IDOS German Institute of Development and Sustainability

IDOS POLICY BRIEF 12/2022

Economic Effects of FDI: How Important is Rising Market Concentration?

Kasper Vrolijk

Summary

Many governments adopt policies and actively compete to attract foreign direct investment (FDI). Particularly for lower-income countries, attracting FDI – and with it the benefits of cooperating with multinational enterprises (MNEs) – is a promising strategy for participating in global supply chains and increasing local firm productivity. However, empirical findings show contrasting effects and there is heated debate over FDI's advantages and drawbacks. The current trend to rising market concentration also begs the question: Have FDI effects changed in recent years?

This Policy Brief aims to address these questions by studying FDI and what the apparent growth in market concentration implies. Although foreign investment theoretically raises productivity, creates employment and offers many other benefits, the empirical evidence is not unequivocal. Initial coarse country-level data found that receptivity to FDI raises the host country's economic growth. But later research used more detailed sector data and showed ambiguous effects (Görg & Greenaway, 2004). New microdata confirm that FDI effects are differential: Not all workers and households benefit equally. They also showcase the different ways in which MNEs and FDI benefit firms, workers and households in host countries.

Recently, *superstar firms*, which capture large shares of industries and thereby increase market concentration, have emerged. Linked to reduced national economic dynamism and evident in global markets, the rise of superstar firms could negatively impact on FDI effects. They differ from MNE competition effects and confer *market power* so that MNEs can determine prices and wages. This trend toward rising market concentration is observed across multiple sectors and has several possible causes, such as technological and legal factors.

A literature survey reveals a lack of evidence about how rising concentration in global markets is affecting FDI gains. However, other evidence suggests that the positive spillovers to domestic firms may well be lower, with higher market concentration negatively affecting wages and employment.

The following takeaways can be derived for policy-making:

1. **Integrate competition policy:** Competition effects should be considered when evaluating FDI and policies should be introduced to ensure competitive practises after FDI entry.
2. **Improve monitoring:** Collect data on competitive forces and how they change when MNEs enter host economies.
3. **Absorb regressive effects:** Introduce social benefits to counter the potential mixed effects of FDI and MNE market power.

The (largely) positive evidence concerning FDI

In theory, foreign direct investment raises firm productivity, creates employment and offers a range of other benefits to the host economy. However, the empirical evidence is not all positive. Coarse country-level data first showed that FDI openness supports economic growth, while later research using sector-level data found that it has ambiguous effects (Görg & Greenaway, 2004). The effects generally tend to be positive but relatively small in economic terms, and to differ across countries and industries. Benefits are particularly limited for low-income countries (Rojec & Knell, 2018).

More recent micro evidence supports Rojec & Knell's conclusions and shows how FDI can positively impact firms. **Buyer-supplier linkages** are one important channel. A study found that in Costa Rica, domestic firms employ 26 per cent more workers and have 4-9 per cent higher productivity four years after they begin to supply their first MNE (Alfaro-Ureña, Manelici, & Vasquez, 2022a). That said, in the service and retail sector, the effects are half that and they are non-existent in agriculture. The largest effects result from supplying to *smaller* MNEs (perhaps because the larger ones have better bargaining positions).

Another way to generate FDI gains is to **share inputs**. In Bangladesh, domestic garment firms were found to increase productivity levels after they started to share suppliers with an MNE that promoted quality and variety improvements at local suppliers – which spilled over to domestic firms (Kee, 2015). **Joint ventures** are another important way to transfer technology to domestic firms. A study on joint ventures in China shows that MNEs raised domestic innovation and productivity, both at the joint venture firm and at firms upstream (Jiang, Keller, Qiu, & Ridley, 2018).

New microdata presents evidence of positive (albeit differential) effects on domestic workers and their **earnings**. In the United States (US), the entry of a foreign MNE led to a wage increase for employees at domestic MNEs that was 7 per cent higher than for comparable workers at other domestic firms. For high-skilled workers the effects were greater (Setzler & Tintelnot, 2021). When MNEs expanded, employment, added value and wages (for better-earning workers) grew at domestic firms. Data from Costa Rica shows *wage premiums* of 9 per cent for MNE workers and a higher rate of labour earnings growth in local firms (Alfaro-Ureña, Manelici, & Vasquez, 2022b). That said, effects on wages differ: They are larger for women and low-skilled workers.

In terms of **household consumption**, recent microdata shows positive yet regressive effects in lower-income economies. While the entry of foreign supermarkets into Mexico reduced the cost of living, the effects were greater for higher-income households (Atkin, Faber, & Gonzalez-Navarro, 2018). Furthermore, entry also led to the reduced profitability and closures of local stores, and lower incomes for domestic retail workers.

Rising market concentration

Do the effects change if we consider the increase in market concentration? Recent evidence shows that *superstar firms* are highly productive and able to capture large shares of an industry, thus leading to market concentration (Autor, Dorn, Katz, Patterson, & Van Reenen, 2020). Superstars are linked to reductions in the labour share and wages for low-skilled workers, along with diminished labour force participation, labour flows and aggregate output (De Loecker, Eeckhout, & Unger, 2020).

