

Does FDI Promote Productivity? A Deep Dive

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This paper explores the relationship between Foreign Direct Investment (FDI) and firms' productivity by reviewing the literature over the period 1974 - 2013. In majority of cases over the years, author concludes that FDI does promote total factor productivity as well as labor productivity except in two instances, viz. family-owned enterprises and firms that employ unskilled labor. In the case of family-owned firms, improvement in productivity was insignificant due to their risk-averse approach and constrained strategic aggressiveness. In those cases where unskilled labor were employed, labor productivity was seen to be unchanged.

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Introduction

After the change in regime in 2014 general elections, India's new prime minister has been wooing foreign investors to invest in the country. He made his intention clear by stating that "FDI is a responsibility for Indian and an opportunity for the world. My definition of FDI for the people of India is: first develop India". This shows the intention and importance of FDI which is seen as an enabler for the Indian economy.

Indian manufacturing sector continues to be a subject of debate among policy makers and economists. The reasons for this interest are many, however the major one is that the sector's contribution to the national GDP has remained almost stagnant over the years, with a share of about 15% in 1990-91 to about 16% in 2014-15. In 2015, while India replaces China as the top FDI destination by securing \$63 billion worth of FDI projects, manufacturing sector's share in it was less than 10%. However, it remains to be one of the biggest employers and a potential source to alleviate poverty in the country. It then becomes utmost important to carry out a deep analysis of manufacturing sector in the light of FDI which is largely

considered to promote productivity and see its impact.

The trend of inwards FDI across countries increased in recent years due to globalization and trade reforms. Economic growth, open trade and emerging economies are the drivers behind this change. While in late 1960s and early 1970s, inward foreign direct investment (FDI) was frequently alleged to be disadvantageous for host countries, opinion in recent years have changed drastically (Sahu & Solarin, 2013). Most of the countries now offer generous tax and financial incentives to entice FDI. The prime motivation of a host country to attract FDI lies upon the belief that FDI would benefit it. Interestingly World Bank stated in 1993 that “FDI brings with it considerable benefits: technology transfer, management know-how, and export marketing accesses.”

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In many cases, host countries expressed concern that FDI entry through the takeover of domestic firms is less beneficial, if not completely harmful, for the economic development than the entry by setting up new facilities. The rationale behind such concerns is that overseas acquisitions do not promote the productive capacity but rather transfer ownership and shift the control from domestic to foreign hands. This transfer is usually accompanied by layoffs or optimized

by closing some production or functional operations. Most importantly, the primary reasons to make these changes in the structure of firm are usually an important factor to achieve benefits; however they are frequently opposed by labor unions. Due to these challenges, the FDI route that promotes to takeover of the firms, is largely less researched and the literature is still evolving, especially in the case of cross-border acquisitions. This issue has been handled by the literature on multinational enterprise (MNE), and scholars in the field of industrial economics. On the other end, the FDI route where foreign firms invest in the enterprises in host countries are well researched and good amount of evidences are available. Besides, a new topic which is being researched in last few years viz. the FDI impact on family vs. non-family firms, is also gaining momentum. This paper reviews the literature associated with inward FDI and its impact on productivity first internationally and then in Indian context.

Inward FDI Accelerates Performance

Inward FDI has always attracted firms as it is one way to get access to funds. Besides, this also opens up the gates to access foreign technology and resources. Most of the earlier empirical papers pertaining to the developed and developing countries showcased evidences of positive impact by using cross-sectional data. Caves (1974) was the first to demonstrate the positive correlation between inward FDI and productivity using the time series data. Globerman

