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Why MNEs have little effect on development: applying an extended Lewisian framework

The John H Dunning Centre for International Business

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Development is about moving away from primary and subsistence activity

- The more ‘modern’ an economy the less it depends upon ‘natural assets’, and the greater the dependence on capital. Capital is used in the sense of Smith (physical assets, machines and people, and not (only) in the narrow sense of capital as money)
- assets are enhanced by transforming these natural assets through the adding of value, either through organisational skills, or transforming them through production or processing.
- Economic development springs from reinforcing the efficacy of these transformations within the economy.
- extractive activities are resources that are non-renewable, and are therefore in fixed supply. They have the capacity to provide returns well in excess of their cost of production (referred to as ‘rents’).
- Rents from extractive sectors have the potential to create the basis for further economic activity in other (renewable) industries, therefore acting as driver for sustainable development.

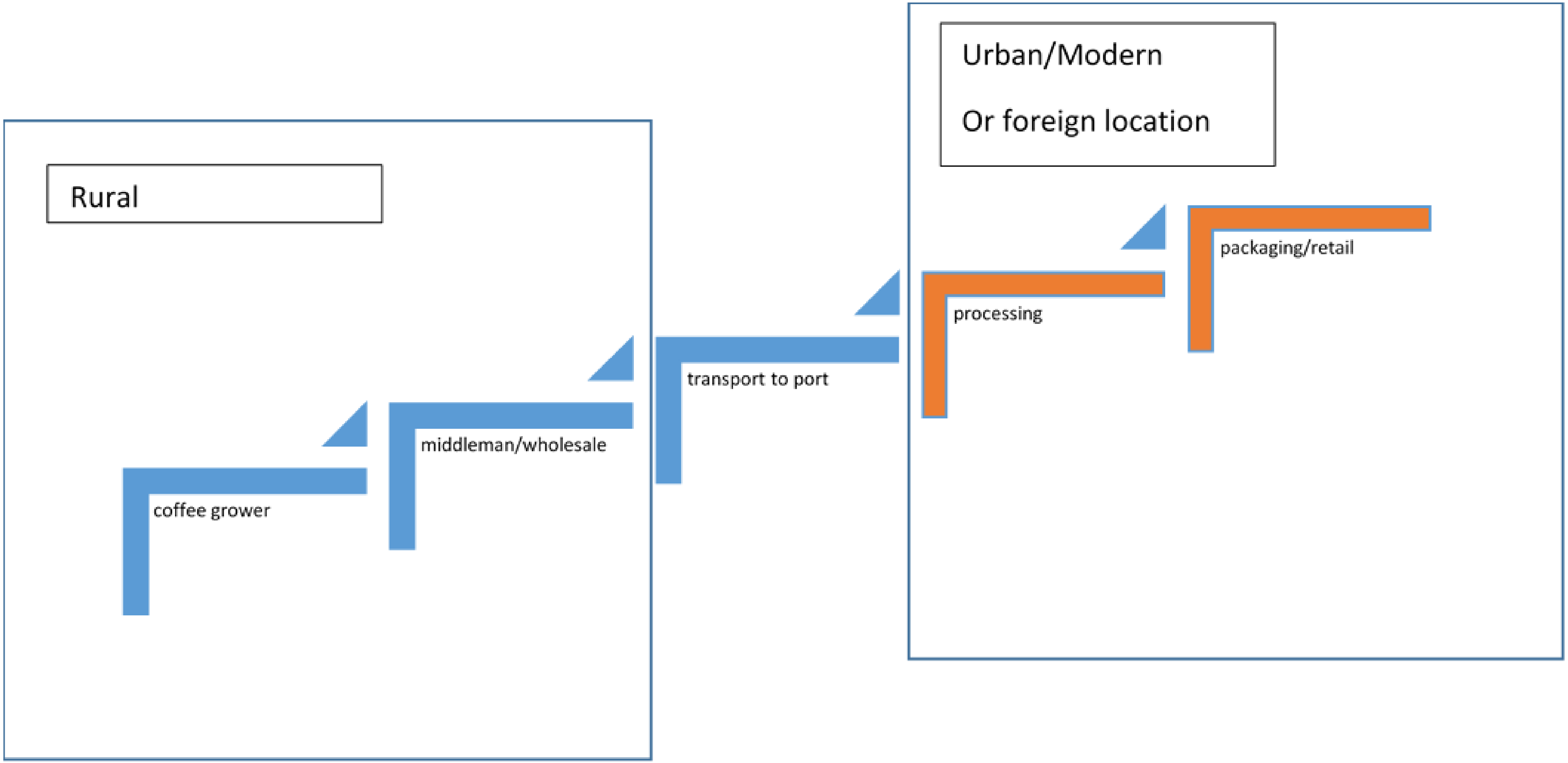
The MNE ('foreign capital') is both the hero and the villain

- Historical view is that it generates too few benefits for the host, causes structural distortions, as well as negatively impacting its political processes.
- MNEs had a habit of internalising the complete value chain and creating enclaves around their facilities that had few linkages or spill overs locally.
- 'enclave economy', and deeply associated with colonialism, and the East (and West) India companies, the original GVCs.
- Considerable path dependence – these structures have survived and shape most economies still.
- They define the concept of duality.

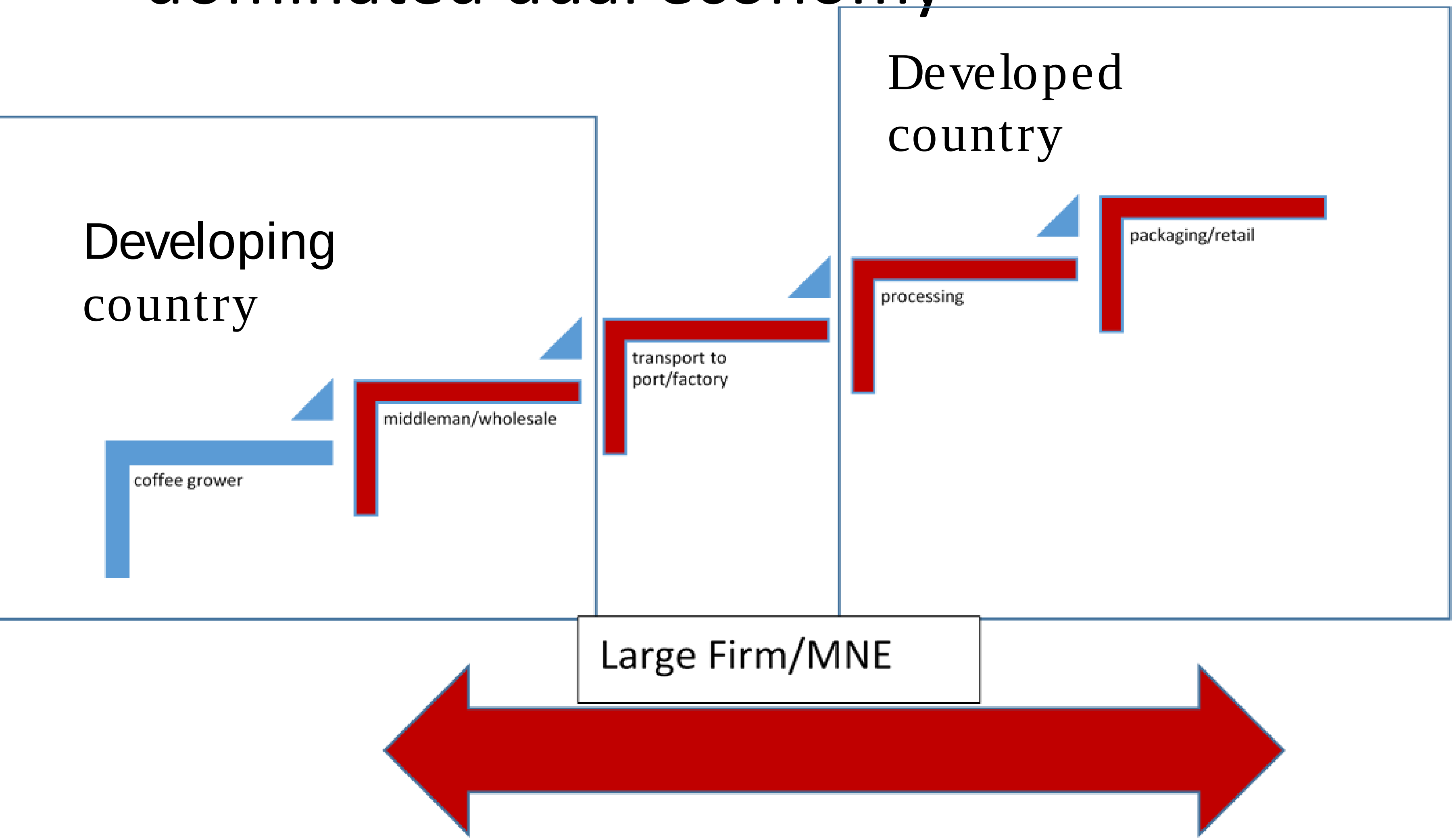
Developing countries: Lewisian dual economy model

