

Western Europe and Japan have developed technological skills to rival and, in many cases, outpace those of the United States. Third, we witness today the strengths of MNEs from emerging economies (especially China and India). The MNEs from India have FSAs in IT; those from China in economies of scale and financing. In summary, the simplistic linkage between firm and country effects posited by Vernon (1966) has become untangled.

In a similar vein the integrative eclectic paradigm of Dunning (1981) combines country and firm factors. The ownership (O) and internalisation (I) components are obviously determined at firm level whereas the location (L) factor is a country variable. In his rich descriptions of the interactions between O, L and I, Dunning weaves together the firm and country effects in a generally convincing manner. Indeed, the eclectic paradigm has been consistently updated and deepened to include many of the developments in the IB field over the last 20 years. In particular, Dunning has argued that the eclectic paradigm is an envelope that encompasses the IB theories (Dunning, 2001). Yet, there remain tensions in some of this thinking.

For example, Dunning argues that asset-seeking FDI is theoretically as important as resource-seeking FDI, efficiency-seeking FDI and market-seeking FDI. Yet, when we recognise that subsidiary initiatives often result in location-bound FSAs, what is the process by which these are transferred into non-location-bound FSAs? In general, Dunning does not address this process of internal knowledge transfer within the organisational structures of MNEs. Indeed, Dunning and Lundan (2001) found no evidence that knowledge-seeking FDI enhanced firm performance. Consequently, the logic of asset-seeking FDI is weak and is antithetical to the basic theory of internalisation. We know from internalisation theory that MNEs need to retain proprietary ownership of knowledge-based FSAs. We also know that MNEs often operate as flagship firms within localised clusters (Rugman and D'Cruz, 2000). We also know that national science policy has the objective of promoting knowledge development in specific home-country clusters. Given these three reasons, why would a foreign firm stand any chance of securing true knowledge assets through the presence of a subsidiary in a foreign cluster?

The answer to this question, as with others in the field, is through empirical research. Yet in testing asset-seeking FDI, scholars run into the fundamental problem that R&D at subsidiary level is generally not reported. Instead, scholars use patent data and citations to these patents as indirect measures of knowledge acquisition. These come from country-level data bases. Yet, this metric is an imperfect measure of knowledge; it does not capture the amount of knowledge FSAs, as does R&D. To summarise, even the rich eclectic paradigm of Dunning runs into trouble when country-level data on patents are used instead of firm-level data on R&D.

The basic premise of this chapter, building on this discussion of Vernon and Dunning above, is that we need to reexamine the linkage between country- and firm-level theory and data. We have country-level data on FDI. This is derived from country-level balance of payments accounts. FDI is part of the capital account rather than the current account which reports trade in goods and services. In the past it has been shown that the world's largest 500 firms undertake over half of the world's trade in goods and services (Rugman, 2000). They also account for over 90 per cent of the world's stock of FDI. This was first demonstrated by Rugman (1988). We recognised that many MNEs are much smaller

than the world's 500 largest firms (Aharoni, 1966), but we shall focus on large firms here. However, for both large and small firms there are problems if firm-level data on MNEs are not distinguished from country-level data on trade and FDI.

For example, many scholars do not distinguish carefully enough between stocks and flows of FDI. The stock of FDI includes the retained earnings of the parent firm and its subsidiaries. Yet, this vital firm-based information is only available in stock FDI data for the United States, the UK, Canada, and a few other countries. In contrast, country-level FDI flow data exclude retained earnings; yet these flow data are used in Japan, Mexico, China and most emerging economy countries as the basis for stock data. In other words, cross-country tests mixing FDI stock and flow data are empirically meaningless at best and theoretically erroneous at worst.

As another example, consider the difficulty in using firm-level data. Given the need to consolidate the earnings of overseas subsidiaries, firm-level data work best for centralised and hierarchical MNEs. They provide reasonable information about the overall performance of the MNE and its degree of multinationality, including its sales and assets in the broad geographic regions of the triad (Rugman, 2005). However, it is extremely difficult to tease out the value of activities and the performance of foreign subsidiaries, especially if the performance is disturbed by consolidation, transfer pricing and other internal, strategic and accounting machinations. Indeed, the variations in accounting rules themselves, along with the foreign exchange rate prevailing at the time of reporting, serve to constrain the accounting information revealed in annual reports. In addition, the firm-level data fail to take into account the valuation of non-equity forms of FDI. Joint ventures, alliances and network relationships are not handled properly by an accounting system that was created for parent firms with wholly owned subsidiaries.

As a final example, recent empirical research has established that MNEs operate not globally but regionally. It was shown by Rugman and Verbeke (2004) that only nine of the world's 500 largest firms operate globally, that is, in all three regions of the broad triad of North America, Europe and Asia-Pacific. These nine global firms are IBM, Sony, Royal Philips Electronics, Nokia, Intel, Canon, Coca-Cola, Flextronics and LVMH. In contrast, 320 of the 380 firms providing data for year 2001 on the geographic nature of their sales average 80 per cent of such sales in their home region. Subsequent research by Rugman and Oh (2007) showed that the regional nature of large MNEs was stable during the 2001–05 period, using both geographic sales and assets.

The lack of consensus about the appropriate metrics to be used in testing IB theories was vividly illustrated in two recent articles. In addressing the regional aspect of IB identified by Rugman and Verbeke (2004) an interesting comment appeared by Dunning et al. (2007) in which country-level data on FDI were used to retest and confirm the regionalisation hypothesis. However, Rugman and Verbeke (2007, 2008) indicate that firm-level data on the activities and performance of MNEs are necessary to overcome deficiencies in the country-level FDI data. This chapter further develops the latter point.

To summarise the thinking to date: first, we need to be careful in distinguishing between country- and firm-level effects. Second, we need to be cautious in linking empirical data with the theories being tested. The complexity arises because in IB there is a linear linkage neither between country-level theory and data, nor between firm-level theory and data. Instead, firm and country are intertwined in theory and in the empirical data. Having raised these issues, in the remainder of the chapter we attempt to reexamine

two basic metrics used in the empirical work on multinationality and performance. We shall examine a firm-level metric which relates foreign (F) to total (T) sales and assets. We shall contrast this with a country-level metric which counts the number of countries in which a firm has a foreign subsidiary. It should be noted that each metric is applicable to MNEs. Furthermore each metric is available from the annual reports of the firm. Yet, the country-level metric, counting the number of countries in which a firm has a subsidiary, has been misunderstood and abused in empirical research in IB. We consider studies in the literature over the last 50 years that make this mistake. We then contribute to research in this area by presenting new data on these metrics across the world's largest 500 firms over the 2000–06 period.

4 THEORETICAL PROBLEMS WITH EMPIRICAL METRICS

We have detected three problems with metrics in international management. First, many authors use a country scope metric instead of firm-level data on foreign sales and/or assets. The typical scope metric counts the number of countries in which the firm has a foreign subsidiary. This means that the raw scope metric counts FDI in any country as equal. (Incidentally, both metrics are available in company annual reports.) There is a lack of theoretical insight in using a scope metric based on the data on the number of countries in which a firm has a subsidiary. A slightly more acceptable scope metric is one whereby the firms' number of subsidiaries in each country is identified and a weighted entropy metric is calculated. But this is rarely constructed.

Second, some authors include joint ventures and other non-equity forms of foreign entry in their data allegedly measuring FDI. Yet the basic definition of FDI refers to majority or wholly owned subsidiaries (WOS). If the author wishes to include equity joint ventures then this must be carefully specified since most joint ventures reported do not exhibit control and are totally unlike WOS. To include joint ventures in FDI betrays ignorance of the basic theory of the field. Third, in international management the term 'international diversification' has been misused to represent the degree of multinationality, or the degree of internationalisation. International diversification (often proxied by a country-level scope metric) is not a good term for the degree of multinationality. Previously in the literature, international diversification has been used correctly as a risk metric. It is thus a term for risk and is unsuitable as a term for the level of return (see Rugman, 1976). In this chapter we focus only on the first issue.

A number of studies have analysed the relationship between multinationality and performance. There are theoretical problems surrounding empirical research in this area. These have been discussed elsewhere (Hennart, 2007) where the problems lie mainly on the performance side. In this chapter we do not focus as much on performance, as on multinationality. In this work, several measures of multinationality have been developed. We can divide multinationality metrics into two broad types: scale metrics and scope metrics. Scale measures include foreign to total sales (FS) and foreign to total assets (FA). Such scale metrics have been used by Errunza and Senbet (1981), McDougall and Oviatt (1996), Christophe (1997), Geringer et al. (2000), Capar and Kotabe (2003), Doukas and Kan (2006) and Rugman and Oh (2010).

Scope measures include: the number of foreign countries and the number of foreign

subsidiaries. Here we define NOFC as the number of foreign countries which a firm has entered and, in order to compare this with scale measures, FC as the ratio of the number of foreign countries to total countries which a firm has entered. We then define FB as the ratio of the number of foreign subsidiaries to total subsidiaries. Such scope metrics have been used by Morck and Yeung (1991), Zahra et al. (2000), Lu and Beamish (2001) and Qian and Delios (2008). Some studies used both types together or developed an index by using two metrics: see Errunza and Senbet (1984), Tallman and Li (1996), Gomes and Ramaswamy (1999), Contractor et al. (2003) and Lu and Beamish (2004).

Sullivan (1994) expressed concern about the validity of several multinationality measures. He proposed a composite index of internationalisation scale comprising FA, FB, FS, top managers' international experience (IE) and psychic dispersion of international operations (PD). However Sullivan's composite index was found to perform poorly by Ramaswamy et al. (1996). Likewise Hassel et al. (2003) compared MNEs' real internationalisation (FS, foreign experience) and financial internationalisation, which is proxied by the number of foreign listings and the ratio of foreign ownership. Their results suggest that the two different dimensions cannot be combined.

