SPILLOVER EFFECTS FROM MULTINATIONAL ENTERPRISES: A LITERATURE REVIEW

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Abstract:

Multinational enterprises play a significant role in the global economy. Their activities can have positive impacts on host countries as these companies tend to bring new capital, technology, and knowledge. Nevertheless, negative effects linked to their presence occur as well. Most studies focus on the overall impact of FDI on economic growth. In this paper, we go beyond this relationship and examine the literature describing specifically the indirect impacts of the activities of multinational corporations on host economies, the so-called spillover effects. We highlight the most relevant studies on this topic. Spillover effects occur both across and within industries and can significantly increase the productivity of domestic companies. The magnitude of these impacts is, however, significantly dependent on the level of development of the host economy and the absorptive capacity of local companies.

Keywords: Economic Growth, Foreign Direct Investment, Global Economy, Multinational entreprises, Spillover Effects.

Introduction:

Multinational enterprises (MNEs) are significant economic players in most of the economies in today´s world. Their numbers began to rise significantly during the second half of the 20th century, in conjunction with the globalization process driven by the spread of new technologies and the gradual removal of barriers to international trade and capital movement (OECD, 2018). The importance of these companies to the global economy can be demonstrated by their share of global GDP, which was 32% in 2016, or their share of global exports, which was even higher at 64% in the same year (De Backer, Miroudot, and Rigo, 2019).

Multinational enterprises can have a profound influence on the development of host economies. Economic literature often mentions the positive impact of their foreign direct investments (FDI)[1] on the economic growth of host countries, primarily through the inflow of new capital, advanced technologies, or enhanced managerial skills and other knowledge possessed by these companies, which can contribute to increased productivity of the host economy's production factors (Lall, 2000; OECD, 2002; Moran, 2005; Dunning and Lundan, 2008). Foreign companies can enhance the performance of the host economy directly through their investment or indirectly through what are known as spillover effects, especially when they promote the development of local suppliers and customers (Javorcik, 2004; Pavlínek and Žížalová, 2014), when technologies and practices of foreign companies are imitated by local competitors,

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1 World Bank (2023) defines FDI as the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor.

or when employees who previously worked for foreign companies move to local businesses (Blomstrom and Kokko, 1998; Aitken and Harrison, 1999). The presence of foreign companies often intensifies the competitive environment, which can increase the efficiency of the host country's resource utilization (Blomstrom and Kokko, 1998; Dunning and Lundan, 2008). On the other hand, the negative impacts of FDI on the host economy are also mentioned, especially when there is excessive displacement of local firms that are unable to compete with foreign companies (the so-called crowding-out effect) (Lall, 2000; Pavlínek and Žížalová, 2014).

In addition to impacts primarily related to economic growth, foreign companies can influence various other areas that determine a country's overall economic development and significantly affect the living standards of its residents (Dunning and Lundan, 2008; Todaro and Smith, 2020). FDI can affect, for example, the state of the environment (Doytch and Uctum, 2016; Choi and Baek, 2017; Zheng and Sheng, 2017), the level of poverty (Zhang, 2006; Magombey and Odhiambo, 2017), or economic and social disparities within society (Bussmann, de Soysa, and Oneal, 2002; Bhandari, 2007).

The aim of this article is to summarize the literature focused on the indirect impacts of the activities of multinational corporations on host economies. This relates to the impact on economic growth as well as the broader impacts of MNEs on the overall development of host countries. Attention is also given to the specifics of foreign company activities in highly regulated markets. By considering these broader impacts of MNEs activities this article intends to complement the existing literature on the impacts of FDI by bringing a more holistic view on the role of MNEs in the host economies. The literature was identified using Google Scholar searches focusing on the most cited literature related to spillover effects from FDI and MNEs.

The structure of the paper is as follows. At first, multinational enterprises and FDI are introduced, Including major studies related to the impact of foreign companies on the economic growth of host economies. In the second section the spillover effects, particularly productivity spillovers and market access spillovers are described. The final chapter concludes the findings from the whole paper.