- a ‘traditional’ (and often informal) sector that reflects a high labour-intensity and a strong dependence on natural resources and agriculture. The ‘traditional’ sector focuses largely on local needs and is trade-extensive.
- a ‘modern’ urban economy which is engaged in knowledge-intensive, capital– and skills-dependent activities. The ‘modern’ economy is linked to global actors.
  - Examining the prospects for the growth of developing countries requires us to acknowledge both these aspects

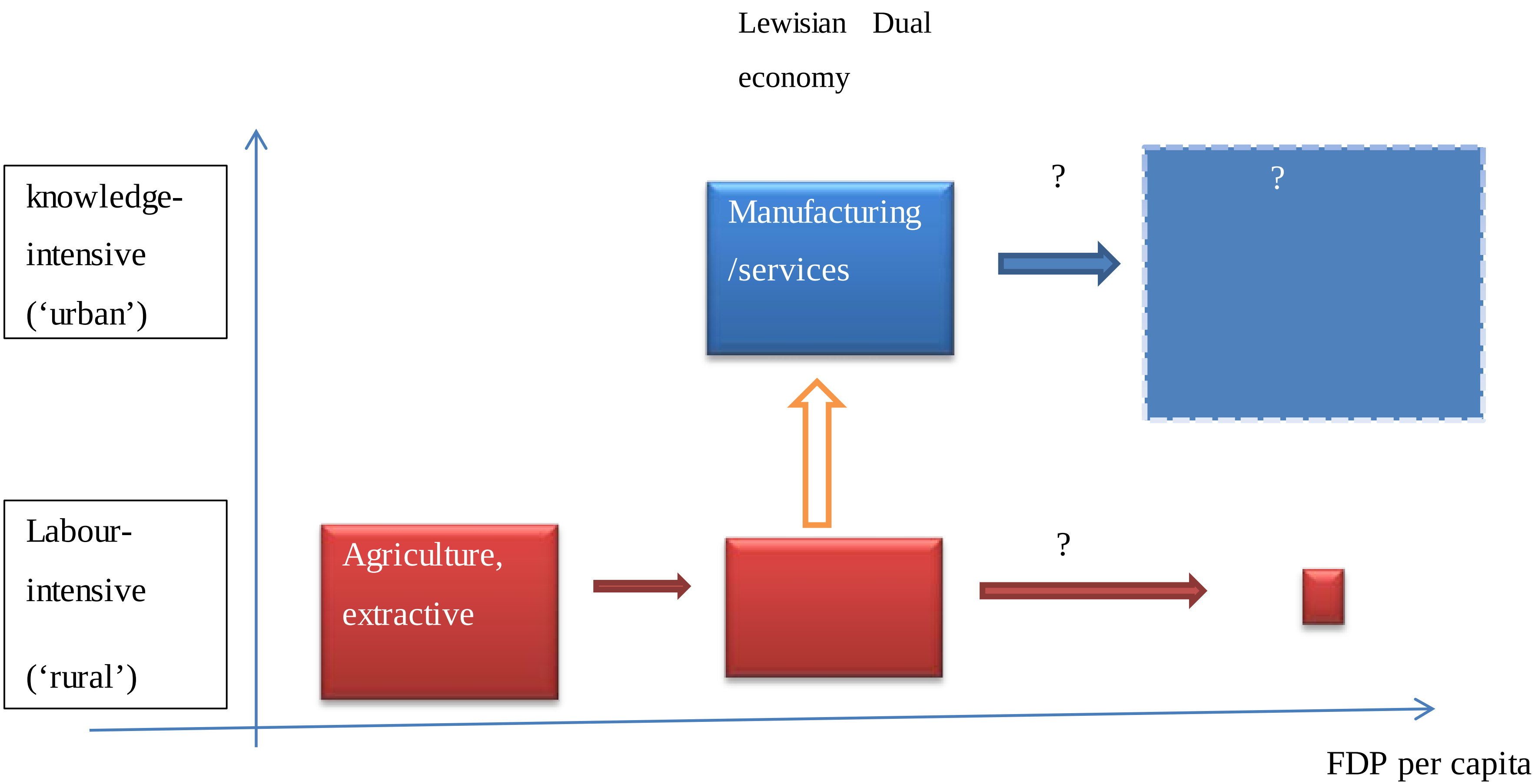
A classic dual economy



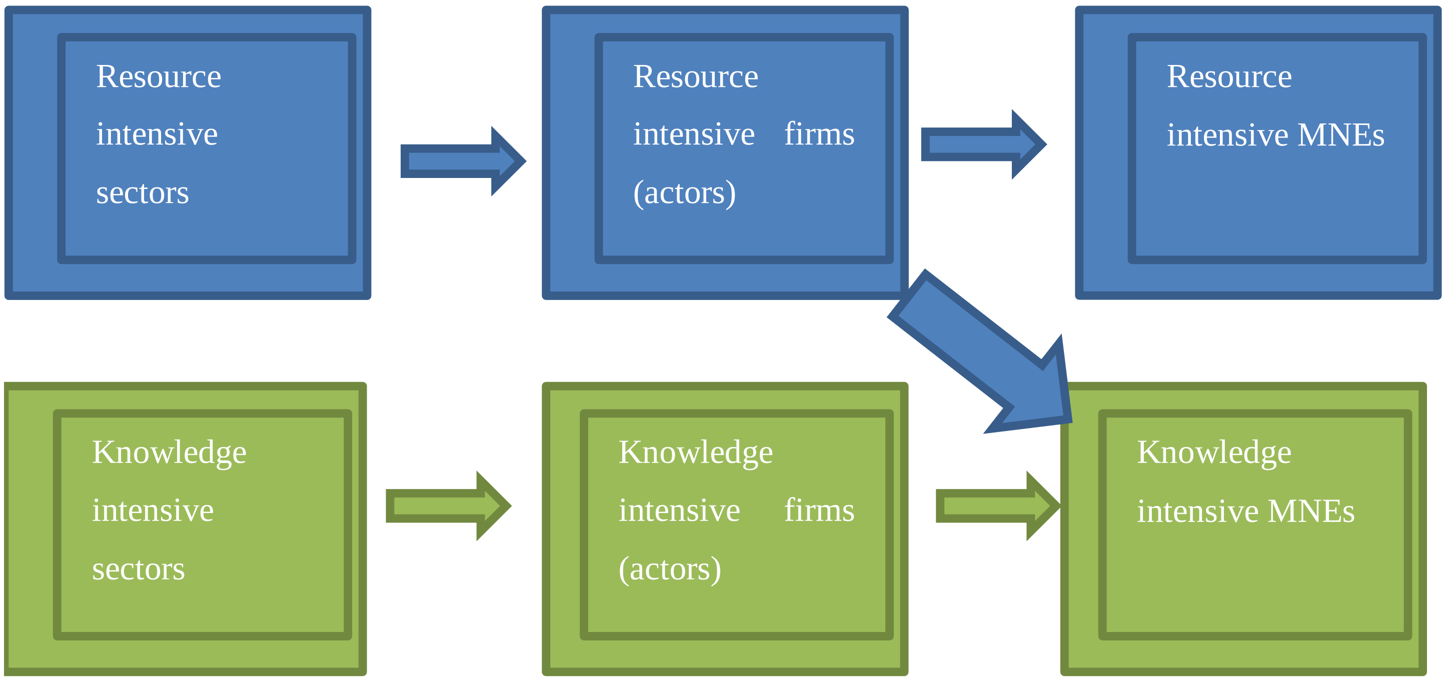
A colonial/foreign capital dominated dual economy



The old school lewisan model – implies linearity



But does not really focus on firms



What are the wonderful things about foreign capital?