It is apparent from this literature that the basic scope metric is a simple count of the number of countries in which a firm has a subsidiary. Clearly this scope metric is not properly capturing the breadth of multinationality as it counts each country as of equal size. Only a few scope studies normalise the raw scope metric into a ratio or construct an entropy measure of the number of subsidiaries in each country. Yet these scope metrics are also poor measures of breadth. We now discuss some of the more important recent studies, especially those using the dubious scope metric.

Kim et al. (2004) explain that data for FS are readily available but they argue that this type of aggregate ratio measures fails to capture the extent of diversification across different countries or regions in comparison with their scope measures (NOFC; number of geographic regions). Kim et al. (2004) also use a scope measure but it does not fully consider the reality and strategic focus of MNE activity, as has occurred in much of the research using data on counts of the foreign subsidiaries of Japanese MNEs (see Delios and Beamish, 2005). Qian et al. (2008) addressed regional diversification, and found that a firm maximises its performance when it operates in some focused regions rather than across several regions. They used the number of countries in 10 regions to calculate an entropy measure of multinationality, but this measurement is biased as each of the 10 regions does not have the same strategic and economic importance. Similarly, Fernhaber et al. (2008) counted the raw number of geographic regions as a proxy of geographic scope to analyse the location choice of new venture firms.

Mansi and Reeb (2002) used an index for the level of internationalisation by using FA, FS and the number of geographic segments. Financial disclosures enable researchers to gather data for geographic and product segments that comprise more than 10 per cent of the firm's operations. However, we note that each company uses its own classification for geographic and product segmentations. For example, some companies combine sales in North America and Asia, while other companies report them separately. Without explicit classification of region or segments, simply counting geographic segments can give biased empirical results or even different conclusions. We now move on to further discuss and then test the nature and explanatory power of scope and scale metrics.

5 EVALUATING TWO METRICS OF MULTINATIONALITY

Of the two metrics available to measure the multinationality of firms, a clear conceptual case can be made in favour of the scale metric over the scope metric. When a firm establishes foreign subsidiaries, the sales of those subsidiaries provide good information about the performance and success of the firm in such foreign markets. The ratio of foreign (F) to total sales (S) is the basic metric showing the degree of foreign involvement. This foreign to total (F/T) ratio has been used extensively in the literature of international business. One problem with the F/T ratio is that F sometimes includes exports from the home country, as well as sales by foreign subsidiaries. It would be nice to unbundle the exports from the foreign subsidiaries, but accounting conventions make this difficult. The advantage of the F/T ratio is that it presents a clear indicator of international activity, separate from domestic activity. In this chapter we refer to the F/T ratio as FS.

There are other variations of this FS metric. Data are available on foreign assets and the number of foreign employees. Therefore it is possible to find the ratio of foreign to total assets for a firm; we call that FA in this chapter. We could also find the ratio of foreign to total employees, which would give us information about the labour market.

In contrast, the scope metric provides simplistic and potentially misleading information about the foreign involvement of the firm. If a firm operates in 100 countries it would seem to be more multinational than a firm operating in two countries. Some scholars argue that firms with a subsidiary in 100 countries have much greater breadth than firms involved in only a few foreign countries. Yet, if this is a Canadian firm and its single foreign market is the United States, this firm is likely to have more foreign sales than a Canadian firm operating in all other countries outside of the United States. Indeed, data indicate that the 20 largest Canadian firms average about 80 per cent of their foreign sales in the US, with the remainder in the rest of the world combined. This is a generic problem in the use of the scope measure. Basically it counts each country of equal size; yet for any firm sales in a large market such as the United States, Japan, Germany, the UK and so on, will be of much greater significance than sales in small countries such as Jamaica, Luxembourg, Tajikistan and so on. In other words, selling in a large number of small countries does not indicate the degree to which the firm is multinational.

The scholars who use scope metrics argue that the presence of a firm in many countries provides some information on the breadth of foreign involvement. (They accept that the F/T ratio provides information on the depth of foreign involvement.) We do not believe that this point is accurate. The scope measure adds little value to our understanding of the extent of multinationality. Indeed, it can provide misleading information. Using the scope metric some firms may appear to be multinational, when in practice they have a very low F/T ratio. We can see no theoretical justification for the scope metric. It appears to be popular with some researchers since it is easy to obtain from annual reports or from the firm directories. Most firms list the countries in which they operate. Some of them produce maps in which they highlight the countries in which they have a business. We believe that serious scholars of IB need to go behind this simplistic interpretation of IB activity. Use of the scope metric needs to be discontinued, and the true extent of multinationality needs to be calculated using the F/T ratio or its variations. This involves more work by researchers as well as careful definition and interpretation of the scale metric. Yet, it is the only way for the IB field to advance.

As a final example of the misuse of the scope measure consider the following paper. All of the tests and results in Flores and Aguilera (2007) use a country scope metric: the number of countries in which the firm has a foreign subsidiary. This assumes equal weight for each FDI by a US MNE in any foreign country. This country scope metric is a biased measure of FDI since it counts each country as of equal size. It thereby undervalues US FDI in large countries such as Canada and overemphasises US FDI in small countries such as Lesotho and Burkina Faso.

Flores and Aguilera argue that between 1980 and 2000 the largest 100 US MNEs expanded more into non-home region countries than into Canada and Mexico. In their appendix, Table A.2, they define the number of countries by region as follows: Asia-Pacific (20); EU (15); North America (2); and rest of the world (110). Given this definition they find that US MNEs expand more in Asia-Pacific and other regions rather than in Canada and Mexico. This finding is misleading for the following reason. In 1980 most of the largest 100 US MNEs were already in Canada. Thus there are few left to enter it in 2000. In contrast, in 1980, few US MNEs are in Vietnam, China, Uzbekistan, Kazakhstan and so on, mainly because these communist countries prohibited US FDI. Thus US MNEs would enter non-home region countries due to the particular political institutional change called the 'collapse of communism'. These two points combine into a generic thesis, namely that US MNEs will expand into new countries and into countries beyond their home triad over time.

It is obvious from this analysis that a scope measure giving equal weight to US FDI in each country is completely trivial and meaningless. Instead, it is necessary to evaluate the magnitude of US FDI in each country and by country. This would indicate that US FDI in Canada has increased dramatically between 1980 and 2000 (Rugman, 2000). It will also show that US FDI in Canada (and Mexico) has increased much more between 1980 and 2000 than has US FDI in small and peripheral countries, which made up the vast majority of entries in Appendix Table A.2. If Flores and Aguilera doubt the value of firm-level sales data they would be better off calculating firm-level asset data which are highly correlated with sales data. In general, their use of this country-level scope metric yields unreliable results which can be deconstructed by any entry-level doctoral student.

6 NEW TESTS OF MULTINATIONALITY

For this study, we gathered data on multinationality for both scale metrics (FS, FA) and also scope metrics (NOFC, FC and FB). In addition to these conventional multinationality measures, we add new intra-regional activity measures in the light of recent development of international strategic management by Rugman and coauthors. We developed five new measures as counterparts to the five conventional multinationality measures:

1. number of intra-regional countries (NOIRC) is the number of home-region countries where a firm has entered;
2. intra-regional countries (IRC) is the ratio of the number of home-region countries to all countries where a firm has entered;
3. intra-regional subsidiaries (IRB) is the ratio of the subsidiaries in the home region to total subsidiaries;

Table 4.1 *Multinationality metrics*

| Year | Scale measures | | Scope measures | | |
|---------|----------------|----------------|-------------------|-----------------|----------------------|
| | Sales (FS) | Assets (FA) | Country (NOFC) | Country (FC) | Subsidiaries (FB) |
| 2000 | 32.41 | 28.21 | 15.31 | 75.19 | 44.66 |
| 2001 | 32.35 | 29.67 | 15.75 | 75.16 | 45.12 |
| 2002 | 33.55 | 30.47 | 15.68 | 75.89 | 44.87 |
| 2003 | 33.50 | 30.55 | 16.16 | 76.08 | 44.70 |
| 2004 | 34.71 | 30.90 | 16.63 | 76.14 | 45.19 |
| 2005 | 35.49 | 31.27 | 16.48 | 76.63 | 45.38 |
| 2006 | 36.99 | 32.29 | 16.69 | 76.19 | 45.59 |
| Average | 34.18 | 30.56 | 16.14 | 75.94 | 45.09 |

Note: 611 firms' data are used in this table for 2000–2006, but numbers vary by year and measure. Average is weighted average of each year.

4. intra-regional sales (IRS) is the ratio of home-region sales to total sales; and
5. intra-regional assets (IRA) is the ratio of home-region assets to total assets.

The purpose of this research is to demonstrate the differences between scale measure and scope measure of multinationality. Among the 697 firms listed in the world's largest 500 firms in any year of 2000–06, data are available for 627 firms for any of these multinationality measures for 2000–06. The data are compiled from the annual reports of these publicly traded companies.

Table 4.1 provides information on the basic scale metric and scope metric for the world's largest 500 firms over the seven-year period, 2000–06. The use of these longitudinal data helps to reveal any trends towards greater or less multinationality by these important firms. The ratio of foreign to total sales averages 34.18 per cent across this time period. There is an increase in this FS measure over time. These results are consistent with those reported by Rugman and Oh (2007). In Table 4.1 we also report information on the ratio of foreign to total assets (FA). These average 30.56 per cent over the seven-year period. Again this ratio increases over the time period. The most interesting point is that both sales and asset measures are similar; they show that the degree of multinationality is increasing in recent years.

In contrast, the scope measures reported in Table 4.1 raise many questions. The country scope metric (NOFC) suggests that the world's largest firms operate, on average, in some 16 countries. The adjusted FC scope metric is 75.94, which suggests that the strategic importance of foreign countries is overemphasised. Indeed, large firms are much less multinational than the FC metric suggests as they average only one-third of their sales abroad in contrast to having subsidiaries in more than 16 foreign countries and an FC of 76. The third scope metric in Table 4.1 is also misleading. The average ratio of foreign subsidiaries to total subsidiaries (FB) is 45. Again, this exaggerates the foreign content of large firms. Many of the foreign subsidiaries are in small countries, so it is misleading to think that large firms average a 45 degree breadth of foreign involvement.

