlike the early studies on FDI, the current debate rarely identifies capital abundance as a strong firm-specific asset: the internationalization of financial markets probably means that few of the leading home or host countries will be strongly influenced by the effects of FDI on total investment amounts.² Consequently, the expected effects of FDI are rarely limited to the impact on investment amounts or the balance-of-payments.

Since the decision to engage in FDI is typically a voluntary decision, it can be assumed that FDI benefits the MNC (although there is a vast literature noting that the expected synergy rents from mergers and acquisitions – which are nowadays the dominant form of FDI – do not always materialize). More specifically, it can be expected that the MNC will grow larger than what would have been possible if it had remained a purely national firm (especially if the home country's domestic market is of limited size). This is a great advantage in industries with substantial fixed costs, e.g. related to capital requirements, technology, or marketing. Larger firms are able to distribute their fixed costs across a larger production volume, so that average cost can be reduced. Moreover, the possibility to exploit international differences in factor endowments and factor costs allows vertically integrated MNCs to reduce their production costs in comparison with firms that are limited to operating in a single national market, with one set of factor prices. A similar argument can be made regarding tax rates and

² It is possible that this generalization does not apply for the group of least developed countries that does not have access to international capital markets. However, they are not home to many MNCs, nor do they figure prominently among the main host countries.

subsidies. The MNC can allocate its operations across international borders to take advantage of low taxes or generous subsidies – it may even have opportunities to use transfer pricing to shift its profits to the locations with the lowest tax rates. Hence, even taking into account the fact that the transactions costs related to multinational operations are substantial, MNCs have a potential to be more profitable than purely domestic firms. Moreover, this assessment applies even if FDI leads to leakages of technology or other assets to competitors abroad. Since these assets are private goods, the MNC will internalize the costs from any losses, and only make the foreign investments if the net effect is beneficial.

The same positive prediction does not automatically apply for the effects of FDI on the home country of the foreign investor. It is clear that the increase in profitability related to FDI may have some effects in the home country, and a number of studies have concluded that internationalization typically strengthens the MNCs' domestic market position and the firm characteristics that made it possible to undertake FDI in the first place (see e.g. Cohen, 1972, Pagoulatos and Sorensen, 1976, Bergsten, Horst, and Moran, 1978, Hirshey, 1982, and Benvignati, 1983). However, it is not obvious that this is to the benefit of the home economy: while higher profits and increased R&D are positive contributions, it is possible that higher market power may well result in higher consumer prices and welfare losses. Furthermore, since the MNC has production facilities in several countries, it has substantial freedom to decide how to allocate the various gains of its international operations. It should also be noted that many factors that appear as costs to the MNC may be considered as benefits by the host and home countries. The clearest example may be tax payments: while the MNC does not necessarily care much about where it pays its taxes (as long as they are suitably low), it does matter for the country that receives the taxes. Similarly, labor and other inputs sourced from different countries may be perfect substitutes for the MNC, but neither the home nor the host countries of the corporation are indifferent regarding the location of employment and purchases of intermediates.

These distinctions between the firm and its country of origin provide good reasons to explore in closer detail how the production decisions of the MNCs affect their home countries. This is not a simple exercise, since the character of FDI varies across firms and countries, presumably affecting both the behavior of firms and the effects in home countries. One reason is that the operations in the MNCs' foreign affiliates can have several alternative relations to

the home country operations of the corporations. From the perspective of exploring the home country effects, it may be most relevant to distinguish between horizontal and vertical FDI. The former seeks to exploit the existing advantages of the MNC, while the latter augments the advantages of the corporation, exploiting lower factor prices abroad or reducing transactions costs by internalizing upstream or downstream activities (i.e. raw material supplies or marketing channels). A special case of vertical FDI that has recently been discussed concerns technology seeking investments that aim to gain access to existing intangible assets or the capacity to create such assets in the future.³ At first glance, such investments may seem to be exceptions from the rule that the investing firm needs some intangible assets to become multinational: the idea may even be to access technologies and knowledge needed to establish entirely new types of activities. However, it is likely that nearly all technology seeking investments are made by firms that possess some firm specific advantages that allow them to pay a price that exceeds the reservation cost of the initial owner of the assets. These advantages may, for instance, be related to specific market knowledge about the home market, where the technology is to be used. The exceptions are likely to be related to cases where the investing company is subsidized by its government, or where the objective of the investment is something else than higher profitability.

Some other distinctions between different types of FDI may also be relevant. For instance, there may be differences between greenfield affiliates (that are established by the investing MNC) investments and affiliates established through the acquisition of existing production units in the host country. It is possible that effects differ between manufacturing and services. The relation between the source country and the home country – in terms of trade policies, factor prices, transport costs, and industry structures – may be important. The time dimension may matter, with different effects in the short run and in the long run. Although some of the implications of these distinctions can be determined *ex ante*, it is not possible to make any strong generalizations on the basis of theory alone. Instead, it is necessary to examine the available empirical evidence to see what generalizations are feasible.

3. Effects of outward FDI on home country exports

³ These investments are sometimes categorized as “strategic asset seeking FDI” (Dunning and Narula 1995) or “home base augmenting FDI” (Kuemmerle 1997).

The question that has been discussed most frequently in the home country debate is whether production abroad complements or substitutes for exports by the parent company or by other firms in the home country. In this debate, exports have often been used as a synonym for domestic production, investment, or employment, although it should be noted already at this point that the employment effects are likely to differ from the export and output effect. The reason is that the exports and output may well increase without any simultaneous increase in employment if there are structural effects, e.g. related to productivity or capital intensity. The debate has re-emerged from time to time, without definite conclusions, because of two complications. A first problem is that the net impact of FDI on home country exports (or production and investment) cannot be determined theoretically, since it combines several separate effects that are sometimes of opposite signs. On the one hand, it is clear that most forms of FDI, both horizontal and vertical, replace some previous home country production and exports. On the other hand, FDI also tends to promote exports of intermediate goods from the parent company or various home country suppliers to the new foreign affiliates: not even purely horizontal affiliates are likely to manage all their operations independently. The net impact of these two effects is likely to vary from case to case, depending particularly on how total sales are affected by the foreign direct investment decision. Looking specifically at horizontal FDI, what matters is the increase in foreign sales resulting from the establishment of a foreign affiliate. The larger the increase in foreign sales, the more likely it is that the export loss in terms of finished goods can be compensated for by an increase in the export of intermediate goods to the affiliate. Although the export substitution debate has rarely focused on vertical FDI, similar arguments can be made about the employment or investment effects of such projects. A vertical FDI venture typically replaces some production that was initially located in the home country, but the net effect on domestic employment depends on how the investment affects the MNC's total sales. By exploiting lower factor costs abroad, the vertical investment makes the MNC more competitive at home as well as abroad. If this increase in competitiveness reduces imports or raises exports, it may create sufficient new employment to compensate for the initial replacement effect. In addition, it is possible that the presence of MNC affiliates abroad facilitates the diffusion of information about other producers from the home country, with positive export and employment effects as a result. Hence, the net impact of outward FDI on domestic production and exports is largely an empirical question.