1. They have technological capability to access resources in remote locations that are extremely difficult to access, and/or to explore and extract more value from subsoil assets that weaker counterparts would have abandoned
2. They possess an intricate knowledge of specialised markets and are able to organise themselves across a multitude of value chains in several locations.
3. They have deep pockets and access to financial capital
4. They have strong political connections both at home and in the host country.
5. (they can build their own infrastructure because of 3 and 4)

But…foreign capital has not been regarded as good at making things better for development

- Development failed to happen despite plenty of foreign capital…we do see countries getting richer, but we still see undiversified economies.
- Singer, Hirschman, Prebisch, Lewis
- One thing has not led to another.

MNEs and the extractive sector: a drama in three parts

- *Act I: the extractive MNE and rent extraction until the 1950s/60s*
  - Investments in the colonies were designed to extract resources for immediate export and subsequent processing and sale at home at the lowest possible cost (and possible re-export back to the colonies after processing). Over-specialisation of countries reflected the priorities from colonial period. related attenuation of other ‘traditional’ economic activities (for instance, artisanal mining, cottage industries, agriculture) shaped the over-specialisation and accentuated the ‘dual economy’ nature of many developing countries.
  - Regulatory and government capture.

Act II: Import-substitution era and the extractive MNE

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- nationalisation and/or emphasis on creating domestic actors and maximising local content created a new set of domestic actors.
- a number of developing countries made concurrent investments in their location advantages, particularly in infrastructure and education. Indeed, many developing countries had built up a certain degree of absorptive capacity, and a small but impressive set of world-class universities, research institutes and support industries. Development requires as a *sine qua non* a variety of key L advantages.
- In others, rents from natural resources were used for current consumption and wastefully dissipated. Weak governments also utilised resource rents to buy legitimacy. large resource rents can aggravate the feebleness of formal institutions, and this in turn means that resource rents are not deployed for development, but to extend the rule of autocratic and corrupt governments

Act III: Extractive MNEs in the age of globalisation and liberalisation

- There is a greater move away from full internalisation by firms towards non-equity and quasi-hierarchical governance of value chains that involve a network of actors. These developments have increased the potential for greater participation for host country actors

- new actors, in the form of large state-owned (or state-controlled) firms, and private MNEs from developing countries with the capital and resources to compete with the 'traditional developed country MNEs. new MNEs (both state-owned and formerly state-owned) have sought to internationalise, oftentimes relying on their *de facto* status as national champions.

- Extractive MNEs have become conscious of their reputation for regulatory capture, MNEs have sought to act with more consideration. Rent-sharing and contractual obligations negotiated between MNEs and nation states are more carefully observed, not only by the actors themselves but also by NGOs, supra-national institutions and stakeholders in the home country '

FDI has the capacity to generate linkages (the new mantra)

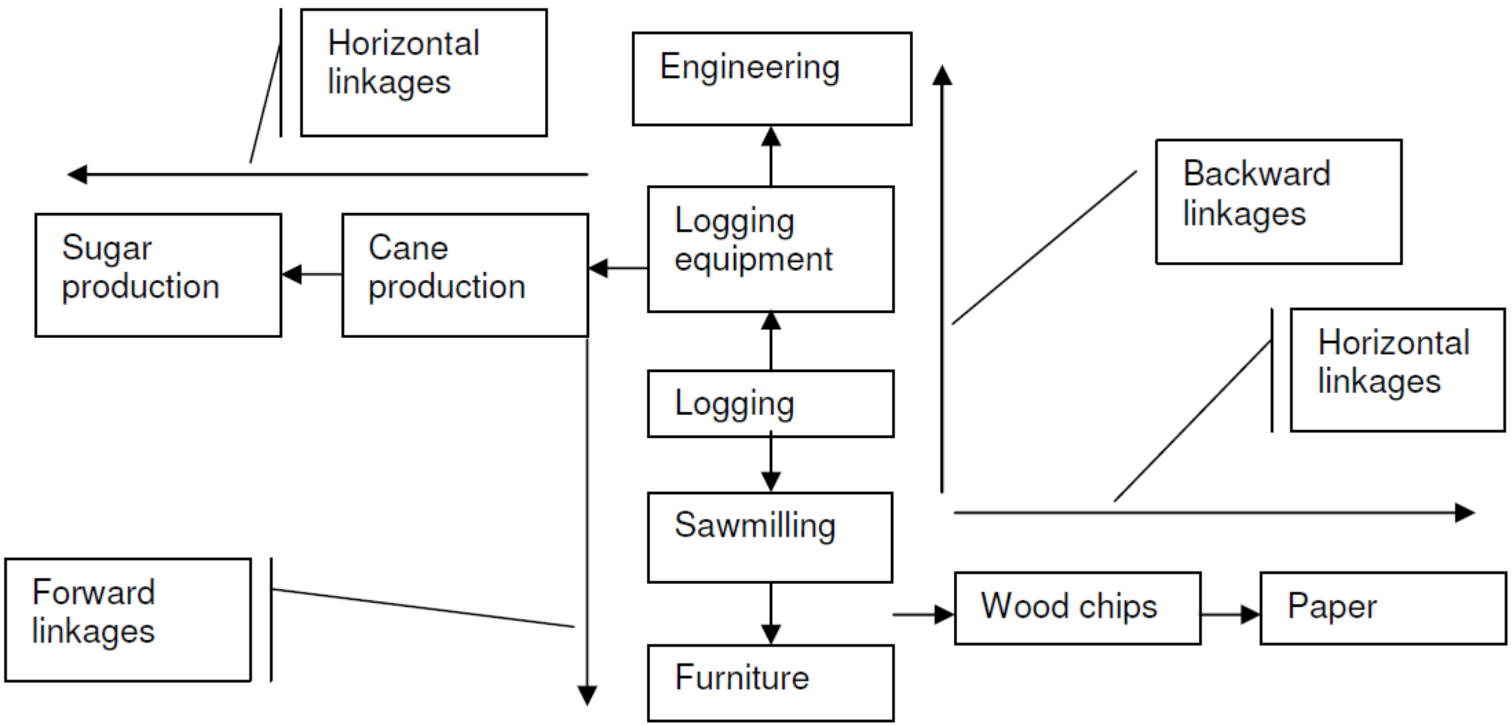
- Fiscal linkages
- Consumption linkages
- Forward linkages
- Backward linkages
- (horizontal linkages)

The new dispensation means:

- increased potential for linkages, both in terms of quantity and quality, and increased the potential for outsourcing and collaborative activities, depending upon the commodity and the institutional conditions of the host country.
- ‘once the lead-firm has made the decision in principle to outsource non-core activities and searched for the lowest cost global suppliers, the logic is wherever possible to have these suppliers on their doorstep, rather than located abroad’ (Kaplinsky)