1. Multinational corporations, foreign direct investment and their impact on the host country

The literature addressing the activities of companies operating in multiple countries primarily employs the term "multinational enterprises" (MNEs, also sometimes referred to as transnational corporations - TNCs or multinational corporations - MNCs), which most authors define as companies engaged in foreign direct investments (FDI) (Dunning & Lundan, 2008). OECD, in certain materials, also uses a broader definition describing MNEs as companies that establish branches and subsidiaries in countries other than their country of origin (OECD, 2018). Dicken (2015) defines them as companies that coordinate or control operations in more than one country, even when these operations are not owned. Both of the latter definitions, therefore, encompass companies operating abroad without direct capital participation, as is the case with many small and medium-sized enterprises (SMEs).

Companies expand internationally for various reasons, such as accessing new markets, resources, technologies, or favorable financial regulations. However, their primary goal, like

domestically operating firms, is profit maximization, aligning with neoclassical economics principles. This entails ensuring that their income exceeds the opportunity costs of expenses (Dunning & Lundan, 2008).

To optimize production processes, companies distribute various production phases across different countries (Saini & Singhania, 2018). Dunning and Lundan (2008) categorize Foreign Direct Investment (FDI) into four primary motivations:

1. Resource-seeking FDI: This type aims to secure specific resources, either unavailable or insufficient in the home economy. It seeks a competitive advantage in its operating markets, often exporting these resources. Subtypes include physical resources, cheap unskilled labor, and various capabilities.
2. Market-seeking FDI: These FDIs aim to access new markets or better serve existing ones.
3. Efficiency-seeking FDI: It optimizes prior investments by spreading activities geographically, yielding benefits like economies of scale or risk diversification.
4. Strategic asset-seeking FDI: This type involves acquiring foreign assets to maintain or enhance global competitiveness.

Yet, many Multinational Enterprises (MNEs) pursue multiple objectives when entering foreign markets, often combining several types. Motivations may also evolve during their operations in host economies, typically starting with exporting products and gradually establishing sales branches, subsidiaries, and manufacturing facilities (Dicken, 2015).

Another common distinction based on motivation and activities involves categorizing them as either horizontal or vertical FDIs. Horizontal FDIs denote investments made to replicate the same activities in the host economy as in the home economy, typically to access the host market. Companies that initially imported their products may establish local production to reduce costs (e.g., transportation and customs) and boost profits. Yet, due to higher initial investments, this shift becomes profitable after a certain sales volume is attained. Vertical FDIs, in contrast, entail investments aiming to conduct different activities in the host economy compared to the home economy. The goal is often resource access or optimizing the production chain (Helpman, 2011). The literature often uses also the term conglomerate FDI, which refers to FDI in complementary assets with the motivation to diversify the current activities of the investing MNE (Andrea, et al, 2019).

FDIs can also be classified by entry mode into the host economy (Cheng, 2006) in greenfield investment (building a new entity), mergers and acquisitions (M&A - Entry occurs through acquiring existing host country companies) and brownfield investment (combining modes, foreign companies acquire host country entities and significantly restructure them).

FDI can have a positive impact on the economic growth of host countries, primarily by contributing to their technological advancement, as affirmed already by Findlay (1978). Other scholars support this, noting that the extent of this impact depends on various factors, including the host country's export openness, human capital, institutional quality, and infrastructure (Balasubramanyam, Salisu, & Sapsford, 1996; Trevino et al., 2002; Borensztein, De Gregorio, & Lee, 1998; Bangoa & Sanchez-Robles, 2003; Olofsdotter, 1998; Slesman, Baharumshah, & Wohar, 2015; Rodrik, Subramanian, & Trebbi, 2004; Acemoglu, Gallego, & Robinson, 2014;

Lim, 2001). The overall impact of FDI on the host economy, whether positive or negative, also hinges on various factors, including the type of FDI (e.g., resource-seeking, market-seeking, efficiency-seeking, or strategic asset-seeking), industry, activities, investment duration, and more (Pavlínek, 2022).