Table 1 Findings of Key Papers

S. No.	Year	Authors (year)	Link between FDI and productivity	Major findings
1.	1974-1980	Caves (1974); Globerman (1979); Subrahmanian and Pillai (1979);	Accepted	First few to establish the link between FDI and productivity using time series data
2	1980	Gulati and Bansal	Rejected	Did not find any link between productivity and FDI
3	1983-1991	Lall and Mohammad (1983); Demsetz (1983); Hughes (1984) Morck et al. (1988); Blomström and Wolff (1989); Dreux (1990);	Accepted	Accepted the link between FDI and productivity Technology gap between foreign and host countries lead to FDI
4	1987-1990	Ward (1987); Agrawal and Nagarajan (1990)	Rejected	Rejected in the context of family-owned firms due to their low risk taking ability
5	1991	Aitken and Harrison	Rejected	Negative impact was recorded for Venezuela
6	1991-1992	Davies and Lyons (1991); Lichtenberg and Siegel (1992)	Accepted	
7	1993	Haddad and Harrison	Rejected	Low productivity recorded for Moroccan manufacturing firms that have more foreign firms Cited that foreign investors may be attracted due to protected domestic markets and not for any other reason
8	1994-1999	Cantwell (1995); Kokko (1996); MacDuffe and Helper (1997); Blomström and Sjoholm (1999); Helpman (1999); Barrel and Pain (1999); Sjohalm (1999); Aitken and Harrison (1999)	Accepted	Economic relations with MNCs provide learning opportunities to local firms FDI reduces innovation costs of host companies that leads to improvement in total factor productivity.
	2000	Morck et al.; Djankov and Hoekman	Rejected	Found no evidence for family owned firms due to their risk averse nature

9	2001	Blonigen and Tomlin; Li et al.;McGuckin and Nguyen;	Accepted	
10	2001	Konings;Girma et al.	Rejected	Incidence of takeover reduces employment growth, in particular for unskilled labor
11	2002	Blalock; Haskel et al.; Rasiah; Driffield et al.	Accepted	Spillovers from foreign invested firms operating in other industries, promote to inter-industry or vertical spillovers that leads to higher productivity
12	2003	Anderson and Reeb; Chopra;De Backer and Sleuwaegen	Accepted	
13	2003	Morck and Yeung	Rejected	Family-owned firms may actively suppress capital-impro- ving innovation to protect their already established wealth Family-owned firms may have lack of strategic aggressiveness
14	2004	MeyerSuryaGörg and Strobl;	Accepted	
15	2006	Hale and Long;Lee; Anitha Kumari Lavu; Subramanian;	Accepted	
16	2006	Villalonga and Amit; Sasidharan	Rejected	Family structure does influence the productivity Did not see any significant verti- cal or horizontal spillover effects of FDI for manufacturing firms.
17	2007	Miller et al.	Accepted	
18	2007	Go´mez-Mejý´a et al.	Rejected	Family considerations can limit the strategic aggressiveness
19	2008	Sciascia and Mazzola	Rejected	Established a structure based ap proach and observed that family structure influences productivity
20	2009-2015	Kundra (2009); Nilekani (2009); Chackochen and Ramalingam (2012); Sahu and Solarin (2013) Barbera et al. (2013)	Accepted	FDI promotes the local firms to improve their productivity by leveraging new technology and resources available to their foreign counterparts.
21	2015	Zahra	Rejected	Family considerations can limit strategic aggressiveness of family firms

(1979) also supported the findings that if foreign firms bring new products or innovation in the domestic market then domestic firms may benefit through the accelerated dissemination of technology. Blomström and Wolff (1989) observed

that the inflow of FDI can reduce the technological gap among foreign and domestic firms of developing country and facilitate the latter to reach technology of the developed countries.

This process of transmission and transformation of technology in the local manufacturing sector may take place through spillover through several inward FDI channels. Domestic firms may get benefited from the presence of FDI in the same industry, leading to horizontal spillovers or intra-industry spillovers, through labor movement and competition impacts. On other side, there may be spillovers from foreign invested firms operating in other industries, promoting inter-industry or vertical spillovers as demonstrated by MacDuffe and Helper (1997) on US firms, Driffield et al. (2002) on UK firms and Blalock (2002) on Indonesian firms. Helpman (1999) demonstrated that economic relations with MNCs provide learning opportunities for the local firms. This reduces their innovation costs, which leads to improvement in total factor productivity. Kokko (1996) found that in due course of time, the changing local demand and the intense rivalry would eventually lead the local firms to improve productivity and adopt new technologies. Cantwell (1995) and Li et al. (2001) proved that the degree of technology spillovers depends on the technology gap between foreign and domestic firms and the technological competences of local firms. Meyer (2004) stated that while facing these kinds of empirical difficulties to measure the technology spillover, it can be evaluated by proxying the improvement in pro-

ductivity among the firms that came in contact with FDI. Sahu and Solarin (2013) demonstrated the spillover by incorporating FDI in measuring productivity of the manufacturing sector at the firm level. Taking the clue of many other regions, Barrel and Pain (1999) for four European countries, Haskel et al. (2002) for UK, Rasiah (2002) for Malaysia, Sjöholm (1999) for Indonesia, and Hale and Long (2006) for Chinese firms, shared ample evidence of confirmatory positive impact of FDI on manufacturing performance.