Need to consider forward, backward and **horizontal** linkages

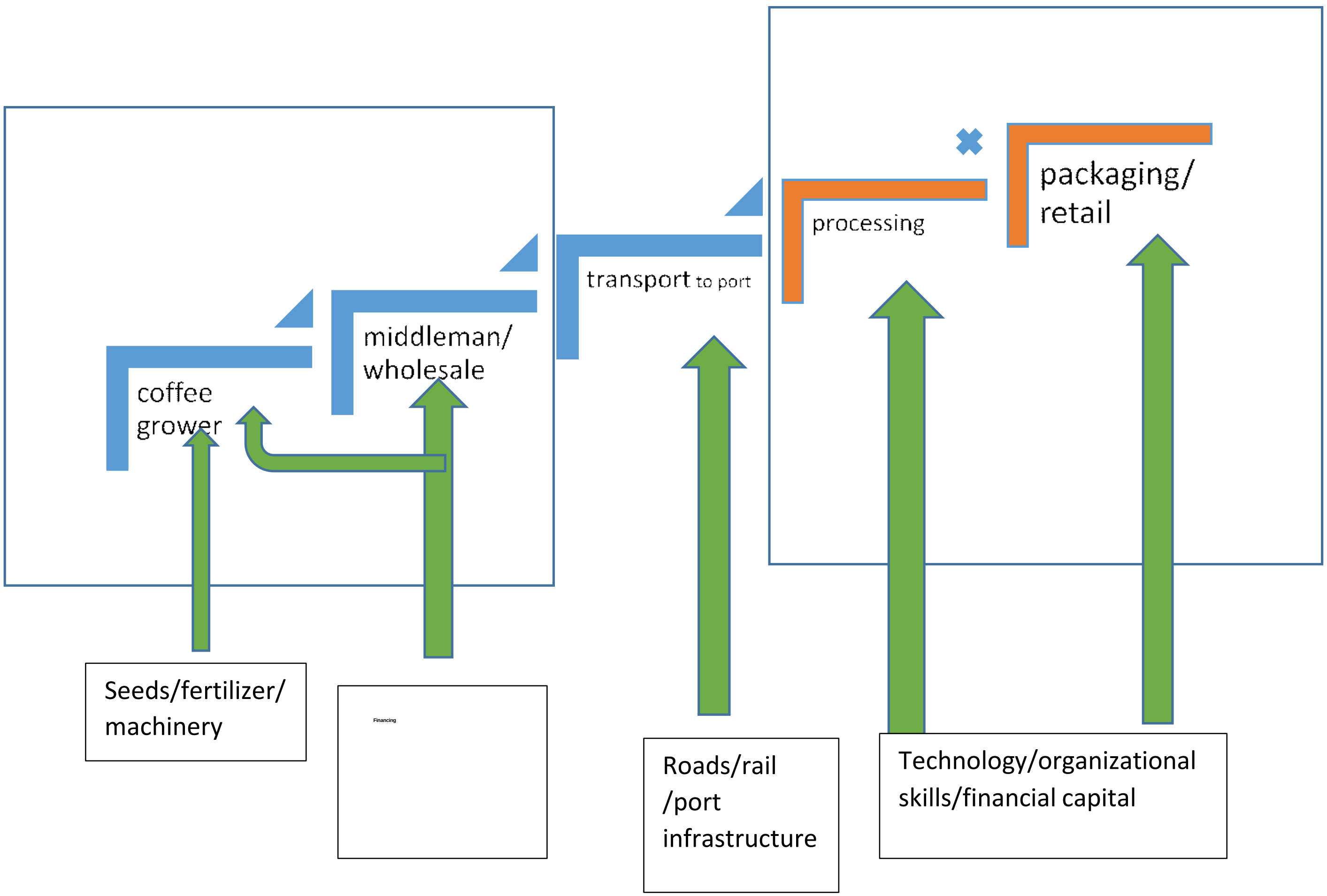
Figure 8: Backward, Forward and Horizontal Linkages from the Timber Sector



source: Kaplinsky, Morris

Intra-sectoral needs to be supported by inter-sectoral

Resources needed to make this happen – on its own the primary sector remains in stasis



but in practise:

- opportunities for supplier firms from less developed countries are limited to support activities that do not require FSAs that derive from global presence and high capital intensity. These include accounting, health and safety, public and community relations, human resources management, marketing, quality control, and civil maintenance. Such activities require local knowledge and contacts, and generate consumption linkages
- opportunities are likely to remain restricted to fiscal linkages and commodity linkages in the absence of a sturdy science and technology infrastructure.
- We see economies that have few actors with which links can be made

'New' MNEs:

- Have altered the market in the extractive industries, but it is not evident that they generate greater linkages.
- Lack knowledge of markets, or how to leverage GVCs
- not interested in fostering supplier upgrade programmes.
- Success largely driven by subsidised capital.

The modified dual economy model

Traditional-Advanced Sector **Primary inputs are natural resource-based, but enhanced by capital. Requires advanced L advantages.** Formal actors utilise FSAs to:

1. Transform natural-resource inputs (steel from iron ore, flour from wheat).
2. Large-scale extractive or farming activities
3. Related industries such as seeds, fertilizers, machinery, tractors, veterinary medicine

Modern-Advanced Sector– **primary inputs are to do with capital. Requires advanced L advantages.** Formal actors utilise FSAs to:

1. Knowledge-based activities and high value-adding segments.
2. Large-scale production activities
3. support industries such as banking, insurance, construction

Traditional-Basic Sector **Primary inputs are land and labour.** Informal and formal actors in a bazaar/feudal/rural economy. These require limited FSAs.

1 Artisanal and cottage industries to produce outputs and services for local consumption (e.g., shoes, laundry, retail)
2 Labour-intensive, small scale farming and mining

Basic-Modern sector Informal and formal actors in the urban environment in a bazaar economy, engaged in location-bound activities with limited FSAs.

1. Artisanal and cottage industries to produce outputs and services for local consumption (e.g., shoes, laundry, retail, restaurants)
2. Labour-intensive, non-scalable services activities

These two sectors in developing countries share many characteristics including non-scalability, weak FSAs, small-scale operations, low capital intensity and a high degree of informality.

So why is foreign capital not very good at promoting development?

- (beyond the obvious)

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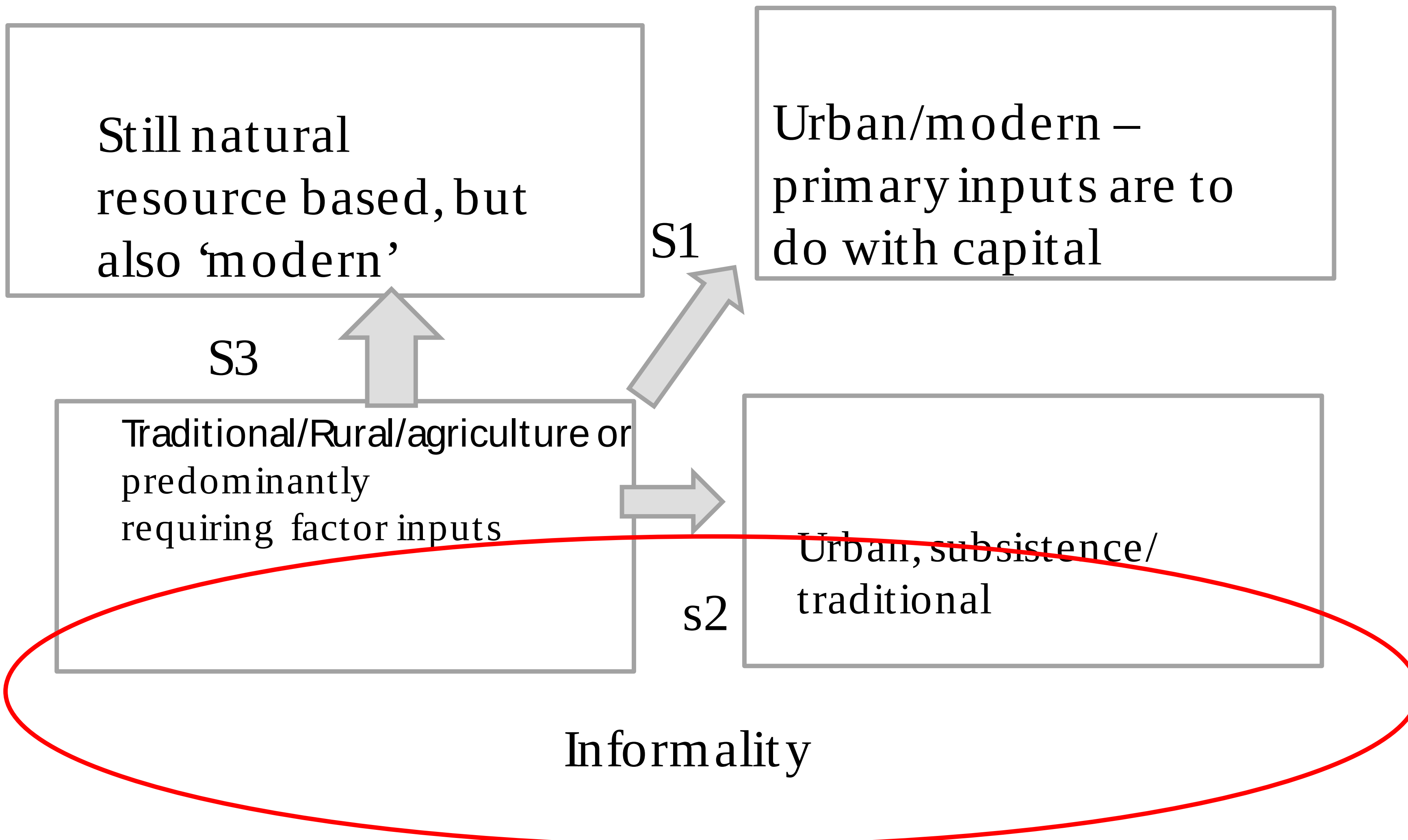
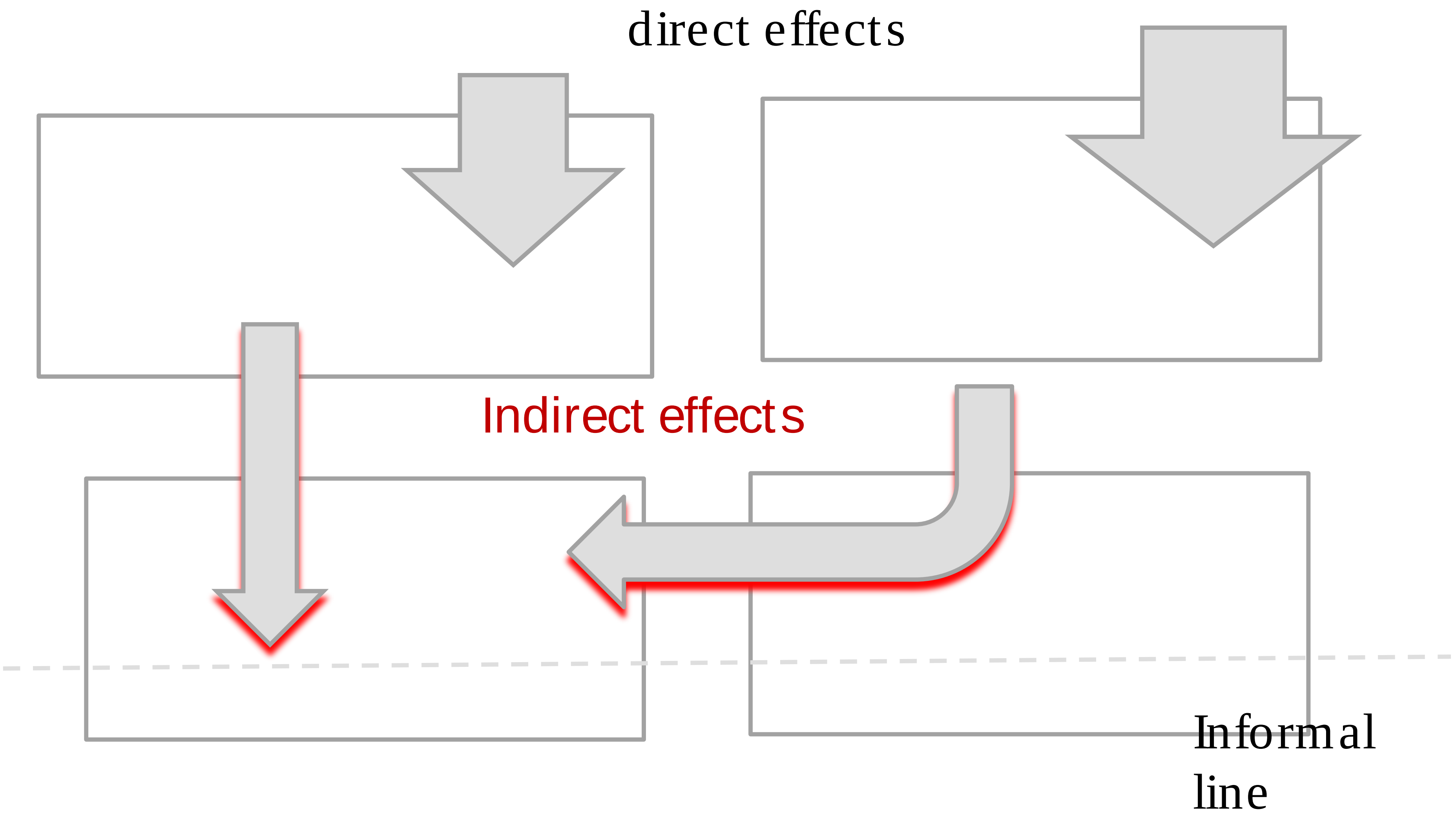
Expanding Lewis