Table 4.2 *Intra-regional activities*

| Year | Scale measures | | Scope measures | | |
|---------|----------------|-----------------|--------------------|------------------|-----------------------|
| | Sales (IRS) | Assets (IRA) | Country (NOIRC) | Country (IRC) | Subsidiaries (IRB) |
| 2000 | 77.17 | 78.37 | 5.20 | 52.64 | 72.25 |
| 2001 | 76.73 | 77.44 | 5.19 | 52.05 | 71.66 |
| 2002 | 76.50 | 77.73 | 5.22 | 52.09 | 72.20 |
| 2003 | 76.48 | 77.98 | 5.43 | 52.81 | 72.61 |
| 2004 | 76.14 | 78.30 | 5.53 | 52.45 | 72.16 |
| 2005 | 75.54 | 78.29 | 5.50 | 52.38 | 72.00 |
| 2006 | 74.82 | 77.99 | 5.57 | 52.44 | 72.11 |
| Average | 76.17 | 78.01 | 5.39 | 52.41 | 72.14 |

Note: 613 firms' data are used in this table for 2000–2006, but numbers vary by year and measure. Average is weighted average of each year.

Table 4.2 applies the same scale and scope metrics as in Table 4.1 but to an examination of the intra-regional activities of the world's 500 largest firms. This is a more refined aspect of overall multinationality as developed by Rugman and Verbeke (2004), Rugman (2005) and others. Recent work by Ghemawat (2007) also emphasises the regional nature of IB, which he calls 'semi-globalisation'. In Table 4.2 the ratio of regional to total sales (IRS) averages 76 per cent over the 2000–06 period. The ratio of regional to total assets (IRA) is 78 per cent. Although both IRS and IRA vary slightly over time, these scale metrics signify a robust amount of intra-regional activity for the world's 500 largest firms. Even though the world's largest firms show increasing trends of F/T in Table 4.1, the intra-regional activities have remained the same. Table 4.2 shows that the world's 500 largest firms have focused more on the intra-regional market than on the inter-regional market.

In contrast, the scope metrics in Table 4.2 are misleading. The MNEs operate, on average, in 5.39 countries in their home region (NOIRC). The ratio of home region countries to foreign countries (IRC) averages 52.41; this underrepresents the home region nature of the activities of large firms. For example, a US firm can only go to Canada or Mexico in its home region of North America. Yet, these two countries have an equal count with all others in the world, although they are larger than most countries in the rest of the world. The third scope metric for subsidiaries (IRB) reports the ratio of subsidiaries in the home region of the triad to all subsidiaries. This averages 72.14 over the 2000–06 period. This is a somewhat better regional scope metric. For example, it suggests that two-thirds of the subsidiaries of a US firm are in North America, with many of these, of course, in the United States itself. In a similar manner, but for a wider set of mostly smaller firms, Ghemawat (2007) reports that when a US firm first goes abroad there is a more than 60 per cent chance that the location of its first foreign subsidiary will be in Canada.

An earlier study by Franko (1975) showed that large US MNEs, European MNEs and Japanese MNEs had 13, 43 and 65 per cent of their subsidiaries in the home region of the triad as of January 1971. Our results show that the largest 500 firms have about 70 per

Table 4.3 Multinationality by regional origins

| Region | No. of firms | Scale measures | | Scope measures | | |
|--------------|--------------|----------------|-------------|----------------|--------------|-------------------|
| | | Sales (FS) | Assets (FA) | Country (NOFC) | Country (FC) | Subsidiaries (FB) |
| N. America | 251 | 27.47 | 26.67 | 17.19 | 70.51 | 38.25 |
| Europe | 196 | 51.27 | 49.17 | 17.59 | 84.52 | 57.84 |
| Asia-Pacific | 160 | 26.69 | 19.71 | 10.82 | 76.95 | 43.40 |

Note: 607 firms' data are used in this table for 2000–2006, but numbers vary by year and measure. Four firms in non-triad region are excluded.

Table 4.4 Intra-regional activities by regional origins

| Region | No. of firms | Scale measures | | Scope measures | | |
|--------------|--------------|----------------|--------------|-----------------|---------------|--------------------|
| | | Sales (IRS) | Assets (IRA) | Country (NOIRC) | Country (IRC) | Subsidiaries (IRB) |
| N. America | 252 | 78.39 | 78.84 | 2.63 | 44.58 | 69.55 |
| Europe | 203 | 69.80 | 71.91 | 9.88 | 63.09 | 74.95 |
| Asia-Pacific | 155 | 81.10 | 83.96 | 5.72 | 56.72 | 74.70 |

Note: 610 firms' data are used in this table for 2000–2006, but numbers vary by year and measure. Three firms in non-triad region are excluded.

cent of their subsidiaries in the home region of the triad. It shows that activities of MNEs are focused more on their home triad region than before.

It is possible to look into industry variations across the major industries in which the world's 500 largest firms are active. We can divide our sample into nine manufacturing industries and 10 service industries with data available for all four measures across 324 firms. Variation of multinationality and regional activity across industry is higher than variation across year. In general, the service industry average IRS of 85.74 per cent is somewhat more regionalised than the average for manufacturing industry at 77.23 per cent. According to the FS and FA data, service firms had less multinationality on average than do manufacturing firms. (These data for industries are available on request.)

Looking behind these data it is clear that this scope bias occurs across the triad. Tables 4.3 and 4.4 report only small variations across the triad in these scope metrics. For US firms as well as for European and Asian firms the scope metrics exaggerate the foreign involvement of such firms. The scope metrics obscure the main point of the country bias in Europe where foreign activity (FS and FA) is exaggerated in Table 4.3 but reported correctly in the regional scale metrics of Table 4.4 (IRS, IRA). The only useful point to emerge from the scope metrics occurs in Table 4.4, where it can be seen that North American MNEs operate in only 2.63 countries in the region (NOIRC) in contrast to 10 countries for European MNEs and 5.7 for Asian ones. But again, the other scope metrics confuse this point.

7 CONCLUSIONS

The IB field integrates country- and firm-level effects. Empirical metrics need to be soundly based in theory and the theory itself needs to reconcile country- and firm-level data. We illustrate some of the theoretical problems involved in the scope metric and explore its explanatory power compared to scale metrics.

We report original research on the multinationality of the world's 500 largest firms (those listed in the *Fortune* Global 500) which provide data on both scale and scope metrics. In Tables 4.1–4 we find that the scope metrics overestimate the foreign involvement of large firms. In general, the large firms have only about one-third of their overall sales and assets taking place abroad. The scope metrics suggest a much higher ratio. We also examine the intra-regional nature of the activities of large firms. Again, we find that the scope metric provides misleading information about the intra-regional sales and assets of large firms.

While additional empirical work could be undertaken in order to further examine the relative significance of scale versus scope metrics of multinationality, and additional control variables could be introduced, it is already clear that the following broad conclusions can be made. As the scale metrics work better than the scope metrics this suggests that much of the literature on multinationality and performance is inadequate. Many studies use scope metrics rather than the more appropriate scale metrics. Finally, the results demonstrate that the intra-regional dimension of multinationality is significant and needs to be examined in much greater detail.

SUMMARY

We demonstrate the theoretical complexities of having country-based theories of foreign direct investment (FDI) coexisting with firm-based theories of the multinational enterprise (MNE). Building on the logic that good theory needs to be empirically robust, we examine two key metrics used in measuring the degree of multinationality of firms; the ratio of foreign to total sales and counts of the number of countries in which a firm has a foreign subsidiary. We review literature using both types of metric and relate both of them to basic theoretical issues of international business. We provide new evidence that the scope metric is unsatisfactory. We apply these findings to the topic of economic integration. We find that both FDI and MNE data show that the world's 500 largest firms operate mainly within their home regions of the broad triad, and are not global.

Keywords

Product life cycle, eclectic paradigm, internalisation theory, scope metric, foreign to total sales, multinationality, international diversification, regional sales.

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NOTE

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5 Economic integration from above and below with the evidence of Japanese MNEs in Europe*

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1 INTRODUCTION

This chapter examines economic integration in the light of evidence from Japanese multinational enterprises (MNEs) in the European Union (EU). Both MNEs and the EU represent different but mutually related types of 'economic integration' in the present global economy, but the point to be stressed first is that the term 'economic integration' has no generally accepted definition. As Jovanović (2006) concludes, there is some confusion and conflict among scholars, largely because of the different approaches to the topic. Thus, we shall start by defining 'economic integration'.

'Economic integration' should be understood to have a double dimension; that is, integration from above, and integration from below.¹ The former dimension means that the central authority sets the regulatory framework, in order to satisfy the various interests within the geographic area. On the other hand, the latter means that the economic actors construct economic relationships according to the given circumstances, including integration from above. Integration from above and integration from below are mutually related, and it is difficult to determine the causality between them. Like other chapters in this Handbook, integration from below is seen here as the prerequisite for the advancement of integration from above in Asia (Pomfret, Vol. I, ch. 16) and Latin America (Frischtak, Vol. I, ch. 18), though their present situation regarding integration from above is still somewhat primitive, such as the free trade area. On the other hand, the opposite causality can be seen in Europe, even if there are many MNEs which have a longer history than the EU. Integration from above in Europe has advanced steadily since the 1950s, and MNEs both within and from outside the EU actively react to the development of the EU. Therefore, the mutual relationships between the EU and MNEs are worth investigating.

