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FOREIGN DIRECT INVESTMENT AND THE DEVELOPMENT OF LOCAL FIRMS

Nicolae MARINESCU[1]

Abstract: *This paper aims to investigate the influence of foreign direct investment (FDI) on the development of local firms with a special emphasis on countries in Central and Eastern Europe. Findings are twofold: FDI may hinder the growth of local firms if it impedes their innovation capacity and contributes to their crowding out, or it can foster their growth in the long run by establishing strong linkages. The outcome depends on the particular context in each country. Therefore, policy-makers need to enact sensitive measures to balance the relationship between FDI and local firms.*

Key words: *foreign direct investment, local firms, crowding out.*

1. Introduction

There is an ongoing fierce competition between countries, including the ones in Central and Eastern Europe (CEE) to attract foreign direct investment (FDI), due to the positive impact it may bring on economic development. Benefits usually come in a package of: capital investment, transfer of technology, implementation of managerial and organizational practices, as well as access to foreign markets.

Mastering logistics networks across the European Union (EU) and enjoying popular, well-known brands for their products, transnational companies (TNCs) have succeeded in penetrating the business environment of CEE countries rather easily.

Domestic firms, sometimes unable to reap the benefits of scale economies as their larger foreign counterparts, and lacking proper knowledge for undertaking an efficient international marketing, are frequently crowded out of their initial markets.

This paper aims to draw attention to some less debated issues related to FDI, i.e. the potential negative effects that foreign entrants may have on the future development of local firms.

2. Literature Review

Central and Eastern European countries are generally seeking to promote the local industry, especially in dynamic, high-tech sectors. Diversifying the technological skills of

[1] *Transilvania* University of Braşov, marinescu@unitbv.ro

local firms may bring greater benefits than obtaining the same technologies from TNCs, as there is little empirical evidence in favour of spillovers (see Gorg and Greenaway, 2004, Javorcik and Spatareanu, 2008). There is higher interaction by domestic firms with local institutions, and, where innovative activities take place, the know-how generated will be used as an own asset for competitive advantage.

Particularly in sectors with complex activities, technological innovation and growth of local firms may be inhibited by the entry of subsidiaries of large TNCs (Acar et al., 2012). Policy makers need to help local firms narrow the gap in such cases (Jensen, 2006).

It is important, however, to distinguish between the crowding out of potentially efficient local firms by subsidiaries of TNCs and the removal of inefficient ones from the market due to their inability to become competitive (UNCTAD, 1999). In a recent paper, Jude (2018) finds positive evidence of creative destruction by FDI in ten CEE countries with short-term crowding out effects, but long-term crowding in effects for local firms. The same positive result of crowding-in in the long run, albeit in a small amount, is found by researchers in the case of African countries analysed over the period 2001-2015 (Seetanah et al., 2018).

In their seminal work from 1999, Markusen and Venables developed a theoretical framework on the ways in which linkages between TNCs and local firms can become a catalyst to the growth of the domestic industry. Positive evidence for the stimulating effect of FDI on local development was found by Tomsik et al. (2001) for Hungary and the Czech Republic and by Fotopoulos and Louri (2004) for Greece.

The ability of local firms in the host country to benefit from foreign technology induced by TNCs is not automatic though. It has been shown (see Blomstrom and Kokko, 2003, Kemeny, 2010) that the most important factor of interaction with foreign companies has to do with the absorption and learning capacity of local firms.

3. Analysis and Results

The development of local businesses is a priority objective for most CEE countries. In this respect, the possible exclusion of local firms from the industry by subsidiaries of TNCs is frequently a matter of concern. This outcome of crowding out due to FDI can take place in two ways:

- in the goods and services market, by negatively influencing research & development (R&D), and the growth process of competing local firms;
- in the factor markets, by reducing the access to certain factors of production, or by increasing costs for local firms.