Kokko and Blomström (1998) opened a new dimension when they found that FDI can also lead to acquisition where productivity needs to be compared before and after the acquisition. They demonstrated that FDI that leads to acquisition raises questions about their benefits. Besides the impact on productivity due to this change, it also led to a wide-ranging debate on the causes and consequences of acquisition and ownership change. Two categories of literature emerged here: first one includes Aitken and Harrison (1999) and McGuckin and Nguyen (2001) who demonstrated the impact of FDI and foreign ownership on the host economy and local firms in terms of efficiency and productivity. The second category rather investigated the impact of ownership changes on target and bidder firms' performance (Lichtenberg & Siegel, 1992), but it has only rarely distinguished between the nature and the nationality of the acquiring and the target companies. An interesting approach was adopted by Hughes (1984) who analyzed the benefits of the FDI, using stock markets approach and measured techni-

cal efficiency and productivity. The result suggested that the impact of FDI on the target firm is positive. Aitken and Harrison (1999) focused on relative advantages and disadvantages of FDI in the firms' productivity and growth. They debated the motivation for FDI, explained why firms engage in FDI and predicted the outcome and performance post investment. They agreed that depending on the attractiveness of the FDI market, some amount of economic benefits will be passed on to the target firm's investors and shareholders and that promotes the productivity. From the mergers and acquisitions perspective, McGuckin and Nguyen (2001) analyzed the effect of ownership change on almost 20,000 US manufacturing firms and demonstrated the relative increases in total factor productivity and the total labor input though they did not differentiate between cross-border vs. domestic investments. They further demonstrated how ownership impacts the productivity, wages, and employment in US food manufacturing and showed that labor productivity and wages of FDI imbibed firms grew faster than those owned by non FDI firms. They also noted that FDI imbibed firms tend to promote their employment faster compared to non FDI firms. Görg and Strobl (2004) found that firms that infuse FDIs into target firms enjoy the ownership advantages and they prefer to exploit it. This allows them to compete successfully in the host country and due to this the productivity excels. Hymer (1960) Vernon (1966), Caves, (1974) and Lall and Mohammad (1983) argued that inward FDI plays a key role to improve the productivity of the firm. Lall and

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Mohammad (1983) defined a workflow by virtue of indicating various factors that attract inward FDI. Interestingly they debated that firm size may not influence or attract the FDI, however other factors such as its know-how, productivity, knowledge, market standing in terms of its differentiation influence the FDI.

Many authors compared the foreign owned and domestically owned firms (McGuckin and Nguyen, 2001) and many of them accepted that foreign owned firms (FDI infused) are relatively more productive than domestic firms (Buckley & Casson, 1976). Interestingly most of these studies supported that FDI infused firms promote the labor productivity. On the same note, Driffield et al. (2002) demonstrated that the labor productivity of local or domestic firms is lower than the FDI infused domestic firms and foreign-owned firms and firms owned by US multinationals. For UK, Davies and Lyons (1991) found that foreign-owned firms record higher productivity than domestically-owned firms. They also noted that labor productivity and outlay per employee and income increased over time in the presence of FDI. For Belgium, De Backer and Sleuwaegen (2003) debated that foreign firms produce more than domestic ones. However, most of the existing literature does not differentiate between green field investments and acquisitions of domestic firms. Though a few authors debated this in the context of Japanese firms' entry into

the US (Blonigen & Tomlin, 2001), and the UK (Davies and Lyons, 1991; Haskel et al., 2002) markets. One of the most interesting findings came from Haskel et al. (2002) who observed that firms that are acquired by foreign firms showcased the increase of labor productivity to the tune of 13% in the seven years span starting few years from the takeover and after the acquisition.