A second problem is that it is hard to judge what would have happened to exports, employment, and investment if the MNCs had not been able to invest abroad. This is a particular problem if empirical results suggest that outward investment has been followed by job losses in the home country. Would the MNCs have been able to maintain (or even increase) the market share they had carved out exporting from the home country, or would they have been driven out of the market by their foreign competitors, leading to a reduction in home country exports and employment even without FDI? Similarly, would the MNC engaging in vertical FDI have been able to maintain its market share and output volume without foreign production, or would a decision to remain in the home country have led to weaker competitiveness?

The empirical literature on the export substitution question has been addressed by business-oriented analyses as well as econometric studies at different points in time in several countries, which means that there is quite some variation in methodology and generality of results. Typically, the more business-oriented or case-oriented authors have attempted to examine what would have happened in specific cases if investment abroad had not been possible, whereas the econometric studies have tried to detect the overall relationship between FDI and home country exports in larger samples of firms or industries.

The results of the business-oriented analyses are mixed. Some of the earliest contributions, like Stobaugh et al. (1972) for the US and Jordan and Vahlne (1981) and SOU (1981a and 1981b) for Sweden, concluded that foreign direct investment had positive effects on home country exports and employment, because the establishment of foreign affiliates typically resulted in large increases in foreign market shares and exports of intermediate products to affiliates. Foreign production was judged to be particularly beneficial for low-technology products with high transportation costs. However, the results rested on very specific assumptions about export survival rates, i.e. the fractions of the affiliates' market share that could have been served by home exports: in both the Swedish and US cases, it was assumed that most of the foreign markets would have been lost in the absence of FDI.

These assumptions were criticized by e.g. Frank and Freeman (1978:9), who noted that they were largely based on surveys and interviews with company officials who were interested in "portraying their foreign activities in as favorable a light as possible vis-à-vis their impact on

the domestic economy”. Arguing for a more “neutral” approach, they therefore used a model of the US economy to estimate survival rates from data on costs and revenues. Their calculations suggested survival rates ranging between 20 and 40 percent, depending on the industry. This implied that foreign direct investment substituted for US exports and that the net employment effect of FDI was negative. In a critical comment, Bergsten, Horst, and Moran (1978) questioned the “neutrality” of the modeling approach used by Frank and Freeman (1978), and presented alternative estimates showing a complementary relationship between outward investment and US exports. The discussion about what is the appropriate counterfactual remains one of the core questions in the case-oriented studies, and later contributions have suggested more sophisticated ways to estimate what would have happened in the absence of FDI. In one of the most recent contributions to this strand of literature, Barba Navaretti and Castellani (2004) uses propensity score matching to identify a group of Italian non-multinational firms that are compared to a group of Italian outward investors. Their results suggest that FDI had no significant effect on Italian employment (although it raised productivity growth and output). It is likely that this debate will continue, probably with mixed results depending on assumed survival rates.

The problem of assessing survival rates and counterfactuals does not usually come up explicitly in the more aggregated econometric studies. Instead, these typically employ regression analysis to determine the relation between exports and various firm, industry, and country characteristics controlling for as many other determinants as possible, the focus is on the partial effect of foreign direct investment (measured e.g. as the stock of foreign assets or the value of foreign production). A negative coefficient for FDI implies that foreign production substitutes for exports, whereas a positive sign suggests that complementarity – the stimulus to home exports of intermediate and other related products – is more important in aggregate. It can be noted that most early US studies of this type, including Horst (1974), Bergsten, Horst, and Moran (1978), Kravis and Lipsey (1988), and Lipsey and Weiss (1981 and 1984) concluded that the complementarities tended to outweigh the substitution effects. Later studies, like Brainard (1997), have reached similar overall conclusions.

Yet, there are differences between the competitive advantages and market conditions of multinationals from different economies, and it is probably not safe to generalize the results from the US. In particular, it is likely that there are differences between MNCs from large and

small economies. While American firms have good opportunities to grow in their large home market before they become multinational, firms from small home countries have to take the step to multinationality at a much earlier stage of their development. Moreover, most American MNCs remain highly dependent on their home market, while MNCs from small countries often have the bulk of their sales and employment outside the home economy. The results from smaller countries like Sweden are therefore highly interesting (and perhaps more relevant for developing economies that are becoming outward investors).

The most comprehensive econometric analyses of the Swedish FDI-trade relationship are presented in Swedenborg (1979, 1982, 1985, and 2001), Blomström, Lipsey, and Kulchycky (1988), and Svensson (1996). The studies are all based on a detailed data set on Swedish multinationals collected by the Industrial Research Institute (IUI) in Stockholm, but there are significant differences regarding the specific time period and the methodology used. Yet, most of these studies conclude that there is no relation, or a small positive relation, between outward FDI and home exports. The exception is Svensson (1996), who focuses on the developments during the late 1980s and early 1990s. In particular, he argues that it is necessary to account for the foreign affiliates' exports to third countries, because they are likely to substitute directly for parent exports. Doing this, he finds substitution between Swedish investment abroad and exports from Sweden. However, the quantitative impact is relatively small. Another possible explanation for divergence between Svensson (1996) and earlier authors could be that Swedish MNCs have increasingly relied on mergers and acquisitions rather than greenfield investments as their mode of foreign market entry. Since acquired affiliates already have local suppliers and subcontractors, they are less likely to need inputs from the home country, at least in the short run.⁴ Hence, the complementarity between Swedish exports and FDI may have declined over time.

⁴ Thinking more about the time dimension reveals some of the complications in trying to generalize the effects of FDI. For instance, in the long run, it is possible that horizontal and vertical FDI will have different effects. While a successful vertical investment may establish a beneficial long-term relation between the affiliate and the parent, it is more unclear what can be expected from horizontal M&As. If plant level economies of scale are important and there is free trade between the home and the host country, the MNC may have strong long-run motives to concentrate production to either country. The impact on the home country would obviously depend on whether it is the affiliate or the home country plant that survives. This, in turn, is likely to depend on the relative competitiveness of the two countries and on how close the activity in question is to the core business of the MNC.

