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Book Review

Multinational Firms in the World Economy

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This excellent book summarises decades of research on the economics of multinational firms. A central puzzle economists pose is why multinational firms choose to establish an overseas presence rather than simply to export goods and services. The two main answers are to gain access to potentially large markets that would otherwise be closed – which the authors call horizontal foreign direct investment (HFDI) – and to gain access to low-cost local inputs as part of a strategy of global competitiveness – termed vertical foreign direct investment (VFDI).

In the chapter on HFDI, the authors ask why multinational firms sometimes set up 'greenfield' operations abroad rather than simply merging with or acquiring a local firm. Mergers and acquisitions 'account for the dominant share of foreign direct investment (FDI) flows, especially to high-income countries.' But greenfield investments are still important; most host countries prefer greenfield investments over mergers and acquisitions.

In the chapter on VFDI, the central question is how a firm will divide its production processes across different locations with different factor prices in the presence of 'trade costs' and 'disintegration costs.' VFDI flows between two countries will not occur unless factor endowments are sufficiently different. However, factor price equalisation will occur over time, partly as a result of VFDI flows, and so VFDI may eventually be replaced by HFDI. Both, however, are dependent on trade and disintegration costs.

Why are the international operations of firms sometimes 'organised internally, in wholly owned subsidiaries' and sometimes 'externally, under arms-length contracts with independent local producers'? The main reason given for internalisation is market failure connected with arms-length contracts. According to the authors, there are three types of market failures: the hold-up problem, the dissipation of intangible assets, and principal–agent relationships between multinationals and local firms. The hold-up problem occurs when a local firm has to make investments that are specific to the

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contracting relationship. The potential losses caused by an altered relationship result in underinvestment. The dissipation of intangible assets occurs when a foreign firm cannot avoid losing control over valued assets because of its contractual relationship with a local firm. The principal–agent problem occurs because of hidden actions or hidden information about local market conditions. The local firm may have an interest in concealing local market information from the foreign firm.

Another chapter summarises large-n quantitative research on the determinants of FDI flows and other indicators of multinational activity. The main factors examined in this chapter are plant-level economies of scale, firm-level research intensity, home- and host-country market size, geographical distance (and other possible barrier-related factors), and transportation costs. The so-called 'gravity model' explains much of the variance in country-to-country flows of FDI so most empirical research controls for gravity in measuring the impact of non-gravity factors. At the end of the chapter, the authors provide suggestions about how to improve existing quantitative research by allowing for a variety of motives for foreign investment (HFDI, VFDI, and combinations thereof), by including both firm-level and country-level variables in the analysis, and by separating mergers and acquisitions from greenfield investments empirically.

In summarising many empirical studies on the impact of multinationals on host countries, the basic conclusion is that 'MNEs are indeed very different from local firms.' They are larger and more efficient, they pay higher wages and employ more skilled personnel. 'This is so because MNEs bring to host countries a bundle of characteristics that are not necessarily available locally: technologies, brands, management procedures, market access, and so on.'

A case study of foreign investment in Ireland, which has been successful in attracting increasing inward flows of FDI, mainly from the United States, shows that Irish tax incentives had a lot to do with the decision of multinationals to locate operations there. The authors conclude with a warning of the possible negative consequences of Ireland's having to harmonise its taxes with other member states of the European Union.

A further chapter on the impact of foreign investment on home countries concludes that this is generally positive because 'foreign investments are more likely to strengthen than to deplete home activities.' The authors are correct in noting, however, that home-country effects are less well studied than host-country effects.

In the concluding chapters, the authors call for 'coordination and supranational regulations…to ensure that international markets work in an efficient and beneficial way.' But they also argue that 'multinationals are a fundamental and efficient component of a globalised world, not an enemy within.' They advise developing countries to emulate Ireland which, in their view, 'successfully managed to use its initial cost advantage to create long-lasting linkages with foreign investors.'

This is an excellent book about the economics of multinationals and FDI, although it will not be a popular work among opponents of globalisation. Unlike other works, it does not ignore negative effects of multinationals. It does not, however, discuss potentially negative cultural impacts of the branding and marketing strategies of global oligopolies. The authors put the onus on governments to see to it that the positive benefits of globalisation can be felt beyond the narrow circle of industrialised and industrialising countries.

I would recommend this book for graduate students and for advanced undergraduates in economics or political economy programmes. It is comprehensive in its coverage and clearly written, a worthy successor to earlier summaries of the field.

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