FDI /formal capital?



Prevalence of a traditional economy – not just about absence of capital (borrowing from Geertz, Hart)

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- financial capital is inefficiently being used, in terms of reducing the dependency of actors on a stochastic but frequent series of spot market transactions, the combined cost of which absorb the energies of the actors, and divert investment from utilising their resources towards longer term (and more profitable) goals.
- “the bazaar-trader is unable actively to search out and create new sources of profit; he can only grasp occasions for gain as they fitfully and, from his point of view, spontaneously arise.”
- civil society is not geared towards modern capitalism and the operations of firms in a ‘modern’ capitalist sense.
- The skills to operate in a modern economy are not easily available, and require learned skills, not inherited ones.

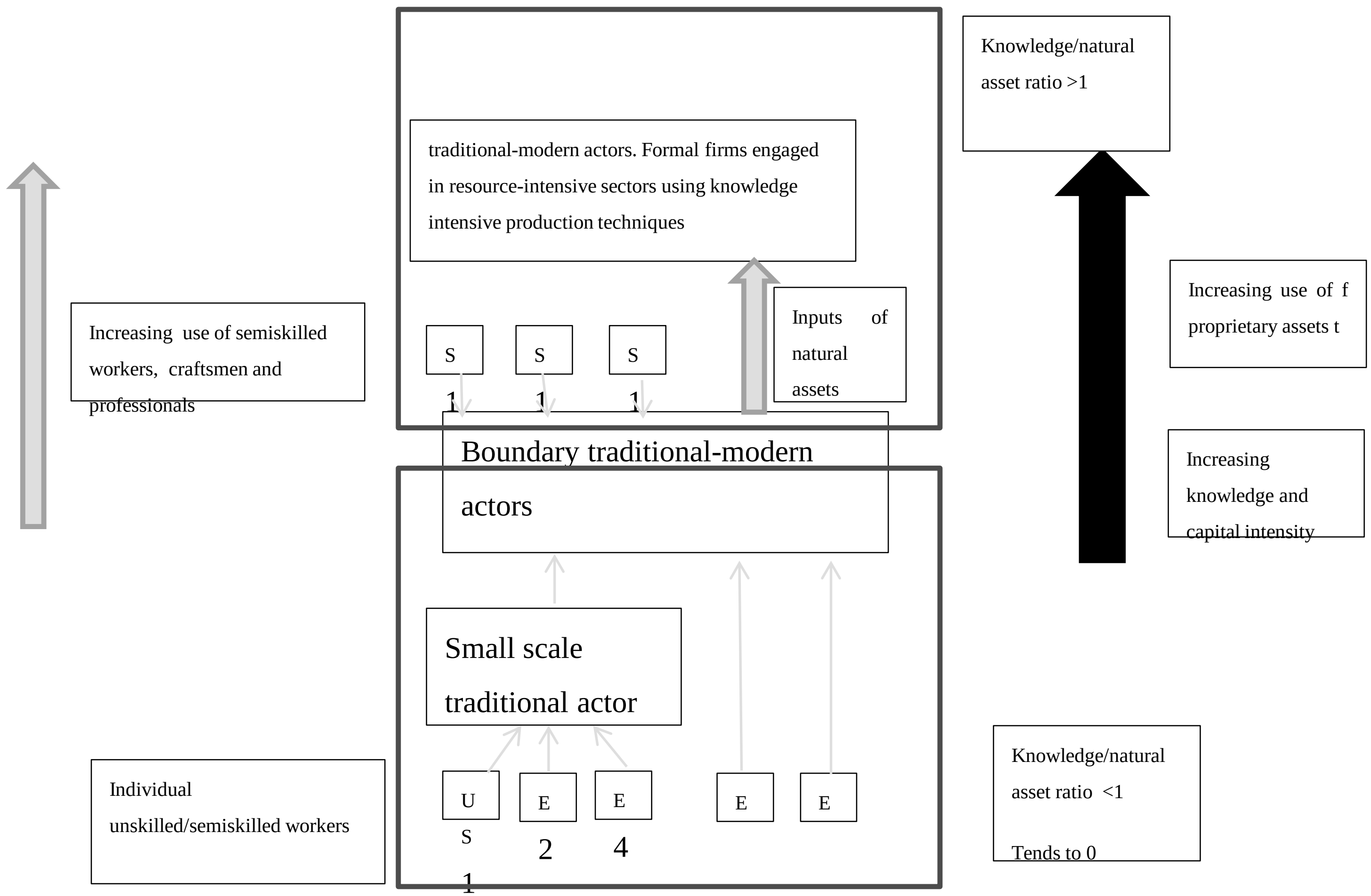
Boundary actors in the traditional economy (21st century feudalism)

- boundary actors have a prominent role, in maintaining the status quo, which on the one hand provides stability and structure, but creates employment rigidities for those lower down in the hierarchy. traditional hierarchical structures reserve the larger share of rents for the boundary actors. Development depends on the benevolence of this single group of actors to improve the welfare of others within their orbit, both individually and collectively. History and evidence indicates that enlightened behaviour is the exception, not the rule.