Similar analyses have explored data for Japan (Lipsey, Ramstetter and Blomström 2000a, 2000b), France (Fontagné and Pajot 2002, Chédor, Mucchielli, and Soubaya 2002), Australia (Productivity Commission 2002), and a host of other developed countries, mostly with the result that the effects on home exports (or output and investment) are small but predominately positive. Confirming the heterogeneity of the problem, Lipsey (2004) concludes that outward investment does not seem to be related to any large movement of aggregate production capacity from the home country, although there may be important differences depending on the type of investment project (vertical or horizontal), target country (industrialized or developing), or technology (plant level or firm level economies of scale).⁵ Hence, while the overall prediction is that the home country does not lose exports or output, it may be possible to find individual cases where the home country is left worse off.

Moreover, it is important to note that all of the evidence discussed above is drawn from studies focusing on manufacturing. Services have emerged as the leading industry for new FDI, but there are very few studies exploring to what extent outward investment substitutes or complements home country activities.⁶ Given the importance of market presence and proximity to customers in most services industries, it can be hypothesized that the substitution effects of FDI are rather small: the initial export potential is often small relative to the volume of operations that can be generated through FDI. In many cases, it is also probable that the vertical links between parents and affiliates are relatively limited – it is not obvious that affiliates in service industries need to import much from their home country. This suggests that the overall production effects are smaller than for manufacturing industries.

Another point to note is that studies focusing on employment rather than trade seem to have somewhat of a bias towards finding substitution rather than complementarity. In other words, they find that increases in affiliate employment tend to reduce parent employment (Kravis and Lipsey 1988, Brainard and Riker 1997, Riker and Brainard 1997, Faini et al. 1999, Braconier and Ekholm 2000, Konings and Murphy 2001, and Cuyvers et al. 2002). This may appear contradictory, but could be explained by structural changes in the home economy. A

⁵ In one of the few studies explicitly discussing such differences, Braunerhjelm and Oxelheim (2000) hypothesize that FDI and exports (domestic investment) should be complements in industries based on Swedish raw materials, but substitutes in industries with R&D and technology as the competitive asset. Generalizing their results, Braunerhjelm, Oxelheim and Thulin (2005) argue that we should expect complementarity for vertical FDI but substitution from horizontal FDI.

simultaneous increase in exports and reduction in employment could, for instance, occur if FDI resulted in higher capital intensity and higher productivity in home country operations. The next section will therefore discuss the impact of outward FDI economic structure in the home country.

4. Effects on economic structure in the home country

The structural effects of foreign direct investment on the home country have received relatively little attention in the international debate, and the few studies that are available have focused on a limited set of issues. In particular, the contributions have discussed the impact of foreign direct investment on the composition of labor demand and wages in the home country (see Hawkins 1972, US Tariff Commission 1973, Frank and Freeman 1978, Kravis and Lipsey 1982, 1988, Gunderson and Verma 1994, Slaughter 1995, Slaughter 2000, Egger and Egger 2003, Dachs and Ebersberger 2006) and on productivity in home country operations (Barba Navaretti and Castellani 2004, Falzoni and Grasseni 2005). The picture emerging from these studies is that MNC parents tend to use less labor per production unit or exhibit higher productivity than non-multinational firms. There also seems to be an increased skill bias in the form of a shift in labor demand favoring “white-collar” employees at the expense of “blue-collar” workers, arguably because multinational firms tend to export production activities, while concentrating management, marketing, and R&D at the home base. Studies on Sweden and Japan give a somewhat different picture. For both Swedish and Japanese MNCs, larger foreign production has been found to correlate with higher labor intensity in home country operations (Blomström, Fors and Lipsey 1997, Lipsey, Ramstetter and Blomström 2000a, 2000b). One possible reason is that both Japanese and Swedish MNCs have needed more supervisory resources at home to manage their international operations; another reason could be that their investments in developing countries have been less focused on exports and more directed to import-substituting industries, leaving less scope to exploit international differences in factor prices. Braconier and Ekholm (2000) also focused on differences between host countries, and found that investments by Swedish MNCs in other high-income economies to some extent substituted for Swedish employment, but that investments in low-wage economies (i.e. developing countries) did not have any such impact.

⁶ For instance, Herrero and Simon (2003) state already in their abstract that “the effects of financial FDI on the home country are virtually unknown”.

However, for most home countries, it is probably wrong to expect the US pattern where the most advanced and skill-intensive activities will always be located at home. Instead, as a result of the increasing pace of globalization and internationalization, it is likely that the international division of labor within multinational corporations will be more closely linked to the comparative advantages of both home and host countries. The most advanced operations will be located at home only if this is consistent with the overall pattern of factor costs and other location determinants. For instance, if there are host countries that offer better conditions for R&D, it is likely to move out from the parent to the most competent foreign affiliates. Hence, FDI may have a substantial impact on the structure of home country industry. The consequences of FDI on the composition of export products – shipments of intermediate inputs and other complementary products to affiliates replace exports of finished products to other customers – could, in fact, be more conspicuous than the effect on the total amount of exports (which, as noted above, is relatively small).

Only a few studies have examined this type of structural effects in detail, and most of the available studies are related to the Swedish debate on the home country effects of FDI from the late 1990s. However, it is not surprising that this debate emerged in Sweden. Sweden is highly dependent on its MNCs – in the late 1990s, they accounted for around 50 percent of value added, exports, investments, and R&D in the country's manufacturing sector – but most of their growth during the 1990s occurred outside Sweden. A very substantial share of Swedish exports was made up of intra-firm trade between parents and affiliates, and the importance of these flows had increased significantly since the late 1980s. There were also marked changes in the structure of intra-firm exports. Whereas intermediates and finished goods had accounted for roughly 50 percent each in 1986, the share of intermediates had grown to nearly 75 percent by 1990. The Swedish MNC parents were clearly concentrating their efforts on production of intermediate inputs. The structural transformation was facilitated by very significant changes in the population of plants owned by MNCs. For instance, over half of the domestic plants and over a third of the foreign plants owned by the 17 leading Swedish MNCs in 1986 had disappeared by 1990. Over the same period, the same MNCs established an even larger number of new plants (Fors and Kokko 2001).