It was Berle and Means (1932) who brought a unique dimension when they sparked a debate on the impact of ownership structure on firms' productivity. That time, FDI was not that popular and their intention was more focused on acquisition rather than investments made by foreign firms in the domestic ones (read FDI). Jensen and Meckling (1976), Demsetz (1983) and Morck et al. (1988) argued this phenomenon by demonstrating on the impact of ownership on productivity and established that change in ownership does promote productivity in those cases where acquirer is more productive than the target.

Among detailed investigations around family vs. non family owned firms and especially those with FDI invested, only modest analysis is done by Anderson and Reeb (2003), Lee (2006), Miller et al. (2007) and Sciascia and Mazzola (2008). They established a structure based approach where family firms are defined by those that are controlled and owned by family based outfits. Following this analogy Villalonga and Amit (2006); Miller et al. (2007); Sciascia and Mazzola (2008), Barbera, et al. (2013) argued that family structure does influence the productivity.

It is for these reasons that Anderson and Reeb (2003) argued that inside family business equity holders are a unique class of shareholders. More specifically, there is strong identification by inside owners between the family and the business and family business owners, unlike owners of other companies, have to satisfy the current and future needs of family members in addition to the needs of the business (Dreux, 1990). This is where the debate of productivity by family vs. non family owned firms started to become serious.

Inward FDI Does Not Boost Performance

While many authors supported the FDI impact on productivity, a few did not see this link. Haddad and Harrison (1993) were the first who could not see any link between FDI and productivity. They employed a unique firm-level dataset to test the spillovers in the Moroccan manufacturing sector. They noticed that the dispersion of productivity is smaller in sectors with more foreign firms. They rejected the hypothesis that foreign presence accelerated productivity growth in domestic firms during the second half of the 1980s. Using detailed information on quotas and tariffs, they also rejected the possibility of a downward bias in estimating technology spillovers because foreign investors may be attracted to protected domestic markets. They also noted several key observations: first, new technology may not be commercially accessible and innovating firms may not be willing to share their technology through licensing agreements. Second, foreign investment may kindle technology diffusion, particu-

larly if domestic firms are protected from import competition. Lastly, foreign investors mainly provide assistance to train human resource that cannot be replicated in domestic firms or purchased from abroad. With such unique advantages of foreign investment and foreign firms, the local firms may get benefited in the long term via several channels such as labor relocation and transfer, technical know-how, etc.

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Djankov and Hoekman (2000), and Konings (2001) used panel data and could not find the evidence to support the link between inward FDI and performance of the firms. Interestingly, at the same time Aitken and Harrison (1991) observed rather a negative impact of FDI on firms' productivity in the case of Venezuela manufacturing firms. With reference to foreign acquisitions in the UK electronics industry during 1980–1993, Girma et al. (2001) find that the incidence of takeover reduces employment growth and labor productivity, in particular for unskilled labor.

It was Ward (1988) who first explained that family considerations can limit the strategic aggressiveness of family firms and may thus reduce the productivity even in the presence of FDI. He observed that family firms may actively suppress capital-enhancing revolution to kill their already established wealth. Suppression of capital-enhanc-

ing innovation may in turn reduce the productivity contribution of family-firm. Morck and Yeung (2003) consider situations in which family firms may actively suppress capital-improving innovation to protect their already established wealth. This may in turn reduce output contribution of capital during family-firm production. They further demonstrated that these family firms may not be able to enjoy the benefits of FDI in certain cases if family effect is large and may be very risk averse. Agrawal and Nagarajan (1990); Zahra (2005); Go´mez-Mej´ya et al. (2007) and Barbera et al. (2013) argued that family owned firms are so engrossed that forgo many risk taking capital investment activities that can reap large benefits. They explained that the reason due to family's wealth is so closely tied to the firm's future; it might become difficult for inside family owners to support such risk taking activities. The outcome of these forgone opportunities is meant the forgone productivity.

Indian Context

The role of foreign investment in the context of Indian manufacturing has attracted much academic attention ever since the early work of Chandra (1977) who established that inward FDI raises the productivity and efficiency of the firms. This increased productivity can then be utilized to expand the firms or diversify its horizons. Later, many noted authors widely acknowledged the importance of inward foreign direct investment (FDI) in the overall economic development and productivity of firms (Anitha Kumari Lavu, 2006; Subramanian, 2006;

Chackochen and Ramalingam; 2012). The R&D promoted FDI was seen to encourage the structural changes in the host country through resource and technology sharing and leverage knowledge spillovers to promote productivity. Chopra (2003) also supported this argument. Competitive advantages, intent to increase productivity and efficiency and access to technology and resources are the driving force of companies to seek FDI or foreign funding. It was demonstrated that FDI can create an impact that promotes the local firms to improve their productivity by leveraging the new technology and resources available to their foreign counterparts. This enhances their competencies not only to compete locally but also to spread their wings internationally or foreign markets (Surya, 2004; Kundra, 2009;).