Most recent studies suggest that superstar firms have also emerged in *global markets*. In past decades, MNE global "markups" (measuring market concentration) have increased, while the labour share in production has decreased (Keller & Yeaple, 2020). This means that MNEs are capturing larger profits and employing fewer workers, thus reducing the potential benefits of such firms for host economies. These studies are in line with earlier evidence that global trade and investment is concentrated among a few firms (in

the US, the top 1 per cent of the largest firms cover 80 per cent of all trade). Because markets in low-income countries are already quite concentrated (Mitton, 2008), this issue deserves investigation.

It should be noted that rising concentration is closely related to the competition effects that often come with MNE trade and investments. Both theory and evidence show that market liberalisation raises competition levels – shifting economic activity toward the most productive firms and raising aggregate productivity (Pavcnik, 2002). In fact, in the study on supermarket entry, cost-of-living reductions mainly resulted from *pro-competitive effects* (Atkin et al., 2018). When concentration increases, competition reduces such that just a few firms capture large parts of the market and gain *market power*. This leads to an uncompetitive market with low economic efficiency. Firms with market power can set prices and wages, affecting consumption and earnings and perhaps making FDI less beneficial to host economies.

What is driving the emergence of superstar firms and in which sectors? They are mostly found in high tech, and in retail and transportation (Autor et al., 2020). Their causes differ greatly. In technological sectors, network effects enable a few firms like Amazon to capture a large part of the market. Weakening anti-trust laws are deemed to have boosted market power in the health and communication sectors (De Loecker et al., 2022). In others such as coffee, acquisitions by multi-brand multinationals may have caused greater market concentration. Generally, investments in intangible assets (e.g., information and communication technology, ICT) and the global fragmentation of production correlate with a rise in market power.

Implications for development

How does market concentration affect FDI effects? Although there is limited evidence on these trends, one can speculate about the implications for local firms and workers. In terms of positive spillovers such as buyer-supplier linkages, superstar firms are thought to offer larger knowledge spillovers than non-superstars. But if superstars have bargaining power, these might be limited (see the Costa Rica study). In fact, we observe that in countries where market concentration has increased, growth in productivity has reduced – indicating a growing gap between superstars and other firms. This suggests that superstar firms have become better at limiting technology diffusion to competitors (Autor et al., 2020). At the same time, by increasing concentration in labour markets, MNEs may negatively affect earnings and employment (Azar et al., 2020; Brooks, Kiboski, Li, & Qian, 2021). Raising concentration in product markets can lower labour shares (Autor et al., 2020) and wages, particularly for low-skilled workers (De Loecker et al., 2020).

This suggests that when MNEs have greater market power, the positive spillover effects of FDI *reduce:* There are fewer productivity spillovers to domestic firms, and fewer employment and wage gains. At the same time, negative competition effects *increase* – stimulating the exit of local firms and workers, and higher prices. This affects the evaluation about whether the costs of pro-FDI policies can be seen as outweighing their benefits.

A few policy takeaways can be derived from this discussion:

1. **Integrate competition policy:** Most FDI policy focuses on attracting and retaining new investments. Governments should (a) include competition effects when they assess FDI – before its entry – and (b) introduce policies that ensure competitive practices after FDI enters. For example, in South Africa, the Competition Appeal Court commissions studies in advance on how FDI entry is likely to affect local firms and workers.

2. **Improve monitoring:** Besides monitoring and evaluating the positive effects of FDI (more jobs, buyer-supplier linkages), governments should also collect data on economy-wide competitive forces, such as market concentration, the exit of local firms and workers, and how the entry of MNEs affects competition. This would allow policy-makers to better understand FDI impacts and the policies needed to reduce any negative effects.
3. **Absorb regressive effects:** Evidence suggests that FDI has heterogeneous effects across firms, workers and households. Market concentration may further amplify these effects and harm some groups more than others. Therefore, policy-makers should introduce social benefits, such as (a) social protecttion to temporarily mitigate labour losses and (b) skills programmes that facilitate mobility across industries.

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Dr Kasper Vrolijk is a researcher in the “Transformation of Economic and Social Systems” programme at the German Institute of Development and Sustainability (IDOS).

Email: kasper.vrolijk@idos-research.de

Published with financial support from the Federal Ministry for Economic Cooperation and Development (BMZ).

Suggested citation:
Vrolijk, K. (2022). *Economic effects of FDI: How important is rising market concentration?* (Policy Brief 12/2022). Bonn: IDOS. https://doi.org/10.23661/ipb12.2022.

IDOS Policy Brief / German Institute of Development and Sustainability (IDOS) gGmbH

ISSN (Print) 2751-4455
ISSN (Online) 2751-4463

DOI: https://doi.org/10.23661/ipb12.2022

Tulpenfeld 6, 53113 Bonn
Email: publications@idos-research.de
http://www.idos-research.de

Printed on eco-friendly, certified paper.