This structural transformation raised questions about what kinds of production the Swedish MNCs kept at home and what they decided to locate abroad. Rather than assuming that the home country operations would be concentrated to the areas with the highest value added and wages, the hypothesis was that the intra-firm trade of MNCs should be based on the specific advantages of the countries where the affiliates were located. However, it was not immediately clear what the advantages of Sweden were. On the one hand, conventional trade theory suggested that the production undertaken at home by Swedish multinationals should capitalize on Sweden's factor endowments and focus on products using the country's abundant raw material supplies (Blomström, Lipsey, and Ohlsson 1990, Andersson 1993). On the other hand, modern trade theory emphasized market size and market structure, agglomeration effects, technology gaps, and government policies aiming to secure national control over "strategically important" industries as determinants of competitive advantages (see e.g. Helpman and Krugman 1985, Krugman 1986, Porter 1990), suggesting that factor endowments were not so important. However, it was unclear to what extent these country characteristics would also influence the production pattern of MNCs: the different skills and technologies that are treated as country-specific in the literature on international trade are often transferable between the MNC parent and its affiliates. For instance, public support to R&D in a "strategically important" sector does not guarantee R&D intensive production and exports, since the MNCs may decide to use the results of the R&D investments in their foreign affiliates (Blomström 1990).

Due to lack of detailed data on product categories and factor intensities, there are no direct studies of how Swedish MNCs distributed their international production across countries. However, several authors have used information on other aspects of MNC operations to speculate about the pattern of specialization. Andersson (1993) noted that the labor productivity of EC affiliates increased at an average annual rate of 5.5 percent between 1986 and 1990, while the parents' productivity growth rates were negative. He posits that this was mainly caused by a shift in the location of the Swedish MNCs' various production stages. Earlier, most of the value added was produced in the parent company and many affiliates functioned as relatively simple assembly plants. After the mid-1980s, he argues, affiliates took over some of the more skill-intensive parts of the production process, while parents specialized in simpler, raw material based operations at lower stages in of the value added chain. Andersson also examined firm level data for the periods 1974-1978 and 1986-1990 in a

regression analysis, and found a significant negative relation between labor productivity growth in parents and increases in the share of intermediate goods in the parents' total exports to their EC affiliates. From this, he concluded that FDI was leading to an increasing specialization in raw material based production with relatively low value added. Similarly, looking at the employment structure in Swedish MNCs, a government assessment (SOU 1983) found that increasing foreign production in Swedish MNCs was apparently accompanied by lower skill requirements in home based production already in the early 1980s, which was hard to explain unless the production stages requiring higher skills were located outside Sweden.

The most explicit discussions on the structural effects of FDI are found in Hakkala and Kokko (2000), Fors and Kokko (2001), and Kokko (2002). All three studies discuss the change patterns in the domestic operations among Swedish MNCs, and compare productivities and wages in expanding and contracting plants (or plants that had newly been established and those that were about to be closed). Their main findings were that the new plants established in Sweden by Swedish MNCs in the late 1980s paid lower salaries than the Swedish MNC plants that were sold or closed during the same years. This was taken as an indication that relatively "good" (i.e. well-paying) jobs were disappearing from Sweden, and probably moving to foreign affiliates. By the early 1990s, the pattern had changed, so that the new MNC jobs created in Sweden exhibited higher salaries than those that disappeared.⁷ Interestingly enough, it can be argued that the relative competitiveness of Sweden as a location for production changed over the period in question, contributing to the character of structural change. In the late 1980s, the Swedish economy was overheated, the supply of skilled labor was very limited, and the currency was highly valued, making Sweden relatively unattractive as an export base. By the mid-1990s, as a result of the financial crisis 1992-1994, substantial reforms had been undertaken, labor was easily available, and the currency had depreciated, improving the competitiveness of Swedish production. The structural impact of FDI on the home country varied accordingly. When Swedish competitiveness was weak, Swedish MNCs decided to locate many of their "desirable" jobs elsewhere. When competitiveness improved, the desirable jobs returned.

⁷ The positive development during the 1990s is confirmed by Hansson (2005), who notes that increased vertical FDI led to higher skills in the home operations of Swedish MNCs during the period 1990-1997.

Examining the patterns of South Korean FDI, Debaere (2004) also notes a similar adjustment to the business conditions in home and host countries. He found that the capital intensity of South Korean MNC parents tended to drop as a result of FDI in more capital-abundant countries, and increased as a result of investments in labor-abundant countries. Hence, instead of concluding that the specialization in home country production depends on the relative competitiveness of the home country vis-à-vis the rest of the world, he suggested that the structural effects would depend to some extent on the country pattern of outward FDI and conditions in host countries. A roughly similar pattern is suggested by Falzoni and Grasseni (2005), who found that the most advanced Italian MNCs seemed to reap productivity benefits from investments in more advanced economies, while there was no such impact of FDI in developing countries.

Apart from noting that the home country effects of FDI probably vary depending on the business environment in the home country, the Swedish debate also touched upon the possible consequences of the increasing specialization of MNC production. In particular, the effects on industry structure were emphasized. The specialization of the MNCs' domestic production to selected intermediate goods was expected to have a profound impact on thousands of their non-multinational suppliers and subcontractors in Sweden. Overall, it had already been noted that there was a downward trend in the number of local subcontractors, as well as a fall in the share of inputs purchased in Sweden (Braunerhjelm 1991). This essentially amounted to a more concentrated industry structure, with a more or less unchanged number of large MNCs but a substantial reduction in the number of small and medium sized firms. One possible consequence identified in the debate was a reduction in the economy's ability to benefit from R&D-spillovers. Although Swedish MNCs retained a disproportionately large share of their R&D at home, there were fewer non-multinational firms to absorb and exploit the potential spillover effects (Kokko 2002). Another worry was related to growth and dynamism. Small and medium sized firms were instrumental in generating the relatively high economic growth in the US and the UK during the 1980s (Evans 1987, Hall 1987, Dunne, Roberts, and Samuelson 1989), and they played major roles in the development of new high-tech industries throughout the world during the 1990s. The concern was that an industry dominated by a small number of large MNCs specialized in a few intermediate products would be less flexible and unable to exploit new technologies and market opportunities (Kokko 2002). However, rather than suggesting various policies restricting the location choices of MNCs,

the Swedish debate stressed the need to provide strong incentives for innovation and SME development.

5. Other effects on the home country

Apart from the effects of outward FDI on home country exports, employment, and economic structure, there are a number of other issues that have appeared from time to time in the research and policy debates on FDI. In most cases, the debate has been motivated by the concern that increasing outward investment flows may be harmful for the home country. While it is hard to provide any comprehensive survey of the numerous issues discussed in the numerous countries that have participated in this debate, it appears that those issues that appear most frequently can be categorized into two groups. These have to do with the loss of MNC assets to foreign countries and the effects of multinationality on bargaining and decision-making, both at the enterprise level and at the macro level.