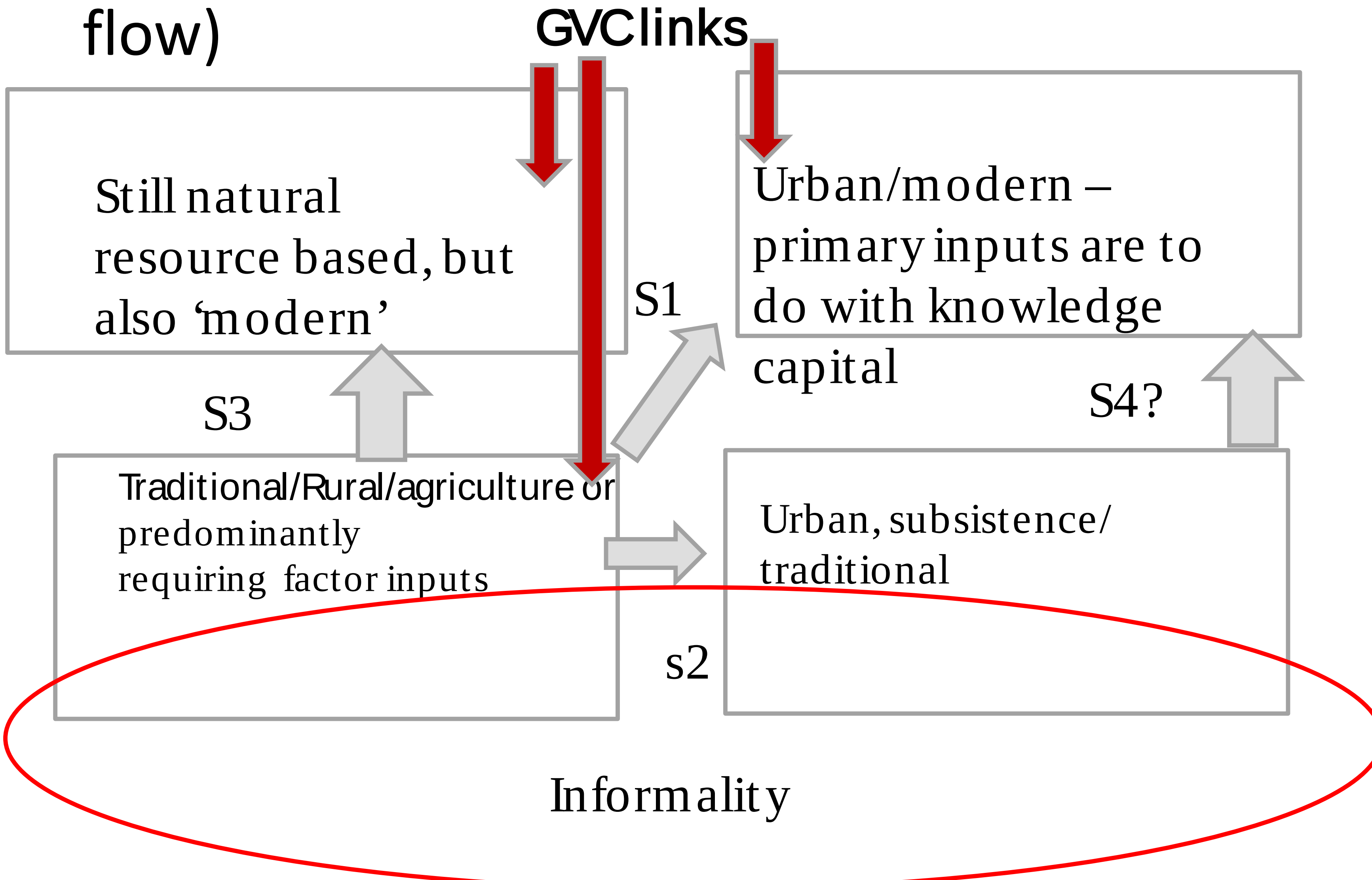
- Nonetheless, boundary actors are often endowed with the managerial and organisational expertise needed to create efficiencies; they most closely resemble formal firms. Large actors may employ trucks, drivers, mechanics, accountants, managers, and other specialists on an ongoing basis. Boundary actors may provide services that act as a 'public good' (should they choose to do so) to their subservient communities.

- He or she benefits instead from an alternative system of institutions. Services and infrastructure, such as they are, are courtesy of the boundary actors. Links to the formal economy must go through them.

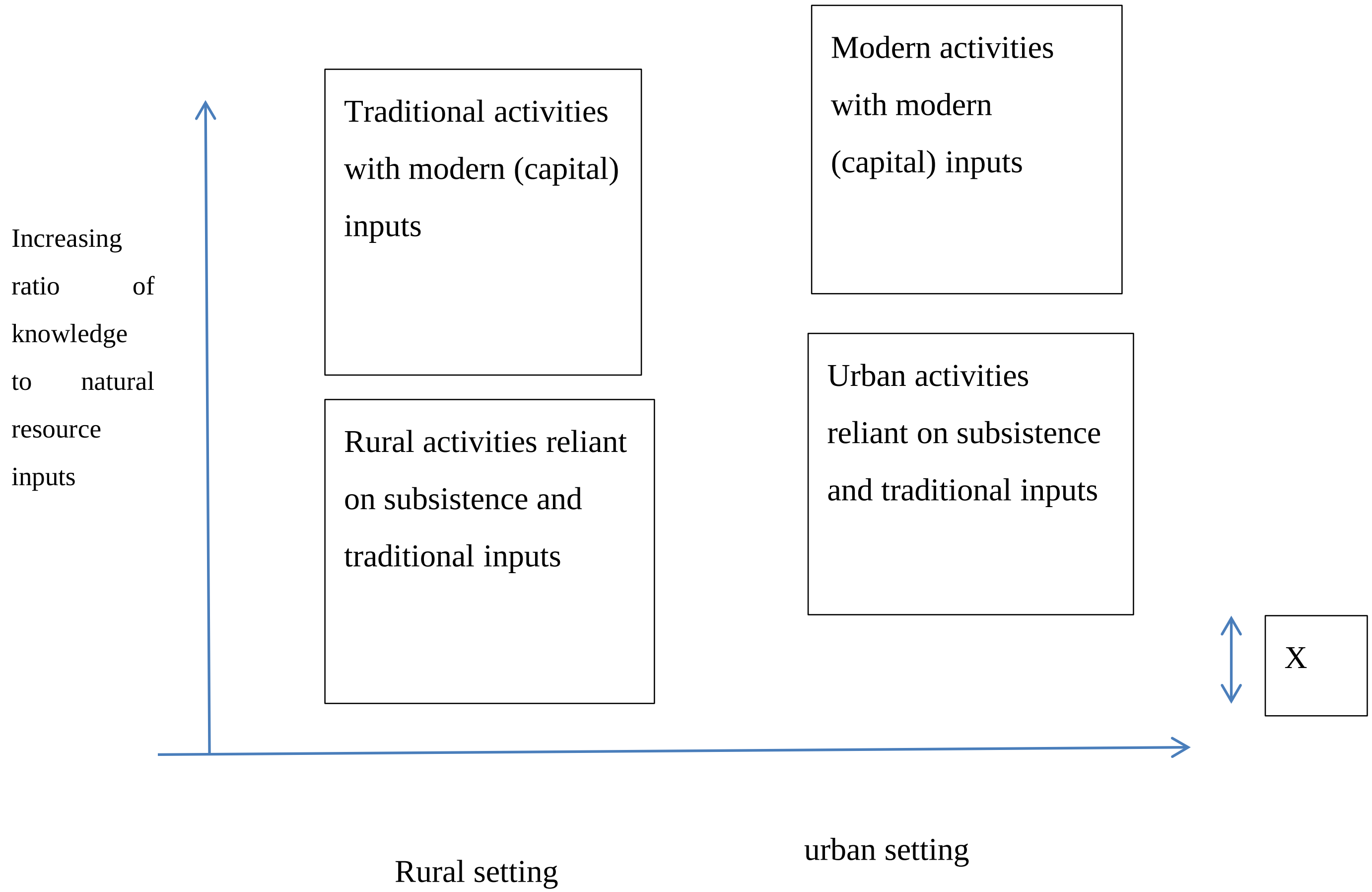
Splitting the traditional/bazaar/rural economy