Because of the long history of integration from above and below in Europe, there is an accumulation of literature on the EU and MNEs. Servan-Schreiber (1967) points out the active responses from American MNEs to the development of the EU in the 1960s, and advocates European strategic action from improving management organisation of European firms to industrial policy at the European level. Franko (1976) echoes Servan-Schreiber, and shows that European MNEs also effectively exploit the benefits of the EU. It is interesting to point out that the textbooks on the EU economy (Robson, 1987; El-Agraa, 1994; Pelkmans, 2001) generally treat capital movement in the static comparison model without trade, which might well be suitable for portfolio investment, but not for foreign direct investment (FDI). A more realistic model, which explicitly explains the change of FDI following the establishment of customs union, is provided by Kindleberger (1966), is extended by Yannopoulos (1990), and is used by the UN (1993) to assess the

effects of the Single European Market (SEM). This model suggests that MNEs would respond to the benefits and threats offered by the EU through four types of FDI, that is, defensive import-substituting investment, reorganisation investment, rationalised investment and offensive import-substituting investment. The recent enlargement of the EU also encourages scholars to investigate FDI into Central and Eastern European countries (CEECs) (Oxelheim and Ghauri, 2004; Meyer and Peng, 2005). Some test the attractiveness of the low-wage location in CEECs, others assess the acceptability of hosts.²

In spite of the different periods, perspectives and models analysing the relationships between the EU and MNEs in the literature, we can recognise a common feature among them. That is, they examine the change of FDI by MNEs facing the development of the EU, that is a static comparison in nature. However, the EU is not a static, but a dynamic regional scheme, which shows not only a cyclical, but also an evolutionary development of its organisation. As a result, the European economy institutionalised by the EU is evolutionary in nature (Jovanović, 2009). Furthermore, MNEs themselves also possess an evolutionary character in their organisation (Kogut and Zander, 1993). Thus it is worth reconsidering the mutual relationships between integration both from above and from below, from the perspective of evolutionary institution through the case of Japanese MNEs in the EU.

Needless to say, not only the reason for choosing the EU for the analysis, but also the selection of Japanese MNEs must be justified. In social science, the relative independence of Japanese MNEs from the political movement of EU integration is a kind of asset for the analysis.³ The EU and Japan are relatively distant from each other in terms of political relations. This leads us to expect that the decision making by Japanese MNEs is relatively independent from the national interests of the EU member states. It is reasonable to assume that the relatively short history of Japanese MNEs' operation in Europe means that they are not deeply influenced by pre-EU history, for example, compared with their American counterparts, some of which started operation before the First World War.⁴ Therefore, an investigation from the evolutionary institution perspective would be expected to clarify the mutual relationships between integration from above and integration from below through the cases of Japanese MNEs in the EU.

This chapter is structured as follows. In Section 2, we begin by examining integration from above, that is the development of the EU. Compared with other regions, the formal institutions provided by the EU are wide and deep, and the membership has also expanded during the last half-century. In order to assess the mutual relationships between integration from above and integration from below, in Section 3 the effects of integration from above will be investigated from the eclectic paradigm, which is the widely accepted framework for international business research. Then, Section 4 examines the phenomenon of Japanese MNEs entering and expanding their operations in Europe as an example of integration from below. The final section summarises, and concludes with suggested future research topics.

2 INTEGRATION FROM ABOVE

International economic relations after the Second World War were intentionally liberalised through the General Agreement on Tariffs and Trade/World Trade Organization

(GATT/WTO) and the International Monetary Fund (IMF), but the formal integration process at the regional level has developed much more than the global forum. No one can deny that the EU is a highly developed project, even if there has been a wave of regionalism during the last decade (Whalley, 2008). As often stated, the EU's economic integration has two characteristics: 'deepening' and 'enlargement'.⁵ Both are a feature of integration from above in Europe, and the examination starts with the 'deepening' characteristic.

Unlike economic integration schemes in other regions based on free trade agreements, the EU originated in a customs union, progressed through the common market, and has now reached the stage of economic and monetary union.⁶ A customs union not only abolishes the tariffs and quotas among the member states, but also sets up common external tariffs. Thus, a customs union is not distorted by the circumvented imports from the lower external tariff member states in the free trade area; the EU reached this stage of a freer internal market in 1968. However, various non-tariff barriers (NTBs) prohibited freer and more competitive market conditions in the 1970s and the first half of the 1980s, mainly due to the global economic disturbances following the Nixon shock in 1971, and two oil shocks in 1973 and 1979. In order to respond to the economic decline, and fiercer competition from the United States and Japan, especially in the electronics industry in the high-technology sector, the EU went ahead to liberalise the internal market, establishing the free movement of goods, service, capital and people, in the so-called 1992 Single European Market programme. In order to realise the SEM, the EU introduced the qualified majority vote for the decision making of SEM-related EU laws, and the principle of mutual recognition. The mobility of commodities and factors was realised through the SEM, whose aim was to establish a freer market.⁷

The introduction of the single currency, the euro, from 1999 was another step forward in establishing a freer and more transparent market in the EU, even if not all member states participate in the monetary union.⁸ Indeed, the introduction of the single currency has significant implications for both the macro economy of the EU and also its macro-economic policy. However, the one-size-fits-all policy in the euro area has some limits on the macro economy of member countries. The interest rate level set by the European Central Bank has been so high for some countries like Germany and France that their economies were constrained, while the same rate can be so low for others such as Spain and Ireland that the housing bubbles in these countries were overheated until 2007. At the same time, the microeconomic implications must not be overlooked. Since the single currency removes the exchange rate risk among the euro area countries, reduces the fluctuation of the exchange rate between the euro and the neighbouring currencies such as the UK, and makes price comparisons easier than otherwise, competition and transparency in Europe has intensified.⁹ In sum, the deepening of the EU is aimed at raising productivity by providing more competitive conditions in Europe.

The other aspect is 'enlargement' which has entailed the expansion of the member states of the EU for the last half-century from six to 27.¹⁰ Indeed, not only economic, but also political and historical considerations have influenced the membership of the EU. However, the increase in the number of member states has some significant, but not always harmonious implications for the EU economy. These include a larger and more transparent market,¹¹ more competitive conditions, a greater variety of economic development levels, more divergent orientation towards EU policy and so on. Along

with the enlargement of the EU, some economic actors, both the existing members and the newcomers, enjoy the growth-enhancing effects of a large, transparent, and competitive market, but others have to adapt to the new conditions, and are sometimes forced into difficult situations including serious restructuring and relocation. Thus, enlargement may well both provide positive opportunities and also cause negative frictions in the EU economy at various levels.

At the same time, we should keep in mind that the EU is not a simple entity that can liberalise the internal market among member states, but also has the power to intervene in market failures through its common policies (El-Agraa, 1994; Pelkmans, 2001; Jovanović, 2005), which is classified as 'positive integration' by Tinbergen (1965).¹² This is the most distinctive feature of the EU compared with other regional schemes such as the Association of South East Asian Nations (ASEAN), the North American Free Trade Agreement (NAFTA) and so forth. Some common policies of the EU are intended to enhance the market mechanism to work for more efficient allocation of resources, while others mediate the difficulties suffered by some economic actors as a result of the development of the EU economy, as well as the competition from outside. Competition policy is a typical example of the former, and its influence now extends beyond EU territory. The latter include a wide range of policies from the budgetary redistribution (for example, the Common Agricultural Policy, regional policies and so on), to those indirectly influencing the behaviour of economic actors (for example, social and environmental policies and so forth).¹³ Even if the size of the EU budget is much smaller than those of member states compared with GDP, the direct and indirect impacts become increasingly important. Some policies such as the common commercial policy can be said to be a mixture of both features, since it has unified and reduced the common external tariffs, and tried to manage trade relationships, especially with Japan in the 1980s and 1990s (Mason, 1994a, b). Thus, positive integration is not only unique in the EU, but also includes conflict in itself.

From this short summary of what the EU has achieved, mixed purposes can be identified, summarised as 'efficiency, stability, and equity' according to Padoa-Schioppa (1987). In spite of its competition orientation, which is fully based on the treaties, it is worth remembering that the complicating features of the various EU policies are based on the different economic conditions and philosophies of the member states.

3 REASSESSMENT OF EU INTEGRATION

Based on the liberal economic principle set by the Rome Treaty, the EU has long been struggling to establish a freer market more than any other regional integration.¹⁴ However, the abolition of the existing barriers for the free movement of goods, services, people and capital does not guarantee the perfect competitive market that neoclassical economics assumed. Positive integration is necessary even in the process of establishing a freer and larger market. Furthermore, integration from above is an incremental process rather than immediate, and the process so far has been evolutionary, not cyclical. This leads to the recognition that the EU economy does not exist in a vacuum, but rather is structured by the institutional framework. The importance of the institution for the market economy is underlined in institutional economics,¹⁵ and this can be applied to the case of the EU.¹⁶ This recognition is also consistent with the perspective of international

business scholars, who emphasise the significance of transaction costs in the market economy.¹⁷ Thus, it is worth reassessing the integration from above in Europe from the perspective of international business, which is part of integration from below.

The starting point for the reassessment is the consideration of the eclectic paradigm proposed by Dunning,¹⁸ which is the focal point of FDI research. The eclectic paradigm insists that firms can successfully invest abroad when all three advantages – that is, ownership, location and internalisation – exist. The ownership advantage (O-advantage) means what the firm in question uniquely possesses as the competitive edge in the host economy. However, that does not automatically lead the company to invest abroad, and other methods such as exports or licensing may well be alternatives. Advantages that are related to a special place are called ‘location advantages’ (L-advantages), even if any one location is unable to benefit all industries. The special conditions at each location from the economic size, the endowment of natural and created resources to government policy are not the same for all. These comprise the location conditions, but they are not always positive for every industry. In other words, even if the L-advantage is the attraction for MNEs to conduct business in a particular location, a decision whether to locate also depends on the industry and the operation. The final advantage is internalisation (I-advantage), which concerns the firm’s ability to internalise transaction costs. The transaction costs in the market economy are the reason for the very existence of firms (Coase, 1937). In contrast to the ideal of the neoclassical model, the market is full of failures, and the main and structural obstacles can be listed as follows: imperfect and insufficient information, the asymmetry of information, the strategic or opportunistic response of actors, limited rationality, path dependency and so on. These can easily be recognised even in the domestic market, but international business intensifies their difficulty and complexity to a greater degree than operations in the domestic market. When MNEs face dynamic change caused by integration from above, they have to discover what kind of transaction costs there are and how these should be internalised.¹⁹

Originally, the eclectic paradigm advocated that if the three advantages exist simultaneously, the firm in question could conduct FDI successfully. However, the advance of FDI research makes clear the complexity, significance and influence of the configuration among the three advantages. Since integration from above influences the L-advantages, we should look at the configuration of the three advantages by regarding L-advantages as the reference point. Some changes are worth mentioning concerning the L-advantages brought by integration from above; that is, the enhancement of the growth potential, the asymmetrical development between market and production, and the limits of a freer market.