The first aspect refers to the well-known „infant-industry" argument, but without its usual meaning of protecting sectors or companies with growth potential from competing import products. It refers to supporting and accelerating the R&D process in local companies compared to foreign ones. FDI may stop or hinder the development of local firms, when direct exposure to foreign competition prevents them from undertaking costly, long-term R&D activities. Subsidiaries of TNCs also undergo a process of adapting to the local environment with the introduction of new technologies

and the training of employees. However, they usually dispose of much greater financial resources and considerably more extensive experience for carrying out these processes.

The second way in which the crowding out of local firms occurs refers to the difficulties faced by local firms due to the segmentation of local factor markets: TNCs may get privileged access to the financial markets (which gives them a special advantage, especially vis-à-vis local firms) and to skilled labour due to their reputation and size. This can increase the costs of entering the industry for local firms or simply deprive them of the best production factors available.

The argument of protecting local firms differs from that of protecting infant industries through protectionism (UNCTAD, 1999). When tariff or non-tariff protection is removed, consumers benefit from cheaper import products and a wider variety of goods, but part of local production may become bankrupt and jobs in that sector fall. It is exactly the situation of many sectors in Romania that started to confront the entire international competition following the liberalization in the early `90s.

The absence of a similar protectionism from FDI does not necessarily lead to a reduction in local production and employment in return for higher benefits for consumers. However, the domestic business development may be impeded and slowed down in the face of increased FDI presence.

Having a strong domestic technological base is vital not only to increase the competitiveness of local firms, but also an important source of attracting FDI with higher technology-intensity.

At the same time, there are, of course, major risks in deliberately restricting FDI so as to encourage local businesses. By the infusion of new technologies and competition, FDI leads to the exit of inefficient firms from the market and an increased efficiency of those that stay. Without such a renewal process, the economy will lack the necessary dynamics and flexibility to withstand international competition.

In practice it is very difficult to identify the thin line between forced crowding out of local firms and legitimate competition. If policy-makers fail to make this distinction, they may support inefficient local firms for a long time, which will impose high costs on consumers and have detrimental effects on economic growth. The risk is that domestic firms will be unable to enter export markets in fields with strong product differentiation and integrated production processes at international level (UNCTAD, 1999).

The crowding out effect depends also on the type of FDI: greenfield FDI, as opposed to an acquisition. If greenfield FDI may provoke crowding out by sheer competition (as is the case in retail, for instance, with larger units entering the market and pushing smaller local units aside), acquisitions, per se, lead to the elimination of a competitor (the local acquired firm) and maybe other exclusions, if partnering contracts are discontinued.

However, it is beyond doubt that acquisitions of local firms by foreign investors may generate positive effects. This was especially the case in CEE countries when the buyer made long-term commitments in the acquired firm and invested in new technology, providing altogether efficient management techniques. In this situation, the impact is very similar to that of greenfield FDI. Such investments play an important role for the modernization of a previously state-owned sector.

TNCs can also determine the growth of local firms in the industry when they build solid business networks with domestic suppliers and subcontractors. This “migration” of local firms to a specific sector occurs when FDI increases business opportunities, extends the number of local linkages, and attracts many resources. Such incentive effects arise in particular when FDI is concentrated in industries that are new in the host economy.

The positive outcome would be the rise of a horizontal industry, with many small ‘satellites’ from the local company base that circle around the subsidiary of the larger TNC, acting as suppliers, distributors or business partners. This outcome also leads to a high number of indirect jobs, besides the direct ones, pertaining to the TNC. In CEE countries, the indirect job-effect was particularly useful to absorb part of the workforce that has been laid off from former state-owned enterprises.

In effect, backward linkages established by TNCs with local firms for supplying raw materials, parts and components can improve employment and the revenues of local small and medium-sized enterprises, as demonstrated by Marinescu (2016). Nicolini and Resmini (2010) investigate evidence for spillovers across CEE and find that FDI-induced spillovers vary significantly from country to country, depending on the technological gap between foreign and local firms.