Nevertheless, research at the national level may introduce bias. For instance, Vu, Gangnes, and Noy (2008) confirmed the positive impact of FDI on labor productivity in Vietnam and China, with significant variations across industries. Taguchi and Wang (2017) reached a similar conclusion, noting positive effects mainly in eastern Chinese provinces.

Beside prevailing positive findings regarding the impacts of FDI on host economies as mentioned above, some studies fail to confirm a strong connection between FDI and host economic growth. Cerkovic and Levine (2005) analyzed data from 72 countries and found a weak link between FDI inflows and growth. Choe (2003) reported similar results from an 80-country study. De Mello (1999) confirmed FDI's positive impact on technological levels and managerial skills but found a weak link to economic growth in 32 developing countries. Elkomy, Ingham, and Read (2016) did not confirm the influence of FDI on growth in 61 countries classified as democracies, except for hybrid democracies and authoritarian regimes. Li and Tanna (2019) found only a weak FDI-growth relationship in a dataset of 51 developing countries, suggesting institutional quality plays a more critical role than human capital.

It is important to note that several studies proved that the positive effects of FDI can be limited in countries that apply strict regulations to FDI. For example Moran´s (1998) researches in Brazil, Mexico, Thailand and Malaysia found a significant difference in size, the level of output or technology used between subsidiaries of MNEs integrated into global distribution chains and subsidiaries oriented towards the protected markets of the host countries, which were limited through certain requirements to use local suppliers or to include capital participation of local firms. Hewlett-Packard, Compaq and Apple in Mexico, under the conditions of protected markets, produced computers several classes inferior to what was common in the USA (Peres Nuñes, 1990). In China, Malaysia, and Thailand, hard drive manufacturers such as Seagate only made 100% control investments, mainly to prevent new technology leakage and minimize company coordination problems (McKendrick, Donner, & Haggard, 2000). Kim (2016) focused on the impacts of FDI in the Gaesong Industrial Complex special economic zone in North Korea. The research showed a certain benefit of FDI, especially through the creation of new jobs, but the study did not confirm other benefits in the form of an increase in overall productivity, mainly because of the high isolation of the economic zone.

2. Indirect Impacts of Foreign Companies' Activities on Host Economy Growth. The Spillover Effects

The activities of foreign companies may be accompanied by a range of indirect impacts (externalities) that can significantly influence the performance of companies in the host economy (Moran, 2005; Blomstrom and Kokko, 1998; Dunning and Lundan, 2008; Marlevede and Schoors, 2005). These indirect impacts are often referred to in the literature as spillover effects and are typically divided into spillover effects related to productivity (affecting the productivity of local companies through the transfer of technology and know-how from MNEs and

increased competitive pressures) and spillover effects related to market access (enabling local firms to access new markets through MNE channels or imitation) (Blomstrom and Kokko, 1998; Aitken and Harrison, 1999; Javorcik, 2004; Pavlínek and Žížalová, 2014). As these categories are frequently used in most of the literature focused on spillover effects, they are further elaborated in this chapter. Dunning and Lundan (2008) also mention so-called financial externalities, which arise when MNEs create new demand for goods and services from local suppliers, enabling them to increase production, intensify competition, and realize economies of scale. Spillover effects can occur both within the same industries (horizontal spillover effects) and between different industries (vertical spillover effects) (Javorcik, 2004). While spillover effects may not be a significant or decisive factor in the decision-making process for foreign investors, they can have a substantial impact on the host country's economy (Kotíková, 2019).

Regarding the precise definition of spillover effects, Dunning and Lundan (2008) distinguish between the indirect impacts of MNE activities on linkages and spillover effects. Linkages, according to Dunning and Lundan, develop between MNEs and local firms that cooperate with MNEs (such as suppliers or customers), while spillover effects arise when local companies do not have a direct linkage to MNEs. A similar distinction is also used by Moran (2005), who divides the indirect impacts of FDI into primary effects and externalities. Most other authors (e.g., Blomstrom and Kokko, 1998; Aitken and Harrison, 1999; Javorcik, 2004; Pavlínek, 2022) consider all indirect impacts of MNE activities as spillover effects. In this work, all indirect impacts of MNE activities, including those resulting from cooperation between MNEs and local companies, will be considered as spillover effects.