First, integration from above is expected to improve the growth potential of the region in question (Cecchini, 1988; Monti, 1996). A freer market enables resources to be allocated more efficiently, while easier market entry makes the competition more severe. Through this process, less-efficient producers would be eliminated, while more-efficient ones could expand their production and market share. As a result, the whole of the economy increases its productivity, and grows faster, even if the losers must be eliminated. From the viewpoint of MNEs, this means improving their L-advantages, and gives them the incentive to exploit their own O-advantages. This is especially true for the outsiders, since they may well be discriminated against by external tariffs and NTBs. However, at the same time, the probability of failure also becomes greater due to the high

level of competition. Thus, the important question is not if MNEs invest in the region, but to what extent and how they do.

The change arising from L-advantages under integration from above is not simple, but complicated. Note that the changes that L-advantages realise are neither harmonious nor simultaneous in every dimension. Rather, the asymmetrical feature is the rule of change, since, while the regional market becomes freer and unified on one hand, production conditions remain different from each other on the other. The skill and quality of the labour force are heavily influenced by the education and vocational training system, while the accumulation of the suppliers and supporting businesses are different from one country to another.²⁰ Reflecting these conditions, business practices and institutions are likely to be characterised at the national level, even under the development of integration from above. This does not reject the convergence of the institutional framework under intense market competition. Indeed, some elements of the production conditions such as the legal requirements for health and safety can be converged, and the convergence is not always a race towards the bottom, but can also be upwards (Tosun and Knill, this volume, ch. 12). However, the point to be emphasised is that firms, especially MNEs, must keep in mind the different speed of convergence between the market and the production dimensions, as well as the non-converged conditions, so that they can utilise the best opportunities offered by integration from above.

The geographical expansion of the EU through enlargement complicates the L-advantages. Because of the different levels of economic development, historical background, industrial structure and so on, the increase in the number of member states means a widening of the opportunities that MNEs have in the choice of location, while the asymmetrical change of the L-advantage becomes more complicated than without enlargement. From the viewpoint of the member states, enlargement brings tension between old and new members regarding keeping or attracting FDI. Even if the L-advantage is not limited to cheap labour, the relocation of production by MNEs raises job concerns negatively for the developed members, and positively for the less-developed ones. Here, the former is important as the marketplace, while the latter is significant as the place of production. Therefore, the asymmetrical feature of integration from above becomes clearer, following eastern enlargement.²¹

Given the changes arising from L-advantages, integration from above makes the operation of MNEs in the integrated area both more attractive and more complicated. In order to exploit the opportunities under certain constraints, MNEs have to transplant and utilise the O-advantages in the invested location. However, since the O-advantages have generally been cultivated and accumulated mainly through the operation in the home country, which has its own L-advantages, it is risky to automatically assume the transferability of the O-advantage to other locations.²² MNEs need to adjust to the L-advantages and L-disadvantages in foreign soil, so that they can survive and grow there. Some L-advantages, such as the size and growth of the market, are not directly related to the maintenance of O-advantages, but others like the relationship with suppliers and workers must not be underestimated. Because of the continuous change in L-advantages, the configuration between the O- and the L-advantages must be intentionally and constantly adjusted along with the development of integration from above. Furthermore, the configuration among the different locations also changes along with the enlargement of the integrated area. Therefore, adjustment must be accelerated by

the enlargement, while entry to the new market is also encouraged. In other words, the I-advantage of MNEs is tested in the adjustment process of MNEs faced with integration from above.

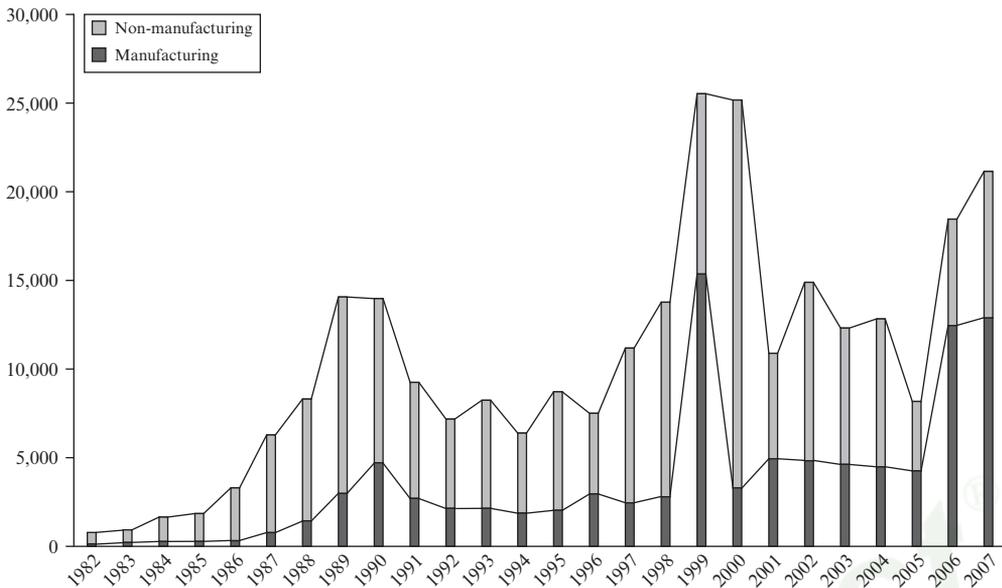
The important question is how we can recognise and assess the effects of integration from above and the configuration of OLI advantages. The growth enhancement effects can easily be recognised through the growth of FDI and the MNEs' involvement in the integrated area. The location pattern of FDI could show the asymmetrical impact of integration from above, while the operating content of MNEs would suggest the limit of integration from above for setting up a freer market. Along with these approaches, the following section will look at Japanese MNEs in the EU from the view point of integration from below.

4 INTEGRATION FROM BELOW

Since integration from above in Europe changes the economic conditions in the EU, the reactions by various economic actors to the change result in integration from below through trade, migration, capital movement and FDI, not only within the integrated area, but also from outside. We shall examine Japanese MNEs as an example of integration from below.²³

First, the involvement of Japanese MNEs in Europe must be considered, because the growth enhancement effects of integration from above improve the attractiveness of the integrated area as the FDI location. Japanese presence in Europe has steadily increased since the 1980s, with some fluctuations. Both the FDI value at current price and the number of plants show the expanding trend of Japanese MNEs in Europe. The surge of Japanese MNEs was significant and noteworthy from the late 1980s to the early 1990s, but the last decade has witnessed an easing off (Figure 5.1). Partly because of inflation and changes in the exchange rate, the FDI at current price has fluctuated during the last quarter-century, but the general trend for decades has been upwards. Until the mid-1980s, Japanese FDI was negligible, but it increased dramatically to nearly \$15 billion in 1989 and 1990. The FDI flow to Europe stabilised at less than \$10 billion for the mid-1990s, but every year since 1997 except for 2005 it has reached more than \$10 billion, and in 1999, 2000 and 2007 it exceeded \$20 billion.²⁴

Like the FDI flow, the number of Japanese subsidiaries has shown a fluctuating increase for the last two decades. According to JETRO (2007), the total number of Japanese plants in Europe numbered 996 in 2006, although the figure in 1986 was only 178. These 996 manufacturing subsidiaries comprise 773, 206 and 17 subsidiaries in Western Europe, Eastern Europe and Turkey, respectively. The number of new establishments in each year shows a similar trend as the FDI value (Figure 5.2). The highest jump can be seen between 1989 and 1991, and then the number plummeted to its lowest level in 1994. Since then, we can see a recovery trend to more than 50 new establishments in the twenty-first century. Under the recovery process, Japanese MNEs are expanding not only into Western Europe, but also into Eastern Europe. At the first peak of plants' establishment around 1990, most of them were located in the West, while in the twenty-first century almost half of new plants of Japanese MNEs in Europe have been set up in the East. As a result, there are 773 plants in Western Europe and 206 in Eastern Europe.



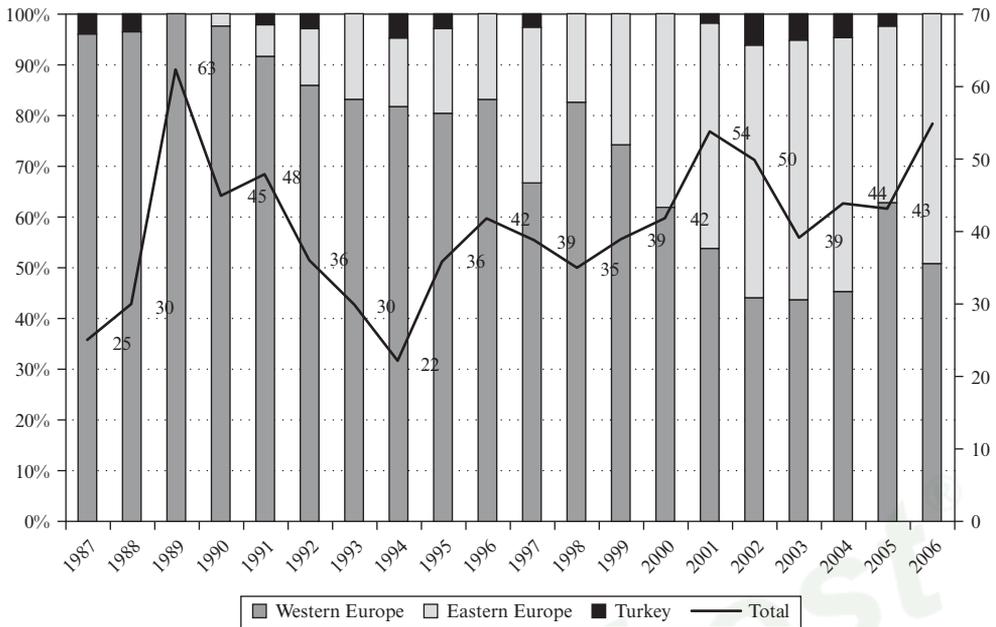
Note: Figures between 1982 and 1988 are for EU12.