In sectors where local firms are well developed, but still have difficulties competing with subsidiaries of TNCs, the detrimental effect of their crowding out will be felt. In some cases, they may become suppliers for foreign companies, or be taken over.

One important aspect, specific to countries of Central and Eastern Europe, is the privatization of state-owned enterprises with foreign investors. Some acquisitions that result in a simple change of ownership similar to portfolio investments are less valuable in terms of development. They may be damaging to the local innovative capacity and competitiveness if R&D activities of the acquired firms are reduced.

Particularly in the case of acquisitions, there is also the danger of diverting relations with local firms providing parts and components to foreign suppliers, which will lead to increased penetration of imports, with negative employment effects and a potential collapse of the entire horizontal industry. This may happen especially when local suppliers fail to meet quality requirements in the short term. Some of the most famous examples for such casualties in the first few years after privatization are the acquisition of the Czech car-maker Skoda by Volkswagen in the early 1990s and of the Romanian car-maker Dacia by Renault in 1999.

Whether it arises through acquisitions or from sheer market power, another negative effect that the penetration of large companies may have on the local industry appears when they significantly reduce the number of competitors in the market, especially for non-tradable goods at international level, such as most services.

Striking the proper balance between the strategy of restricting the entry of foreign firms and encouraging free competition is a delicate and complex decision to take for governments in CEE countries. Only few developing countries at the initial stage have managed to establish a domestic base of advanced technological skills and world-class innovation systems, while restricting access to the local market for TNCs in specific areas, most prominently South Korea and Taiwan (Mazilu, 1999). There are quite many examples of countries that have severely limited the penetration of TNCs, but have

failed to promote competitive domestic firms in high technology industries, often with disastrous economic results, for instance various countries in Latin America. Other countries such as Malaysia, Thailand or Singapore have relied heavily on FDI, integrating their economy into the production and distribution networks of large multinationals and have promoted competitiveness through continuous auto-improvement inside those networks.

Among CEE countries, Hungary has opted right from the start of the 1990s to welcome large TNCs so as to turn around the Hungarian economy and development followed in a fast pace according to the speedy privatization. In comparison, Poland attracted most of its FDI only after registering significant economic growth, while Slovenia became the most developed country of CEE in income per capita without relying strongly on FDI.

The success of any strategy is certainly dependant on many other elements apart from protecting R&D and growth processes, including the availability of complementary resources (physical, financial, human), the level of economic development, the size of the internal market and the competitive environment in which it is applied.

4. Conclusions

The aspects investigated in this paper on the crowding out of local firms by subsidiaries of TNCs still remain a significant topic to be addressed in future research.

The crowding out of local firms can generate a long-term loss to the host country's economy if it prevents or slows down the development of local innovation capacity. This can lead to a technological dependency on FDI and to the host economy remaining at a lower technological level than its potential.

As such, this matter should be carefully analysed by policy-makers in CEE countries in order to take appropriate measures. It is certain that there is no one-size-fits-all strategy on addressing FDI. To be effective it must be tailored to the specific context.

The infant industry argument remains valid and may justify public intervention to promote the development of competences of local firms, but such interventions require a lot of attention in their selection and application. They should be closely monitored and remodelled or fully withdrawn when necessary.

It is very important to create real and solid opportunities for local firms to enter an industry once FDI in the sector has already been undertaken. This could be achieved by boosting research activities and fostering the strengths of local firms, as well as by setting up a strong group of small and medium-sized enterprises to develop business relations with subsidiaries of TNCs.

Taking into account that in Romania local firms compete side by side with FDI in most markets, the government will need to exert both great flexibility and clarity in the future measures that will be taken in this area.

As TNCs tend to focus their activities in concentrated industries, they increase the concentration index of a sector and may lead to the abuse of market power. The development and implementation of an effective competition policy is becoming paramount in a world where large companies can easily dominate a particular industry in the host economy.

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