2.1 Productivity spillovers

Productivity spillovers occur in the horizontal direction primarily through three channels: (i) local firms imitating the technologies and practices of MNEs, (ii) local firms hiring employees who previously worked for MNEs, and (iii) increased competition resulting from the entry of MNEs compelling local firms to enhance their efficiency (Blomstrom and Kokko, 1998; Aitken and Harrison, 1999). In the vertical direction, spillover effects occur, for instance, when MNEs actively assist local suppliers (backward linkages) or customer firms (forward linkages) in improving the quality of their products through training or when local firms themselves gain new experience through collaboration with MNEs. In many cases, the requirement by MNEs for their local suppliers to adhere to specific standards and possess international quality certifications also has a positive impact on the performance and competitiveness of domestic firms (Javorcik, 2004; Pavlínek and Žížalová, 2014). Horizontal spillover effects typically occur unintentionally from the perspective of MNEs, as they seek to minimize spillover effects within their own industry and toward competitors. Vertical spillover effects, on the other hand, can be beneficial for MNEs in many cases and may occur intentionally (in the case of supplier training) or unintentionally (when domestic suppliers imitate MNEs) (Blalock and Gertler, 2008; Javorcik, 2004). Blomstrom and Kokko (1998) suggest that significant productivity spillover effects can be expected, especially when the technologies used by MNEs are not readily available in local markets, when MNEs sell their products in local markets, and when MNEs enter industries with higher capital requirements and advanced technology, where competition is typically lower, and MNE entry has a greater impact on the efficiency of local firms.

2.2 Market access spillover

Market access spillover effects allow local firms to penetrate new export markets through MNEs and can occur in several ways. They may arise when local suppliers are involved in the production of a product exported by MNEs. In this scenario, local suppliers may simultaneously acquire new knowledge related to foreign market preferences, such as quality, packaging, design, and so forth. Furthermore, market access spillover effects occur when local firms leverage their experience from previous collaborations with MNEs to enter export markets on their own or replicate MNEs' approaches for accessing foreign markets. Domestic firms can also be influenced by the outcomes of MNE lobbying efforts, especially in the context of trade liberalization (Blomstrom and Kokko, 1998).

The magnitude of spillover effects depends on various factors, including the strength of the ties between MNEs and local firms, the absorptive capacity of local firms, technological gaps, or geographical distances (Blomstrom and Kokko, 1998; Javorcik and Spatareanu, 2005; Demena and Bergeijk, 2019). Javorcik (2004) mentions that the mode of operation of MNEs can also significantly impact the size of spillover effects. MNEs collaborating with local businesses through joint ventures or formed through mergers and acquisitions typically have a greater tendency to cooperate with local suppliers than greenfield MNEs. Moran (2005) emphasizes that the impacts on local firms can vary greatly depending on the level of development of the host economy as less developed countries with lower level of education and technology tend to have lower absorptive capacity. High labor mobility (between foreign and domestic firms, as well as among domestic firms) is also considered a significant prerequisite for the operation of spillover effects, as it enables the broader dissemination of knowledge generated in the research and development activities of foreign (and domestic) firms across economic sectors (Foster and Poschl, 2009).

2.3 Crowding-in and crowding-out effect of spillovers

The ultimate impact of the aforementioned spillover effects on the host economy can be either overall positive or overall negative. In the case of an overall positive effect, it is referred to as the "crowding in" effect, while in the case of an overall negative effect, it is termed the "crowding out" effect (Dunning and Lundan, 2008). Lall (2000) highlights that MNEs possess several advantages over local firms that position them more favorably in the market, such as superior negotiating power, greater capacity for employee training, continuous improvement of processes and technologies, better access to financial resources, and sometimes privileged access to local natural resources. When local firms lack the capacity to leverage the advantages stemming from the presence of foreign companies, the crowding-out effect may prevail, potentially rendering a significant number of local firms non-competitive. However, it is important to assess whether foreign companies are displacing potentially efficient local firms or firms that can never achieve efficiency and full competitiveness. Given that supporting local firms is a key policy objective for many governments, concerns about an excessive crowding out effect are understandable.