Source: Ministry of Finance, Tokyo.

Figure 5.1 Flow of Japanese FDI into Europe (\$m)

When Japanese FDI into Europe started to increase dramatically in the second half of the 1980s, the SEM and protectionist measures such as the voluntary export restrictions of Japanese cars to European countries are pointed out as the motivation for FDI by Japanese MNEs (Ishikawa, 1990).²⁵ Based on the product life-cycle model, Thomsen and Nicolaides (1991) maintain that the EU does not affect the total volume of Japanese FDI, but rather the timing of investment. Indeed, Japanese FDI declined and stayed at a relatively low level in the 1990s, but for the last decade it has shown a fluctuating but upward trend, as mentioned above. Thus, we can say that Japanese MNEs play an increasing role in integration from below, which echoes integration from above, even if Japan is seen neither as an invader, nor as the main investor.²⁶ In other words, the effects of integration from above in improving the L-advantages, in general, stimulate integration from below.

The geographic pattern of Japanese FDI in Europe reflects the asymmetrical and unbalanced feature of integration from above, which has progressed more in the marketplace, and less in production conditions. Therefore, Japanese MNEs must identify the most suitable location for their operation. If we look at the location of Japanese MNEs within Europe, Japanese factories seem to concentrate in some large countries. Among nearly 1,000 plants in the JETRO (2007) survey, 210 plants are in the UK, while France and Germany have 136 and 129, respectively. In Eastern European countries, the Czech Republic is the biggest recipient with 68 factories, and Poland and Hungary follow with 58 and 48, respectively. However, a close examination shows a somewhat different



Source: JETRO (2007).

Figure 5.2 *New establishments of Japanese plants in Europe, geographic share (left-hand scale) and units of new establishment (right-hand scale)*

picture (Table 5.1). Since the member states of the EU differ from one another with regard to size, we should assess the degree of concentration with the adjustment based on some indicators, for example, population and GDP.²⁷ Indeed, the number of factories in a country is not an appropriate indicator of concentration, but it still shows some interesting features.²⁸ The GDP adjusted concentration indices suggest a divergence from the West to the East, as the index for the former is less than 1, and that for the latter is more than 3.5. A similar but less explicit trend can be seen in the population-adjusted indices. As a general trend, the indices are relatively higher in some smaller member states than in the larger ones, while the exceptional cases are the UK in both indices, France in the population-adjusted index, and Poland in the GDP-adjusted one.²⁹

At the same time, we can see the concentration trend of Japanese plants at the sub-national regional level within the member state. Using the information obtained from various sources, including the interviews at JETRO and the inward investment promotion offices of each member state of the EU, this author can confirm that there were 458 plants located in France, Germany and the UK in 2006, and 118 plants located in the Czech Republic, Hungary and Poland in 2003 (NUTS-2 region).³⁰ These countries are the main host countries for Japanese MNEs in Western and Eastern Europe, and numbers range from 27 plants in Poland to 239 in the UK. Table 5.2 reports the degree of concentration of Japanese plants at the NUTS-2 region in each country. The top-three regions in each country receive a share of from 18.8 per cent (UK) to 70.0 per cent (Hungary) of the total number of Japanese plants in each country. Thus, these data must

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Table 5.1 Concentration of Japanese manufacturing plants (2006)

| | Estab- lishment (units) | Simple share (%) | | | CIPOP | | | CIGDP | | |
|----------------|-------------------------------|------------------|-------|-------|-------|------|------|-------|------|------|
| | | (a) | (b) | (c) | (a) | (b) | (c) | (a) | (b) | (c) |
| UK | 210 | 27.2 | 21.1 | 21.5 | 1.79 | 1.99 | 1.76 | 1.59 | 1.35 | 1.34 |
| France | 136 | 17.6 | 13.7 | 13.9 | 1.11 | 1.23 | 1.09 | 1.10 | 0.93 | 0.92 |
| Germany | 129 | 16.7 | 13.0 | 13.2 | 0.80 | 0.89 | 0.79 | 0.80 | 0.68 | 0.67 |
| Netherlands | 53 | 6.9 | 5.3 | 5.4 | 1.67 | 1.85 | 1.65 | 1.43 | 1.22 | 1.20 |
| Belgium | 40 | 5.2 | 4.0 | 4.1 | 1.95 | 2.17 | 1.93 | 1.83 | 1.55 | 1.53 |
| Luxembourg | 1 | 0.1 | 0.1 | 0.1 | 1.12 | 1.24 | 1.10 | 0.43 | 0.36 | 0.36 |
| Ireland | 15 | 1.9 | 1.5 | 1.5 | 1.83 | 2.04 | 1.81 | 1.24 | 1.05 | 1.04 |
| Spain | 59 | 7.6 | 5.9 | 6.0 | 0.69 | 0.77 | 0.68 | 0.87 | 0.74 | 0.73 |
| Italy | 59 | 7.6 | 5.9 | 6.0 | 0.52 | 0.57 | 0.51 | 0.58 | 0.49 | 0.49 |
| Finland | 8 | 1.0 | 0.8 | 0.8 | 0.78 | 0.87 | 0.77 | 0.69 | 0.59 | 0.58 |
| Sweden | 18 | 2.3 | 1.8 | 1.8 | 1.02 | 1.14 | 1.01 | 0.85 | 0.72 | 0.71 |
| Denmark | 10 | 1.3 | 1.0 | 1.0 | 0.95 | 1.05 | 0.93 | 0.66 | 0.56 | 0.55 |
| Austria | 10 | 1.3 | 1.0 | 1.0 | 0.62 | 0.69 | 0.61 | 0.56 | 0.48 | 0.47 |
| Portugal | 17 | 2.2 | 1.7 | 1.7 | 0.83 | 0.92 | 0.82 | 1.58 | 1.34 | 1.33 |
| Switzerland | 5 | 0.6 | 0.5 | 0.5 | 0.35 | 0.39 | 0.34 | 0.23 | 0.20 | 0.20 |
| Greece | 3 | 0.4 | 0.3 | 0.3 | 0.14 | 0.15 | 0.14 | 0.20 | 0.17 | 0.17 |
| Poland | 58 | 28.4 | 5.8 | 5.9 | 0.73 | 0.87 | 0.77 | 0.73 | 2.62 | 2.59 |
| Czech Republic | 68 | 33.3 | 6.8 | 7.0 | 3.21 | 3.79 | 3.36 | 2.04 | 7.31 | 7.24 |
| Slovakia | 12 | 5.9 | 1.2 | 1.2 | 1.08 | 1.27 | 1.13 | 0.92 | 3.30 | 3.27 |
| Hungary | 48 | 23.5 | 4.8 | 4.9 | 2.30 | 2.72 | 2.42 | 1.82 | 6.54 | 6.48 |
| Romania | 13 | 6.4 | 1.3 | 1.3 | 0.29 | 0.34 | 0.31 | 0.46 | 1.64 | 1.63 |
| Lithuania | 2 | 1.0 | 0.2 | 0.2 | 0.28 | 0.34 | 0.30 | 0.29 | 1.03 | 1.02 |
| Bulgaria | 2 | 1.0 | 0.2 | 0.2 | 0.13 | 0.15 | 0.13 | 0.27 | 0.98 | 0.97 |
| Slovenia | 1 | 0.5 | 0.1 | 0.1 | 0.24 | 0.29 | 0.25 | 0.11 | 0.40 | 0.40 |
| Turkey | 17 | | 1.7 | | | 0.13 | | | 0.65 | |
| Western Europe | 773 | 100.0 | 77.8 | 79.1 | 1.00 | 1.11 | 0.99 | 1.00 | 0.85 | 0.84 |
| Eastern Europe | 204 | 100.0 | 20.5 | 20.9 | 1.00 | 1.18 | 1.05 | 1.00 | 3.59 | 3.56 |
| Total | 994 | | 100.0 | 100.0 | | 1.00 | | | 1.00 | |

Notes:

- (a) West–East divided.
 (b) West–East combined.
 (c) West–East combined minus Turkey.

Source: Author's calculation from the data, and information from JETRO (2007) and Eurostat.

be compared with other concentration levels of these top three regions, and we use area, population and GDP concentration as the benchmark. We can see that the concentration of Japanese plants in the top three host regions outweigh the concentration of all these benchmarks except for GDP in France, and it is fair to say that the subnational concentration is an important feature of Japanese MNEs in Europe.³¹

The combination of the divergence within the EU and the concentration within each member state has complicated implications. Japanese MNEs seem to fully make use of

Table 5.2 *Plant concentration in top three NUTS-2 region within each member state*

| | France | Germany | UK | Czech Rep. | Hungary | Poland |
|---------------------------------|--------|---------|------|------------|---------|--------|
| Japanese Plants | | | | | | |
| Total number | 136 | 83 | 239 | 51 | 40 | 27 |
| Top three host regions | 57 | 30 | 45 | 32 | 28 | 17 |
| Share of top 3 host regions (%) | | | | | | |
| Plant | 41.9 | 36.1 | 18.8 | 62.7 | 70.0 | 63.0 |
| Area | 10.8 | 5.6 | 9.8 | 49.1 | 33.8 | 21.7 |
| Population | 34.1 | 16.2 | 6.8 | 37.1 | 51.6 | 33.4 |
| GDP | 43.1 | 18.7 | 5.0 | 31.4 | 63.5 | 42.0 |

Note: Data on France, Germany and the UK in 2006, Czech Republic, Hungary and Poland in 2003.

Sources: Author's calculation from data and information from JETRO (2007), Inward Investment Agency in each country, and Eurostat.

the different L-advantages in the member states. At the same time, national governments hope that inward FDI should be allocated in as balanced a way as possible, since that could contribute to solving regional disparity problems. Sapir (2004) points out that since the 1990s the inequality has become worse, and the inequality is widening within countries rather than EU-wide. The inequality within a country, which can be a cause of social concern, raises difficult questions to be answered, but we can still say that integration from below has something to do with regional disparity. This may well be the reason why the EU's regional policy is part of the 'positive' integration from above, as well as that by national governments.