While the above results were in the favor of FDI promoting the productivity, a few of them showed the opposite. Agrawal and Nagarajan (1990); Zahra (2005) and Gómez-Mejía et al. (2007) discussed the issues with family-owned firms which are so engrossed to forgo many risk taking capital investment activities that can reap large benefits and increase productivity. They explained that family's wealth is so closely tied to the firm's future; it might become difficult for inside family owners to support such risk taking activities. Eventually, the outcome of these forgone opportunities meant the forgone productivity. They further debated that these family firms may not be able to enjoy the benefits of FDI in cases where family effect is large and may be very risk averse. An interesting observation was made by Subrahmanian

and Pillai (1979) who debated that inward FDI is infused by those firms which are already productive and which are producing at rates above the average of their peers. Apparently, FDI helps them to create a longer term partnership rather than boosting the productivity. Gulati and Bansal (1980) argued that inward FDI may not improve the productivity of the family run businesses mainly due to slow decision making, risk-averse approach and slow dissipation of knowledge. Sasidharan (2006) demonstrated virtually no significant vertical or horizontal spillover effects of FDI on the manufacturing performance.

Concluding Remarks

The prime motivation of a host country in attracting FDI rests upon the belief that the presence of FDI would benefit it. Many authors showed that FDI brings considerable benefits: technology transfer, management know-how, and export marketing access. A few authors failed to find linkages between FDI and productivity.

Following observations are made from the literature review:

1. Most authors agreed that FDI promotes productivity (TFP as well as labor productivity) for manufacturing firms in normal circumstances. This consistently holds good for non-family owned firms. Two minor exceptions in this category exist: firstly, where domestic firms are already productive and second, where industry is already saturated with multiple foreign players. In these two catego-

ries, the improvement in productivity may not be significant.

2. The inflow of FDI can reduce the technological gap between foreign and domestic firms of the developing country and bring the latter close to the technology of high-income countries. With such distinct advantages of foreign investment and foreign firms, the domestic firms may get benefited in the long run through several channels such as labor transfer, managerial know-how, etc. that can lead to higher productivity.
3. Major exceptions where FDI does not promote productivity are noted in two cases: few cases of family-owned firms and companies that employ unskilled labor.
4. In certain cases where family-owned firms take up FDI, due to their low risk appetite and lack of strategic aggressiveness, either productivity may not improve or if it does, the change may be insignificant.
5. In a few cases where firms that employ unskilled labor, no change is seen in labor productivity with FDI. This may be due to firms' inability to upskill the labor due to their natural orientation.
6. In the Indian context as well, authors established that inward FDI raises the productivity and efficiency of the firms. The increased productivity can then be utilized to expand the firms or diversify the business.
7. Few Indian authors made the similar observation in the line of global lit-

erature and noted that inward FDI did not help family run firms much compared the way it helped non-family owned firms. This is due to shortcomings of family owned firms i.e slow decision making, conservative approach and slow absorption of knowledge.

Suggestions for Policy Making

Following suggestions can be considered for policy making in the light of concluding remarks:

1. The real benefit of FDI is realized when a gap exists between host firms and their foreign counterparts. To reap this advantage, FDI from developed countries needs to be sought.
2. Special consideration needs to be given to those industries where unskilled labors are employed as FDI may not promote the productivity. In these cases, technological or innovative means need to be adopted to increase productivity besides upskilling the workers.
3. The industries that are saturated with the investments made by foreign players, need to be dealt carefully. FDI may not bring the obvious advantage here.
4. Special policies are required for family-owned firms based on their risk taking ability and their past track record.
5. The FDI vs acquisitions policies need to be drafted thoughtfully. The advantages of inviting FDI are many, how-

ever if this leads to forceful acquisitions, this may hamper the morale and bring down labor productivity

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