Lall (2000) emphasizes that in practice, distinguishing between the crowding out effect and ordinary competition is exceedingly complex. However, if policymakers fail to make this

distinction correctly, it can lead to inefficient and uneconomical support for local firms, with a high negative impact on domestic consumers. The risk of countries falling technologically behind due to restrictions on the entry of foreign companies can be very significant in this regard. Regulations of FDI for the protection of domestic firms may be meaningful but must be applied with the utmost caution, monitored, and, if necessary, revoked.

A significant portion of the related empirical literature aims to assess the extent of spillover effects occurring in the host economy (or whether they occur at all) and their resultant effects. In economic literature, the magnitude of spillover effects is typically evaluated through econometric models examining the relationship between FDI inflows and aggregate factor productivity or labor productivity, often derived from the production function (see, for example, Javorcik, 2004, or Geršl, Rubene, and Zumer, 2007). One limitation of these approaches, as noted by Pavlínek (2022), is the inability to identify the specific channels through which any spillover effects operate. For this reason, he highlights the approach employed by economic geographers, which involves conducting structured interviews and questionnaires.

Concerning the findings of previous research, there is a certain consensus regarding the existence of positive spillover effects in the vertical direction, occurring through direct collaboration between foreign firms and local supplier firms (backward linkages). However, when it comes to horizontal spillover effects and vertical spillover effects between foreign firms and local customer firms (forward linkages), the results are highly heterogeneous. The heterogeneity in results can be attributed to significant differences in the methodology used in various studies, encompassing a wide range of econometric and qualitative approaches. Additionally, spillover effects are dependent on a multitude of variables, such as the size of local firms, the technological gap between MNEs and local firms (Blomstrom and Kokko, 1998; Demena and Bergeijk, 2019), or the level of development of the host economy (Moran, 2005) as mentioned in previous chapter.

When comparing the significance of vertical and horizontal spillover effects, Javorcik (2004) conducted research based on panel data from Lithuanian firms spanning the period from 1996 to 2000. Her findings revealed significant vertical spillover effects between MNEs and local suppliers. However, she did not confirm the presence of horizontal spillover effects or vertical spillover effects occurring through linkages with local customers. These conclusions were corroborated by Geršl, Rubene, and Zumer (2007), who analyzed spillover effects in Central and Eastern European countries using data from the period 2000-2005. The authors examined the relationship between the development of aggregate factor productivity of domestic firms and the presence of foreign entities in the same economic sector (horizontal spillover effects) and in sectors connected to foreign entities through distribution chains (vertical spillover effects). They demonstrated that more significant and economically important spillover effects occurred in the vertical direction. The study also revealed the existence of some negative spillover effects leading to a reduction in the productivity of local firms, such as the outflow of skilled labor to MNEs (brain drain) or the limitation of market share available to local firms (market stealing effect).

Several other studies further supported the greater significance of vertical spillover effects between MNEs and their local suppliers, including Ivarsson and Alvstam (2005), Blalock

and Gertler (2008), and Gorodnichenko, Švejnar, and Terrell (2014). In contrast, Pavlínek and Žížalová (2014) arrived at opposite results regarding the assessment of the significance of vertical and horizontal spillover effects. They analyzed the relationships and potential spillover effects between companies owned by foreign entities and domestic firms in the Czech Republic's automotive industry. The authors utilized data collected from 317 domestic and foreign companies through their own questionnaire in 2009 and conducted 100 interviews with company representatives in the periods 2009 and 2011. Their analysis demonstrated a higher share of horizontal spillover effects, which were both positive and negative. Negative spillover effects were primarily caused by increased competition, leading to the closure of several firms or their acquisition (or partial acquisition) by MNEs, resulting in a strong crowding-out effect. Surviving domestic firms, on the other hand, benefited from positive horizontal spillover effects through mechanisms like imitation and improved access to domestic and foreign markets, leading to the enhancement of their products and integration into global production chains. A lower prevalence of vertical spillover effects compared to horizontal ones was found, and it was attributed to limited cooperation between firms owned by foreign entities and domestic firms (86.5% of suppliers were non-local). The limited collaboration with local suppliers was primarily due to their perceived lower quality and the unavailability of certain materials and products. Demena and Bergeijk (2019), who analyzed the channels through which spillover effects operate in Uganda, also arrived at the conclusion that spillover effects, both positive and negative, occur through various channels, with increased competition due to the presence of foreign firms being the most significant. The significance of the horizontal channel of imitation (where local firms replicate the practices and products of MNEs) was confirmed in the case of eight sub-Saharan countries in the study by Demena and Murshed (2018). The importance of spillover effects through the horizontal channel of labor mobility was identified in research conducted by Gorg and Strobl (2005) focusing on Ghana and by Balsvik (2011) in a study centered on Norway. Labor mobility was also recognized as the most significant channel in the study by Jude (2016), which assessed spillover effects in Romania.