Until the mid-1970s, it was commonly thought that capital was the main asset of MNCs, and that outward investment might substitute for investments in the home country. This debate was closely connected to the discussion about the export effects of FDI. The general finding that FDI and exports tend to be complements rather than substitutes suggested that the need for domestic investment would not diminish as a result of outward investment.⁸ However, two problems complicated the analysis of investment effects. Firstly, the FDI can be expected to influence the capital costs of the investing firm. The so-called funding hierarchy hypothesis states that firms behave as if they face an upward sloping supply curve of capital, presumably because the preferred internally generated – retained profits – funds have a lower opportunity cost. This suggests that FDI could be a stronger substitute for domestic investment, because the decision to undertake a foreign investment project would raise the investment costs for subsequent domestic investment ventures. At the same time, it is conceivable that FDI could have a positive impact on domestic investment if it raises the profitability of the MNC and increases the amount of internally generated funds. The observation that MNCs tend to be very large supports view that their willingness to invest is not deterred by FDI, but the

⁸ In one of the latest contributions to this debate, Desai, Hines, and Foley (2005) find strong complementarity at the firm level between foreign and domestic investments by US multinationals.

empirical evidence on how the home country is affected is mixed (Stevens and Lipsey 1992, Caves 1996).

Secondly, as long as capital markets were fragmented and many countries applied fixed exchange rates, investment flows could also be expected to have macroeconomic consequences. In particular, there were expectations that FDI flows would have an impact on the balance-of-payments and the terms-of trade (Hufbauer and Adler 1968). Apart from analyses of the transfer process (i.e. the demand and spending effects of a transfer of one dollar from the home country to a foreign country), the analyses focused on the time dimension of effects: the initial capital outflow was expected to be offset by subsequent inflows of repatriated profits, but it was not clear how long this process would take. One consequence was that many governments imposed restrictions on capital outflows. For instance, the US Foreign Direct Investment Program (1968-1974) restricted outflows of FDI in the absence of offsetting borrowing abroad, and Sweden maintained restrictions on domestic borrowing to finance investment abroad until the 1980s. Another issue discussed in some detail was exchange rate risk, particularly the impact of changes in fixed rates (Kohlhagen 1977, Cushman 1985). Many of these concerns have diminished substantially since the 1970s, as a result of the integration of the international capital market and the increasing popularity of flexible exchange rates (or, as in the EU, the introduction of a common currency).

Another reason for the reduced emphasis on the consequences of capital flows is the insight that FDI is mainly a transfer of knowledge and other intangible assets from MNC parents to their affiliates, rather than a transfer of capital from the home to the host country. This has shifted attention to what may happen with the technological advantages of the investing firm and the home country. Direct investments abroad are likely to allow foreigners better access to information about the MNCs' proprietary technology and knowledge, some of which may spill over to local firms (Blomstrom and Kokko 1998). Once local firms have learned to use the foreign technologies, they may be able to challenge the foreign firms and capture market shares from the MNC affiliates, with potentially detrimental effects for home country exports and employment as well. However, it is likely that the costs related to knowledge leakages are taken into account in the MNCs' foreign investment decisions. Following Vernon's (1966, 1979) product life cycle models, MNCs often keep their most valuable and modern

technologies at home, and focus on using older technologies in their affiliates. They may also take explicit steps to reduce the leakage of knowledge to outsiders (Zander 1992). The fact that some technologies are still likely to spread to local firms in the host countries is not necessarily a problem, since FDI may simultaneously help the MNC to create new knowledge. As it grows larger thanks to its foreign investments, it will be able to afford to spend more on training and R&D.

In fact, if anything, it is likely that the impact of knowledge flows through MNCs is beneficial to the home country. This is most obvious in cases of strategic asset-seeking FDI, where the explicit motive is to get access to foreign technology (Kuemmerle 1997, Dunning and Narula 1995), but also for many other types of FDI. For instance, Globerman, Kokko and Sjöholm (2000) note that outward FDI seems to create spillovers of knowledge back to the home country. Tracing the patent citations in Swedish innovations, they found that Swedish firms, MNCs as well as non-multinational companies, were more likely to cite patents from countries with more Swedish FDI, even controlling for the effects of trade, distance, country size, and other possible determinants of knowledge flows. The proposed reason for the positive impact of outward FDI on non-multinational Swedish firms is the exchange of knowledge through business associations, personal contacts, labor mobility, and other similar channels. Similarly, Falzoni and Grasseni (2005) note that the more advanced Italian MNCs benefited from productivity gains as a result of FDI directed to developed economies. A likely reason is that these MNCs were able to absorb some of the technologies and skills used by local host country firms.⁹

The worries related to bargaining power and policy making are perhaps the most serious home country concerns in many of the industrialized countries today. At the firm level, the result of increasing foreign production is simply that the home country becomes less important for the firms overall survival. While it is reasonable that a moderately multinational firm maintains strong home country preferences – e.g. when decisions about new investments or plant closures are made – this may not apply for those companies that have grown global.

⁹ Note that this effect is very different from the positive productivity impact observed at home as a result of FDI in developing economies, discussed in Section 4 above. There, the productivity gains resulted from an international division of labor within the firm, whereby labor intensive operations were transferred to foreign affiliates and more advanced operations were kept at home. In the case discussed by Falzoni and Grasseni (2005), it is not likely that MNCs transfer labor intensive operations to other developed countries: instead, they probably benefit from knowledge flows from their affiliates.

For many MNCs from the smaller European economies (the Netherlands, Sweden, Finland, Switzerland) the home country share of employment and sales can be as low as 10-15 percent. In these cases, it is not clear whether the home country plays any special role for the firms' future anymore: in fact, it is not even clear whether it is relevant to talk about a home country for some of the largest global players like ABB or Nestle.¹⁰ One result of increasing outward investment may therefore be that the labor force in the MNCs' home country operations will perceive increased economic insecurity and risk related to employment and wages. In particular, there has been some focus on the impact of outsourcing on low-skilled workers, who compete directly with cheaper labor in developing host countries (Scheve and Slaughter 2001). However, the debate is not limited to blue-collar workers – increasingly, developing countries like China and India have also begun to compete for white-collar jobs in sectors like IT, banking and finance, research and other services (Kirkegaard 2004). In fact, examining surveys of worker perceptions of economic insecurity without distinguishing between different job categories, Scheve and Slaughter (2004) show that employees in industries with higher (and increasing) levels of FDI systematically reported higher levels of economic insecurity. Although their analysis is limited to Great Britain during the period 1991-1999, it illustrates one of the main impacts of globalization: the increasing mobility of capital and companies has meant that workers are no longer competing only with other workers in the same economy, but increasingly also with workers other countries.