Now, we should look at Japanese FDI in the context of enlargement. This is because integration from above changes the L-advantage in the former planned economies to make them more attractive locations through the *acquis communautaire*. The enlargement of the EU raises the possibility of relocation, which is not always acceptable among member states. New member states expect to attract inward FDI through relocation from the old ones, which fear the loss of production and jobs. Further, through an examination of the location of Japanese plants, we can consider the meaning of integration from below (Ando, 2006). The plants in Eastern Europe can be classified based on their relation with their Western counterparts into three categories; that is, 'Eastern expansion', 'new entry', and 'relocation'. The first category, Eastern expansion, comprises those which possess and maintain the plants formerly owned in Western Europe, and expand their production capacity with new plants in Eastern Europe. The second, new entry, comprises Japanese MNEs that had not undertaken production in Europe until new factories in Eastern Europe were established. Finally, relocation, comprises those partly or completely closed down Western production facilities, and newly opening Eastern plants.³²

As mentioned above, as a general trend, Japanese FDI gradually shifts the weight from the West to the East, and this process has seen 98 MNEs possessing 127 plants in Eastern Europe by the end of 2004. Using the data from Toyo-Keizai (2008), these 127 plants can be classified into three categories (Ando, 2006). Most examples can be seen in the Eastern expansion, with 44 MNEs establishing 68 plants, and the new expansion

Table 5.3 Entry pattern of Japanese FDI into CEECs (units)

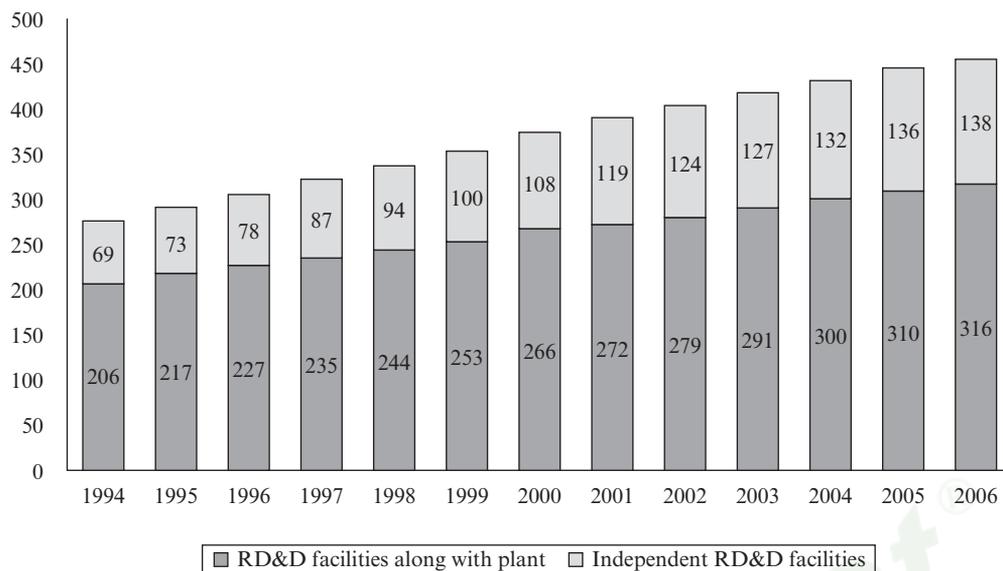
| | Total | New entry | Eastern expansion | Partial relocation | Full relocation |
|-------------|-------|-----------|-------------------|--------------------|-----------------|
| Parent MNEs | 98 | 47 | 44 | 6 | 1 |
| Plants | 127 | 50 | 68 | 8 | 1 |

Sources: JETRO (2007) and Toyo-Keizai (2008).

involves 47 MNEs setting up 50 new plants. As far as Japanese MNEs are concerned, relocation involves the smallest number, with only seven parent MNEs shifting nine plants to Eastern Europe (Table 5.3). This pattern of Japanese FDI into CEECs confirms that Japanese MNEs exploit the L-advantages there, which are different from their Western counterparts. Thus, for more than half of the MNEs maintaining their Western plants, it can be said that the production network is well established along with the different L-advantages between Western and Eastern Europe.³³ In other words, the expanding integration from above brings about expanding integration from below.

Now, we shall examine the operation of Japanese MNEs. Note the significance of the non-manufacturing subsidiaries of Japanese MNEs in Europe, because that will clarify the limits of integration from above, which aims to set up a freer market. The non-manufacturing operations by Japanese MNEs include research, design and development (RD&D) facilities and sales and marketing, and we shall begin with the former. Following the growth of Japanese plants, Japanese MNEs increased their RD&D facilities (Figure 5.3). Even if the available data are limited between 1994 and 2006, the JETRO survey (JETRO, 2007) reports that the total number of RD&D facilities increases from 275 in 1994 to 454 in 2006, of which 138 are independent RD&D facilities. Here, the UK leads the top location with 158 RD&D facilities, and 63 independent facilities. France and Germany lag far behind with only 78 and 74 RD&D facilities, and 17 and 23 independent ones, respectively. These three countries share two-thirds of total RD&D facilities and three-quarters of independent ones (Table 5.4). Unlike manufacturing operations, the Eastern diversification is limited to only 10 of total RD&D facilities. The interesting point here is that the independent RD&D facilities, which are more basic research oriented, raised their share in total from 25 to 30 per cent in the same period.

At the same time, the sales and marketing business by Japanese MNEs is also as important as the non-manufacturing operation. Toyo-Keizai (2008) lists more than 3,000 subsidiaries in EU27, but the manufacturing subsidiaries comprise a relatively smaller share with 765, one-quarter of the total (Table 5.5). The main part is divided among the wholesale operating affiliates with 1,559 subsidiaries in total. At the same time, services other than commerce have 596 subsidiaries, among which finance, logistics and business services comprise the main parts, though various operations are involved. Here, more non-manufacturing subsidiaries are located in Western Europe than in Eastern Europe, compared with the allocation of manufacturing facilities. The new 12 member states of the EU (EU12) from CEECs share 16.3 per cent of the manufacturing subsidiaries in EU27, but that of commerce is merely 7.8 per cent. This suggests that the L-advantages in EU12 are production rather than market oriented.



Source: JETRO (2007).

Figure 5.3 Growth of Japanese RD&D facilities in Europe (no.)

Table 5.4 RD&D facilities in Europe (2006)

| | Total | | Independent | |
|-----------------|-------|--------|-------------|--------|
| UK | 158 | 34.8% | 63 | 45.7% |
| France | 78 | 17.2% | 17 | 12.3% |
| Germany | 74 | 16.3% | 23 | 16.7% |
| Others | 144 | 31.7% | 35 | 25.4% |
| Total (rounded) | 454 | 100.0% | 138 | 100.0% |

Source: JETRO (2007).

The interesting point to be mentioned is that wholesale trading operations are also undertaken by the manufacturing MNEs. Toyo-Keizai (2008) ranks the top 60 manufacturing MNEs based on the number of foreign subsidiaries around the world (Table 5.6). The total number of foreign subsidiaries for the top 60 is 3,569 worldwide, and 904 in Europe. Despite the number of manufacturing firms, these 60 MNEs possess only 248 manufacturing subsidiaries, which sometimes also conduct non-manufacturing operations. Here, the non-manufacturing business by the manufacturing MNEs includes sales and marketing, RD&D facilities, the regional headquarters and others, which number 710, 54, 30 and 70, respectively, though with some duplication. In other words, sales and marketing may well be the most important business in Europe, even for Japanese manufacturing MNEs.

From these facts, we can say that Japanese MNEs appear to have reached a limit for

Table 5.5 Industrial structure of Japanese MNEs in Europe (2008)

| | EU27 | EU15 | EU12 |
|----------------------------|-------|-------|------|
| Total | 3,183 | 2,906 | 277 |
| Primary sector | 39 | 36 | 3 |
| Manufacturing | 765 | 640 | 125 |
| Services | 2,379 | 2,230 | 149 |
| Commerce | 1,593 | 1,469 | 124 |
| Wholesale trading | 1,559 | 1,436 | 123 |
| Retail sale trading | 27 | 27 | 0 |
| Eating and drinking places | 7 | 6 | 1 |
| Finance & insurance | 132 | 125 | 7 |
| Securities & investment | 54 | 53 | 1 |
| Real estate | 16 | 16 | 0 |
| Transport | 154 | 147 | 7 |
| Other services | 240 | 228 | 12 |
| Shareholding & other | 192 | 192 | 0 |

Source: Toyo Keizai (2008).

Table 5.6 Operation of top 60 Japanese manufacturing MNEs' subsidiaries (units)

| World total | Europe | | | | | | |
|-------------|--------|------------------|------------------|--------|---------|--------|-----------|
| | Total | In manufacturing | | In S&M | In RD&D | In RHQ | In others |
| | | Total | No. of countries | | | | |
| 3,569 | 904 | 248 | 194 | 710 | 54 | 30 | 70 |

Note: S&M: sales and marketing, RHQ: regional headquarters.