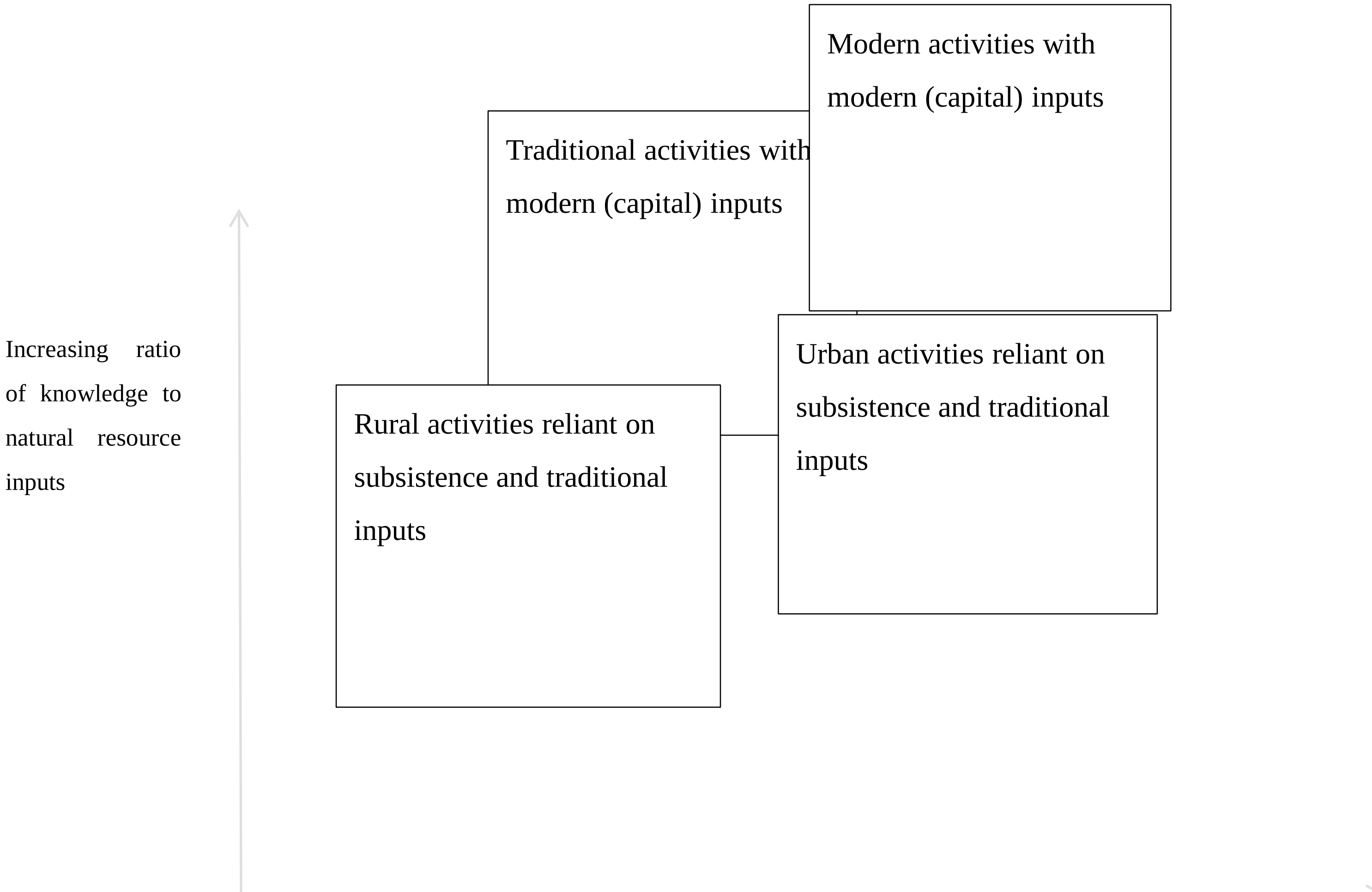
Opportunities from growth come also from S3, not only S1 (the classic Lewis flow)



The difference between the ‘traditional urban’ and ‘traditional rural’ = X = worth of public goods



Overlaps and shares are idiosyncratic and location-specific



Summary
- clarifies the bottle necks that define the vicious cycle of poverty & middle income trap

- FDI does not help development, because only parts of the economy get ‘refreshed’
- FDI is not (only) about financial resources. And FDI is not what it used to be – non equity activities and arms-length arrangements (GVCs)
- Obsession with GDP does not help. Better to focus on employment (and recognise structural underemployment as being undesirable).
- There is limited growth in dynamic sectors that can absorb unskilled workers
- Employment grows in non-scalable activities and activities where greater productivity requires investments in human capital and infrastructure. Movement from informal to formal will only help if public goods are available to incentivise formality.

How to shift resources from inefficient to efficient sectors?

- An industrial development strategy is no longer really viable.
- Deindustrialisation (or no-industrialisation) means LDCs have economies that have only two sectors – traditional urban and traditional rural. And slums. And expanding cities. And emigration. low productivity primary to low productivity services
- Middle-income countries face the same problems
- Better to think in terms of non-formal instead of informal.

Why this is not yet a paper

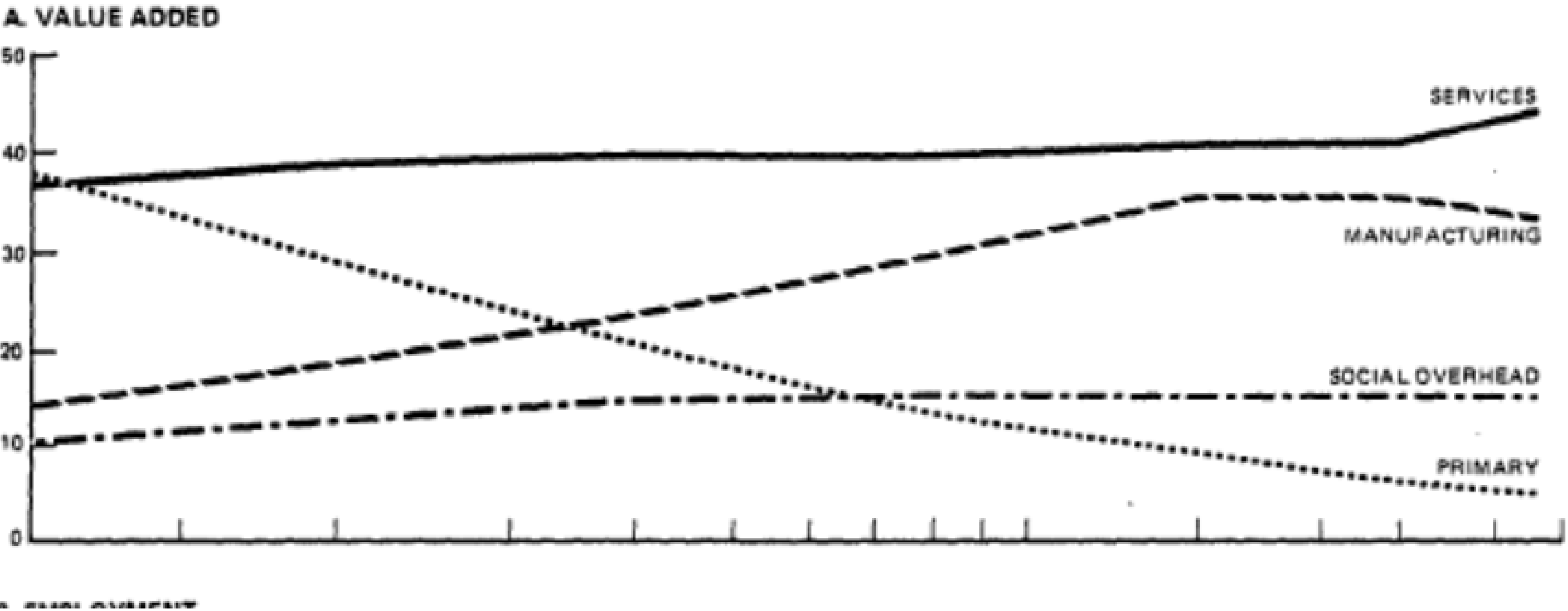
- Imperfect overlap between informality/subsistence, traditional/bazaar/rural - services versus primary? 3 sectors, or 4?
- What is a 'modern' economy? Where are the boundaries? services versus manufacturing?
- Capital – what is it?
  - Knowledge capital/human capital/financial capital
- Institutional lock in versus sociological bottlenecks
- What are the mechanisms to resolve, where government failure/regulatory and institutional capture are pervasive?