At the macro level, the debate has centered on the argument that the influence of multinational companies on bargaining and political decision-making has become stronger in recent years (Summers 1999). The reason is that MNCs can threaten to relocate their plants to other countries if governments do not pursue desirable policies. Since governments are likely to fear that such relocations may lead to unemployment, lost tax revenue, and weaker economic development in general, they may yield to the demands of the MNCs, joining a “race to the bottom” where regulations and controls on MNC operations are gradually taken away (Rauscher 1995). While the existence of many production locations may make MNCs less inclined to spend substantial resources in order to lobby individual governments, it is

¹⁰ Note that this suggests that the distinction between domestic and foreign firms is becoming less relevant: to the extent that domestic MNC are becoming more “global”, they are also likely to behave more like those foreign MNCs that invest in the country. The appropriate distinction may instead be between multinational and non-multinational firms.

likely that they have the potential to be very efficient lobbyists when they decide to enter into the policy debate (Polk 2002).

One field where MNCs are believed to push for liberalization is labor standards, with the argument that much of productive capacity can easily be moved to China if home countries (or other host countries) insist on maintaining costly labor market legislation (Chan 2003). Concerns about FDI weakening environmental regulations are also common, but rarely with respect to the home country. The more common case is instead the one where different host countries compete to provide the least stringent regulations. However, there is not much evidence to support the assertion that MNCs would systematically aim to lower environmental standards (Whitman 1999). As noted by Rugman and Verbeke (1998), it is rarely optimal for the MNCs to adjust to the low environmental standards that may be offered by various host countries. Instead, MNCs tend to adapt to the legislation of the markets that are most important in terms of sales – often, these are found in the developed countries. Taxation is another area where the competition between countries is likely to have an impact on the activities multinational firms (Desai, Foley, and Hines 2006a). Yet, in spite of the fear that the result of such competition could either be a loss of economic activity to “tax havens” with particularly low taxes or substantial reductions in the taxation of multinational companies, there is not much evidence of such effects, at least for US firms (Desai, Foley and Hines 2006b).¹¹ It is possible that the mere existence of tax havens allows MNCs to shift profits to these locations without any other impact on home country operations than lower recorded (taxable) profits in the home country. The fact that these transactions tend to benefit capital owners rather than workers has also raised concerns about the effects on income distribution: does outward FDI make the home country’s poor poorer and the rich richer (Whitman 1999)? While there is no clear answer yet, it seems that skill-biased technical change rather than FDI is the main explanation for this pattern (Cline 1997).

While these concerns regarding increasing multinational activity may be appropriate in some cases, it should be noted that they are not particular to the home countries of MNCs, but equally hotly debated in many host countries. Moreover, the questions regarding the

¹¹ Similarly, Mendoza and Tesar (2005) argue that there has been no such race to the bottom regarding taxation within the EU, where both labor and capital are mobile across international borders. One reason may be that “harmful” tax competition has explicitly been prohibited as an incentive in the competition for FDI within the EU.

autonomy of the nation state are not only motivated by FDI, but rather by increasing internationalization and globalization in general. The pros and cons of globalization in general, with distinct discussions about the role of FDI and MNCs, have recently been outlined by Stiglitz (2002) and Wolf (2004), with the former suggesting a more complex and worrisome picture than the latter. At the same time, it is hard to provide any alternatives to globalization and internationalization, as illustrated by the dire performance of those few countries that have decided not to participate in the global integration process of the past decades. Instead, it may be reasonable to put the emphasis in policy-making on measures to reduce the undesirable effects of globalization and to ease the transition for those workers that are in danger of losing in the process.

6. Policies for outward FDI

From the discussion above, it should be clear that there are positive as well as negative effects of FDI in the home countries of multinational corporations. Moreover, there is some evidence that the effects of FDI vary depending on the type of investment (acquisition or greenfield), industry (manufacturing or services), time perspective (short or long run effects), and various home and host country characteristics. Among the positive effects identified in the empirical literature, the most important one is probably the favorable impact on the investing firm's size and competitiveness. Even though some of the gains that accrue to the MNC are probably realized outside the home country, there are still substantial benefits that remain at home. The financial profits that are generated will to a large extent belong to home country nationals, home country exports are likely to grow (or are at least not likely to diminish much) and the MNC will be able to invest more in marketing, R&D, and other fixed costs that are often concentrated to the home country. As shown by a number of studies on the US and other highly developed economies, outward FDI is also likely to result in an upgrading of the MNC's home country jobs, with focus on more advanced activities – more capital and skill intensive jobs – that typically pay higher salaries. Moreover, outward FDI may secure raw material sources and bring in new knowledge and valuable new technologies, both when the outward investment is of a “strategic asset seeking” type and when there is no explicit motive to access for technology: the mere presence in a foreign market is likely to generate various knowledge spillovers back to the home country.

At the same time, there are several areas where the home country effects are uncertain or negative. While exports tend to be complements to foreign production, home employment is more often a substitute: the number of jobs in the home country may well decrease if FDI is not connected to very substantial increases in foreign sales. As noted in the discussion on Sweden, the structural effects in the home country are not necessarily beneficial. If the home country does not provide competitive conditions for production, the MNCs may decide to relocate the most attractive jobs to other countries. The increase in FDI may also reduce the bargaining power of the national government, since the MNCs may make reasonably credible threats to move out production if their wishes regarding economic policies are not met. In fact, the MNCs' possibilities to use transfer pricing to shift profits (and tax revenue) out of the home country may be strong enough to force the government to adjust their policies. Hence, there may be a loss of policy autonomy as a result of outward FDI. The combined threat from these policy-related worries is a "race to the bottom" regarding taxation and other types of regulations. The competition between different countries may result in an equilibrium where industry is subject to a minimum of requirements, and where the costs, e.g. for financing the public sector, are increasingly concentrated to the less mobile tax bases – consumers and wage earners rather than firms and capital owners.