Regarding the overall impact of spillover effects, Kosová (2010) demonstrated, in research focused on the Czech Republic from 1994 to 2001, a crowding-out effect in the short term (2 years), with a predominance of positive effects in the long term, primarily due to technology-related spillover effects. Kosová also confirmed the necessity of a certain level of technological advancement among domestic firms for them to benefit from the presence of MNEs. Given the proven long-term benefits of MNEs, the author recommends the removal of FDI restrictions by the state. Crowding-in effects of FDI were also confirmed by Lin, Liu, and Zhang (2009) in a study focusing on China from 1998 to 2005. However, the positive effect was not confirmed for FDIs originating from Hong Kong, Macau, and Taiwan. Choi (2018) subsequently confirmed the crowding-in effect on data from Korean firms spanning the period 2006-2013, but only for large companies. Smaller firms experienced a negative overall FDI effect. On the other hand, in Vietnam from 2011 to 2015, Huynh and Nguyen (2021) verified a crowding-out effect. Although the authors demonstrated positive vertical spillover effects between MNEs and local suppliers, negative horizontal spillover effects predominated.

Conclusion:

This paper focused on summarizing existing literature regarding the spillover effects of foreign direct investment. The empirical literature extensively demonstrates that the activities of foreign companies play a pivotal role in fostering the economic growth of host economies. The magnitude and nature of this impact, however, are contingent upon a myriad of factors intrinsic to the host country. A comprehensive analysis of these determinants reveals that the level of export openness (Balasubramanyam, Salisu, & Sapsford, 1996; Trevino et al., 2002), the stock of human capital (Borensztein, De Gregorio, & Lee, 1998; Bangoa & Sanchez-Robles, 2003), the quality of institutional frameworks (Olofsdotter, 1998; Slesman, Baharumshah, & Wohar, 2015; Rodrik et al., 2004; Acemoglu, Gallego, & Robinson, 2014), and the state of infrastructure (Lim, 2001) all exert substantial influence on the extent to which foreign firms contribute to a host country's economic growth. Furthermore, the nature and scope of the activities undertaken by foreign companies within the host economy play a crucial role in determining their impact (Pavlínek, 2022).

One of the primary mechanisms through which foreign companies bolster economic growth is via spillover effects. These spillover effects are not confined to specific sectors but manifest across diverse industries (Javorcik, 2004; Geršl et al., 2007; Ivarsson & Alvstam, 2005; Blalock & Gertler, 2008; Gorodnichenko et al., 2014). They extend their reach beyond inter-industry dynamics and also permeate within the same industries, leading to increased productivity and innovation (Pavlínek & Žížalová, 2014; Demena & Bergeijk, 2019; Demena & Murshed, 2018; Gorg & Strobl, 2005; Balsvik, 2011; Jude, 2016).

The empirical evidence thus highlights the substantial role foreign companies play in fostering the economic growth of host economies. This influence is however contingent upon a complex interplay of factors within the host country, including export openness, human capital, institutional quality, and infrastructure, as well as the nature of foreign companies' activities. Spillover effects, occurring both across and within industries, can also have significant contribution to host economy development. Nonetheless, positive effects are not automatic and we should not forget also about possible negative impacts on host economies.

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