The end!

Spare slides

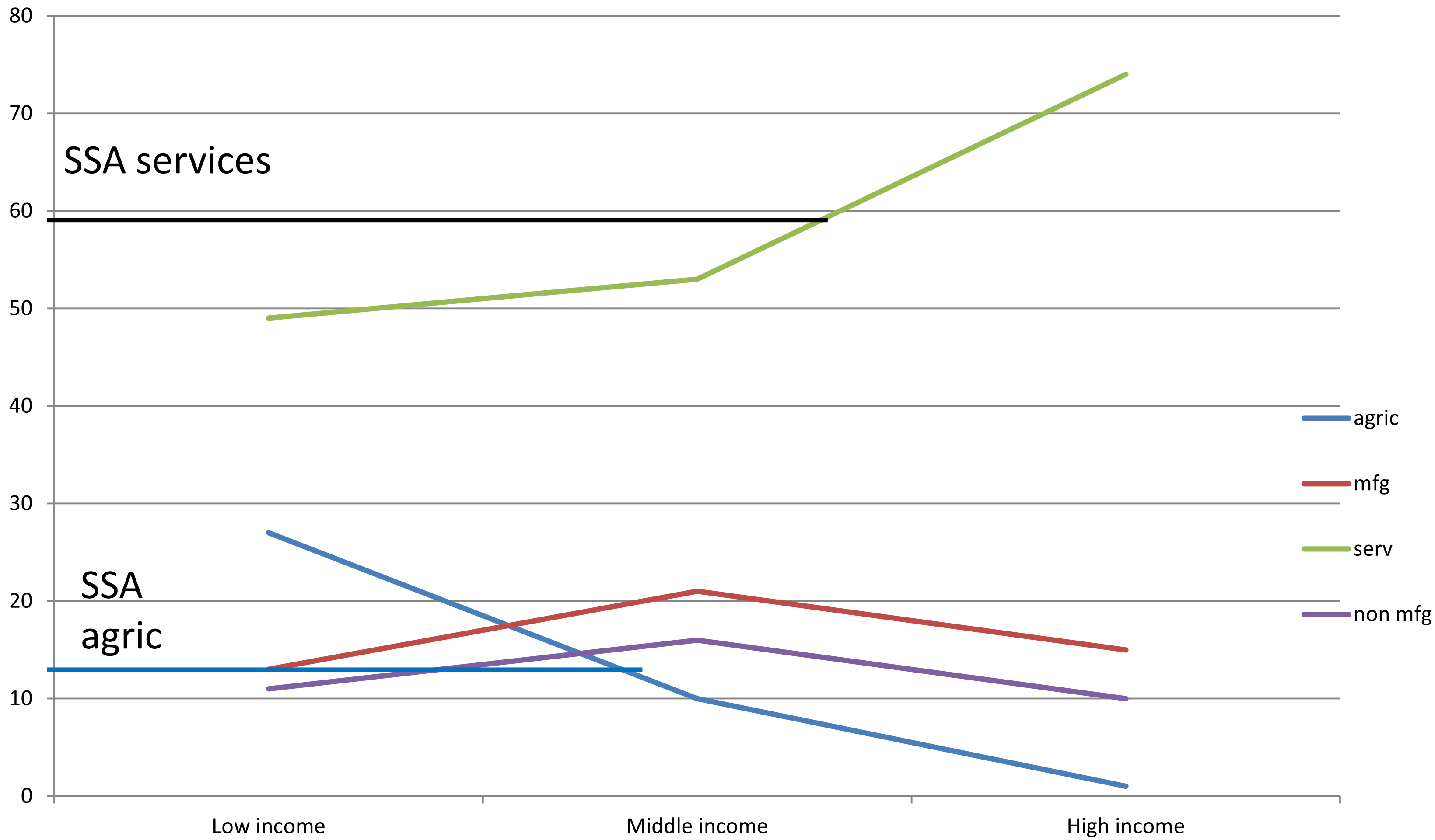
The modern MNE as a meta-integrator

- Apart from technology-type assets, firm must be able to minimise transaction costs and organise its activities. The aspiring MNE needs to be able to manage its multiple operations (and internal markets) effectively.
- An MNE must be able to achieve *economies (efficiencies) of common governance*.
- Many of such skills are ***location-bound***. Specialised management and organisational expertise is required for new operations in new locations.
- Younger MNEs tend not to have the knowledge to systematically ‘translate’ and transfer managerial practices and rent-generating firm specific assets abroad.
- The modern MNE requires the capability to recombine diverse knowledge sets



Note that the average share of services is around 40%

Structural change 2012



'Traditional' MNEs (Vedanta, Petronas, Vale, SAB, Mittal)

'Cross-over MNEs' may expand horizontally

'Modern' MNEs (Embraer, Tata, Infosys, Dr Reddy)

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Both sectors benefit from linkages and spillovers from inward FDI

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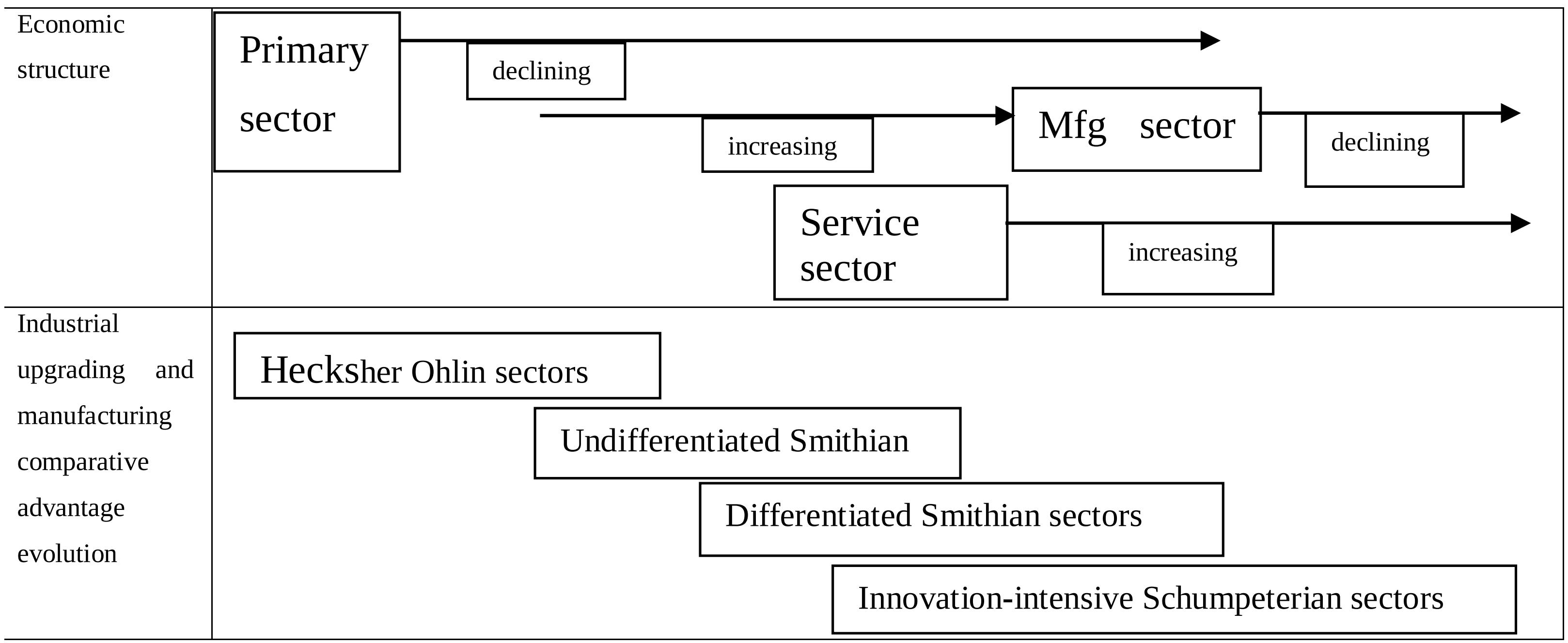
The limits of Kuznets/Chenery.



Narula and Dunning 2010