The home country policies towards FDI to some extent reflect these divergent effects. A first point to note is that the overall attitude to outward FDI in most developed countries is positive. In other words, the beneficial effects of FDI are assumed to dominate. Most governments therefore provide a variety of policies that encourage their firms to invest abroad. For instance, almost all OECD country governments provide information, financing, and political risk insurance for outward investors. The most prominent of the institutions in charge of these functions are the Overseas Private Investment Corporation and the EX-IM Bank of the US, the Commonwealth Development Corporation and the Export Credits Guarantee Department of the UK, and the Japan External Trade Organization and the Japan Bank for International Cooperation. However, similar organization exist in most other developed countries, as well as number of less developed countries that have emerged as outward investors over the past decades: India, Kuwait, Malaysia, Saudi Arabia, Thailand, Singapore, and South Africa are only a few examples.

Outward investment to developing countries is sometimes considered particularly valuable, since it is assumed to promote growth and development in the host country; in addition to any beneficial effects at home. Several home countries have therefore introduced particular policies to encourage such investment and to reduce the risk connected to FDI in developing countries. For instance, in the Cotonou Agreement from 2000 (which is the successor to the Lome Conventions, the preferential trade agreements between the EU and the ACP countries) the EU has made commitments to support outward investment to the ACP countries, and set aside funds through the Investment Facility of the European Investment Bank to provide credits and investment guarantees for such projects (te Velde 2003). Several other home countries provide similar facilities at a national level. In addition, overseas development assistance (ODA) is sometimes used to provide indirect support for outward FDI flows. In particular, efforts to support legal reform, macroeconomic stability, and infrastructure development contribute to creating an environment that is more conducive to inward FDI.

Several of the leading home countries have also been active through bilateral and regional treaties and multilateral organizations (particularly the WTO) to ensure that host country policies are not harmful to their MNCs. For instance, both the EU and the US have been pressing for national treatment of foreign investors, the TRIMs agreement of the WTO has contributed to liberalize the business conditions for many MNCs, and the increasingly effective protection of intellectual property rights through the WTO has reduced the perceived risk of many FDI projects in developing nations.

However, many governments have also shown concern for the potentially negative impacts of FDI, and introduced various rules and regulations to mitigate these effects. In particular, restrictions have been used at times to avoid negative balance-of-payments effects. Two examples were already mentioned in the previous section: the restrictions on domestic borrowing to finance FDI in Sweden and the US. More generally, similar restrictions were implemented in several other countries, and even relatively liberal home economies applied licensing requirements for outward investment until the 1980s. The purpose was to keep the ability to stop investment projects that might have negative effects on the home country without having a general ban on outward investment.¹² In most countries, these restrictions

¹² Blomstrom and Kokko (1997) argue that policies were more liberal in countries with centralized labor unions (e.g. Sweden), since the labor representatives could take into account both the direct negative effects as jobs moved abroad and the indirect positive effects generated by the complementarities between foreign and

and licensing requirements were lifted before the end of the 1980s, as the international capital markets became more integrated and the worries about detrimental balance-of-payments effects diminished. Another reason may have been the publication of the early research results discussed in Section 3, which suggested that outward investment did not seem to pose any threat to home country exports (Blomstrom and Kokko 1997).

A host of other restrictions, brought about by various country-specific circumstances, have also been used to control FDI outflows. The US rules on export controls make up one example. Although the purpose of these rules is to keep military technologies outside the reach of potential enemies, they also limit certain kinds of civilian foreign investment – recently, this may have restricted Boeing’s ability to invest in production facilities in the fastest growing airline market, China. Similarly, some economies (like Taiwan) are trying to limit their FDI in China in order to avoid excessive dependence on developments in the Chinese market. Similar thoughts are discussed in other countries that have a large share of their FDI in China, for example South Korea (Moon 2005).

Whether or not these restrictions are efficient, it is important to note that they do little to address the problems related to the possible job losses and structural changes that may result from outward FDI. The reason is that we still do not know what the alternatives to outward FDI are. Would the enterprises be able to survive and thrive even if they were not allowed to undertake their foreign investments, or would they just become weaker in comparison with those competitors that are allowed to invest abroad? This dilemma suggests two areas for public policies that are not well developed to date.

Firstly, it seems clear that the only restrictions on outward investment that will not weaken individual firms are in the form of universal rules that apply to all companies (or at least to all firms that are in competition with each other). However, it has proved very difficult to reach consensus what rules of conduct are reasonable, and the negotiations aiming to establish a Multilateral Agreement on Investment (under the auspices of the OECD) collapsed in 1998 without any tangible results. Some regional integration agreements, like the European Union, have been able to introduce far-reaching investment rules – for instance, the EU limits the

domestic production (which might occur in other plants or even other firms). In countries with local or company-based labor unions, attitudes were generally more negative, since they were less likely to see the positive indirect effects on the economy.

value of investment incentives and other subsidies used to attract FDI – but there does not seem to be much scope to extend such regulation to cover all or even the main home countries of FDI.

This suggests that home country policy might best be used to neutralize the negative effects of outward FDI, or even to influence how these effects will look. For example, it is likely that increasing outward FDI from high-wage countries will have negative effects on unskilled home country labor. Most of the simple jobs are likely to be outsourced, and the jobs that remain at home will require substantially more skills than what the outsourced jobs did. Restrictions on outward FDI in general are not likely to be good for the home country, for reasons discussed above. However, it may be desirable or even necessary to introduce policies targeting those groups that lose as a result of outward investment. Adult education and training programs, as well as programs to encourage SME development (since SMEs are often too small to outsource production activities) are examples of policy responses that do not obstruct globalization and internationalization, but rather support the adjustment to a more globalized economy.

More generally, it is possible that the home country effects of FDI vary depending on the business environment and economic conditions of the home country. In the host country literature, it has been noted that there are few automatic consequences of FDI, and that many of the effects, e.g. technology spillovers, vary systematically depending on the characteristics of the host country (Kokko 1994, Blomstrom, Globerman, and Kokko 2001). Similarly, the Swedish experiences of outward investment suggest that effects tend to vary according to home country conditions. In the late 1980s, when the Swedish economy was not very competitive due to overheating, high taxes, and an overvalued exchange rate, Swedish MNCs were apparently unwilling to locate their new strategic investments to Sweden: instead, the new jobs with high value added were frequently found in Swedish affiliates in other European countries. Some years later, when the financial crisis of 1991-1992 had forced the government to introduce substantial economic reforms, the pattern of MNC investments changed. Now, the new jobs created in Sweden were more attractive, with higher value added and higher skill requirements. These experiences suggest that policies aiming to create a favorable business environment in the home country may be the best way to ensure that the effects of outward FDI are beneficial.

7. Concluding comments: home country effects in developing countries

So far, this paper has discussed the home country effects of FDI and the home country policies meant to handle these effects from a developed country perspective. To what extent can the results be generalized to developing countries? A first observation is that it may be convenient to distinguish between two types of outward investment from developing countries. Firstly, MNCs from developing economies invest in other developing economies. Whether these foreign investments are horizontal or vertical, they are not likely to differ in kind from FDI flows between industrialized countries. One possible exception concerns the pattern of firm-specific intangible assets that allow firms to become multinational. For developing country firms, it is not very likely that the competitive assets are made up of advanced production technologies (since few developing economies have substantial resources for R&D). Instead, it is probable that developing country affiliates exploit advantages related to organizational skills, marketing knowledge, and other assets that do not require advanced technological capabilities. In general, it can be assumed that these skills or assets are not too distant from the existing advantages of local host country firms. The low technology gap and the difficulties to protect some of these assets with patent rights (e.g. organizational skills and marketing knowledge) are also likely to mean that there is a larger risk for spillovers to local host country firms. If the investing MNCs expect that their competitive advantages are temporary, it should mean that they are more cautious about irreversible production decisions: hence, the structural home country effects of FDI should be small.

Regarding the home country export – FDI complementarity question, it is possible that there are smaller effects than in the case of developed countries. In the developed country case, it was noted that there is a potential for complementarity both for horizontal and vertical FDI. With horizontal FDI, it is likely that the host country market share grows sufficiently to stimulate home country production of intermediates; in case of vertical FDI, the competitiveness of the MNC may grow sufficiently to take market shares from foreign firms, either in the home country market or in export markets. In either case, total home country production may grow following FDI. In developing countries, it is possible that the production linkages between parents and affiliates are weaker. The stylized view is that

horizontal South-South FDI is more commonly found in services like construction and hotels than in manufacturing. The flows of intermediates in these activities are relatively limited, and it is not certain whether home country production will benefit much from FDI. When it does, however, the structural effects are likely to be favorable: what the home country can provide may be concentrated to management and skill development. There seem to be few examples of vertical South-South investments, since the differences in factor prices between developing countries are often relatively small. Hence, the aggregate impact of such ventures is still likely to be very limited.

The main differences between the home country effects in developed and developing countries are likely to be related to South-North investments. It appears that there are relatively few cases of horizontal FDI from developing countries to developed economies. The likely reason is that developing country firms have few assets that can be exploited profitably in developed markets: generally, their R&D investments are too low to generate significant innovations, and their advertisement expenditures have also been too low to establish successful brand names and trade marks. There are some exceptions, but these are more commonly found in services than in manufacturing. Instead, vertical investments seem to be more frequent. However, unlike the standard vertical FDI case, where the parent company and the home country are relatively more advanced than the affiliate and the host country, the situation in South-North FDI is often the opposite. The technology flows and spillovers may also have the opposite direction than in the standard case. More specifically, some share of South-North investments is likely to be motivated by the wish to gain access to technology and skills that are not easily available in the home country. It is obvious that such investments require substantial local capabilities, since the foreign technologies must typically be adjusted for the conditions in the developing home country. These investments focus on backward integration, which suggests that the scope for complementary export increases from the home country to the affiliate is limited. Instead, the parent MNC gains skills and knowledge that can potentially be used for import substitution or exports to third country market. The net trade effect in this case is unambiguously positive, since there is no substitution in the initial stage: the entire employment and export effect emanates from the parent company's ability to make use of the foreign technology. Moreover, as suggested by Globerman, Kokko, and Sjöholm (2000) for developed countries, it is likely that the

knowledge gained through outward FDI will spread to other firms in the home economy, adding to the positive effects on productivity, employment, and exports.

However, roughly the same effects result from inward FDI. In fact, it is difficult to see any theoretical distinctions between the effects of these two types of investment flows, except perhaps for some differences in the trade orientation of the investments. While the inward FDI will often be export oriented, particularly in the smaller developing economies, the technology flowing in through outward FDI linkages is more likely to be import substituting. The reason for this is the competitive situation in the developing country's home market. Foreign export oriented MNCs are often already present, and it is more difficult to enter into direct competition with these firms than to compete with imports. Moreover, the developing country will explicitly have to pay for the technologies that are accessed through outward FDI, and the developing country will also have to cover all costs for adapting the technology to local conditions. In the case of inward FDI, the costs for adjusting the technology to local conditions is born by the foreign MNC, the local firms that are potential beneficiaries of spillovers do not make any formal payment to the owner of the technology, but the foreign MNC will try to extract as much value as possible through license fees, patent rights, technology contracts, and payments for embodied technology. In most cases, the resulting cost will be higher the more successfully the technology can be applied in the developing country. It is an empirical question which of these sources of technology is more economical and more important for developing countries. In one of the few studies inward and outward FDI, Allazzawi (2004) explores foreign patent citations to US patents, and argues that both inward and outward FDI were roughly equivalent as sources of technological information for developed countries. However, the Newly Industrialized Countries were able to gain much more from inward FDI, suggesting that it would be more pertinent for them to attract incoming FDI than to worry about investing abroad. Given the weaker technological capability of most other developing countries, it is possible that it would be even more difficult for them to fully exploit technologies gained through outward FDI.

In summary, it therefore seems fair to conclude that the home country effects of developing country FDI are likely to be similar in kind as the effects in developed host countries, but perhaps smaller in size and importance. The exception may be technology-sourcing outward investments that aim to secure access to strategically important knowledge and skills that

have been developed abroad. Developing countries potentially have much more to gain from these types of investments, although substantial local capabilities are needed to exploit the foreign technologies. Moreover, the potential benefits of these investments are roughly the same as those of inward FDI from developed countries. Still, it is possible to expect some differences in three areas. Firstly, the technologies that can be sourced through the two channels are likely to differ somewhat, with a bias towards import substitution for outward FDI and export orientation for inward FDI. Secondly, the prices paid for the technologies are likely to differ. In the case of outward FDI, the investor will have to pay a price determined ex ante by the market, and carry all of the costs needed to adapt the technology to the conditions in the home country; in the case of inward FDI, the investor is paid through license fees and profits, which are larger the more successful the FDI project is. Thirdly, the incidence of spillovers to local firms in the developing country may vary between the two cases. In one case, the spillovers will emanate from the locally-owned MNC parent; in the other case, from the foreign MNC affiliate. To date, there are no studies exploring and comparing the spillovers in these two cases, although these differences might be important in determining the optimal policies for many developing countries.

8. References

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