Source: Toyo Keizai (2008).

creating a freer market through integration from above. Indeed, the SEM and other schemes such as the single currency enable MNEs to enter and operate in the market more freely than otherwise, but the remaining features of national markets mean that MNEs need to establish sales and marketing facilities, while the RD&D subsidiaries also help to alleviate the difficulties that Japanese manufacturing MNEs face in Europe. The MNEs need to know the customers' requirements, preferences and tastes as much as possible in order to maximise the sales, while they also need to draw up contracts with the most efficient and reliable suppliers to minimise the procurement costs (Ando, 2005). Customers are not always in the private sector; the public sector also plays a significant role, as the high level of public expenditure in the GDP of European countries suggests. For example, the pharmaceutical sector shows a typical example of the importance of the public authorities, both at European and national levels. In order to realise the free movement of medicines, the EU has set up the European Medicines Evaluation Agency (EMA) in London, which centrally authorises the sales of new medicine, as well as

Table 5.7 *Divestment and being acquired cases (units)*

| | World | | Europe | |
|-----------|-------|---------------|--------|---------------|
| | Total | Manufacturing | Total | Manufacturing |
| -1990 | 1,333 | 474 | 142 | 34 |
| 1991 | 219 | 75 | 22 | 3 |
| 1992 | 228 | 71 | 49 | 12 |
| 1993 | 336 | 116 | 73 | 18 |
| 1994 | 337 | 104 | 77 | 13 |
| 1995 | 447 | 128 | 127 | 20 |
| 1996 | 455 | 119 | 104 | 19 |
| 1997 | 453 | 138 | 125 | 13 |
| 1998 | 814 | 201 | 176 | 29 |
| 1999 | 493 | 263 | 105 | 19 |
| 2000 | 438 | 141 | 69 | 15 |
| 2001 | 584 | 152 | 130 | 25 |
| 2002 | 607 | 198 | 127 | 30 |
| 2003 | 443 | 139 | 87 | 16 |
| 2004 | 471 | 162 | 105 | 27 |
| 2005 | 451 | 158 | 79 | 18 |
| 2006 | 395 | 153 | 79 | 20 |
| 2007 | 393 | 143 | 65 | 15 |
| 1991–2007 | 7,564 | 2,461 | 1,599 | 312 |

Source: Toyo-Keizai (2008).

mutual recognition procedures. Thus, Japanese pharmaceutical MNEs locate their RD&D facilities in the UK, so that they can communicate closely with the EMEA with regard to medicine approval procedures. At the same time, they maintain facilities in other countries, and this enables them to foster good relationships with national governments, which decide the price of medicines.

On the other hand, Japanese car assembly plants in Europe have to procure the parts and components in Europe, due to the local content requirement. Then, the supplier need not always locate in the vicinity of the plants concerned, as long as the price, quality and delivery meet the required standard. Since Japanese car MNEs are relatively minor players in Europe, they cannot always force European suppliers to meet their demands, but Japanese MNEs must sometimes adapt the cars assembled in Europe to incorporate the main components that European suppliers provide with the help of RD&D. For these forward and backward linkages, the MNEs must not only control the product and service flow across borders, but also collect and utilise the knowledge and information through the sales and marketing, and RD&D facilities.

We mentioned that relocation is not a typical response of Japanese MNEs faced with EU enlargement, but this does not imply that they can easily operate and expand in the EU. Rather, the present picture is the result of the restructuring and reorganisation of Japanese MNEs. According to Toyo-Keizai (2008), the number of divestment cases including those that are being acquired total 1,599, with 312 in the manufacturing

sector, which are the accumulated figures for between 1991 and 2007 (Table 5.7). These account for more than half the number of existing subsidiaries in 2007. In other words, about one-third of Japanese subsidiaries in Europe have been restructured. Indeed, the closures are not always due to the failure of the subsidiaries in question, but are sometimes a result of the failure of the Japanese parent itself. At the same time, more-positive motivation can be identified, as the consolidation of subsidiaries across borders is necessary to achieve scale economies. Here, it must be remembered that the actual closure of a subsidiary is not the only method of adjusting to the circumstances, but the reallocation of the competence from one subsidiary to another is also a means of obtaining a more efficient division of labour within the MNE concerned. The divestments by Japanese MNEs suggest the difficulty of transplanting the O-advantages into foreign soil, even if integration from above increases the attraction for FDI.³⁴

The quest for an efficient network of tangibles and intangibles by MNEs is proceeding under competition with other players (Ietto-Gillies, this volume, ch. 3), which is further intensified by integration from above. Because of the competitive conditions, the original plan is not always realised smoothly, but is more likely to be confronted by some unexpected reactions from others, and needs to be modified for the new situation. Thus, once a Japanese MNE invests in Europe, it is rarely a one-off project, but rather to be followed with other additional investments and divestments. Thus, the process is likely to be evolutionary with trials and errors, rather than a simple reaction to market signals.

5 CONCLUSION

We have looked at economic integration from both above and below with special reference to Japanese MNEs. Economic integration from above, at least, in Europe is not a simple market-making process, but includes wider objectives, which are not always compatible, as well as enlargement. From the viewpoint of MNEs, integration from above not only promotes the integrated area as more attractive for FDI through the changes arising from L-advantages, but also makes it more complicated and difficult to operate under the asymmetric change of the L-advantages. The reaction of Japanese MNEs to the development of the EU since the late 1980s suggests the significance of integration from above, and the difficulty of exploiting the opportunities provided.

From the findings of this chapter, Japanese FDI in the future may well be expected to undergo a shift in direction, especially under the financial and economic setback since 2007. Note that integration from above in Asia, such as ASEAN and the East Asian Community, follows that in Europe, even if the development level in Asia lags behind Europe. Indeed, there are many factors influencing Japanese FDI, but integration from above in Asia can have a positive effect. Since Asian countries are small in terms of GDP, and GDP per capita, integration from above contributes to establishing a larger market. At the same time, if the regulatory framework were integrated for the freer market, the L-advantages can seem more attractive for FDI. Here, Japan has already committed to the process of establishing regulations and standards at national and ASEAN levels through the various routes, including official development aid (Nakamura, 2009). As far as commitment to the institutional setting is concerned, Japan and Japanese MNEs

could achieve a better position in Asia than in Europe, and that might well shift Japanese FDI more to Asia in the future.

At the same time, the new policy direction of developed countries under the present economic downturn is not only to kick start with budget expenditure, but also to upgrade environmental regulations. In this respect, the EU is the most advanced in the world, and is sure to encourage further efforts in this direction in the future. It is hardly a coincidence that the European Council in December 2008 agreed the European Economic Recovery Plan, which aims at a budget stimulus of €200 billion, and a new approach for sustainable development, which aims to reduce the emissions of CO₂, replace coal and petroleum by renewable energy, and so on. The EU is too large a market for MNEs to ignore, and this is also true for Japanese ones. Therefore, Japanese MNEs need to conform with the regulations and standards set by the EU. As a result, an upgrade of Japanese FDI into Europe may well be expected in the future.

In conclusion, we could raise some questions to be further investigated in future research. The first is that divestment cases are not fully considered in this chapter, but they comprise a large part of Japanese FDI in Europe. Research on divestment is generally lagging, compared with that on FDI, and the shortcomings in the Japanese cases must also be dealt with. The second is the question of economic integration from below with other regions like Asia, from which Japanese MNEs export to Europe a great deal. Even if some research suggests that MNEs tend to concentrate their business in the home region, that does not mean that the cross-regional flow within the MNE in question does not exist. Rather, there are other methods for MNEs to integrate between regions rather than within a certain region. This would be an interesting issue for future research. The third is the question of the impact of Japanese FDI on the demand side, since MNEs can gain profits and reinvest back home or in another region (Ietto-Gillies, 2000). As the history of Japanese MNEs' operation becomes longer, the possibility of a financially independent operation from home is likely to be higher. The Japanese investment income balance now exceeds its trade surplus, although the former includes both FDI and portfolio investment income. The FDI income from European operations is not addressed in this chapter, and this issue must be resolved.

SUMMARY

Economic integration can be categorised into two types, that is, integration from above, and integration from below, and their mutual relationships and causality are different from one region to another. This chapter examines the case in Europe with the evidence of Japanese MNEs. Integration from above by the EU is quite important to establish a freer market, but has some limits due to the unbalanced development between market integration and the convergence of production. Faced with this situation, Japanese MNEs not only invest and expand their European business, but also compete for the best choice of location and operation within Europe, so that they can exploit the opportunities and survive under more competitive pressure. This process confirms the asymmetrical feature of integration from above.

Keywords

European Union (EU), foreign direct investment (FDI), multinational enterprises (MNEs), location, international economic integration.

JEL Classification

F15, F23, F59.

NOTES

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1. This definition is given by Pelkmans (1984), although he emphasises the importance of the elimination of economic frontiers in the modern mixed economy. As we discuss below, integration should not exclude the intervention aspects of a regulatory framework.
 2. In addition to the literature mentioned above, see Dunning and Robson (1988), Cantwell (1992), Robson (1993), and Rugman (2005), among others.
 3. This does not imply the total independence of Japanese MNEs, but the relative situation. It is impossible for social science to simulate the pure conditions in a laboratory, but it may well be more desirable to exclude some influencing factors through target-setting.
 4. Of course, there are some Japanese MNEs with a long history of operation in Europe, as, for example, Mason (1994a) suggests. Concerning US MNEs, see, for example, Wilkins and Hill (1964), Wilkins (1974), and Dassbach (1989) among others.
 5. For a summary of the historical development of the EU, see, for example, Gillingham (2003) and Jovanović (2005).
 6. Balassa (1961) suggests that the level of economic integration progresses from a free trade area to complete economic integration, although the actual process of economic integration does not always follow this path.
 7. The EU assesses and publishes the pre-1992 forecast, and the post-1992 assessment. These are a series of reports, but Cecchini (1988) and Monti (1996) are the compact summaries of the forecasts and the assessments, respectively.
 8. Originally, the single currency started with only 11 among 15 member states in 1999, but in 2001 Greece qualified to introduce the euro. After the enlargement of the CEECs in 2004, three countries (Slovenia in 2007, and Malta and Cyprus in 2008) were authorised to circulate the euro, and Slovakia started to use the euro from 2009. In the face of the global financial crisis since 2007, some outsiders such as Denmark have started to reconsider their opt-out policy.
 9. Emerson (1992) gives the expected effects of the single currency, while the assessment of the euro in the last decade is given by the European Commission (2008a).
 10. The EU started with the six member states, France, West Germany, Italy and Benelux (Belgium, the Netherlands and Luxembourg), of the European Coal and Steel Community in 1952. In 1973, the UK, Ireland and Denmark became members of the EU (the 'northern enlargement'), while the 'southern enlargement' includes Greece in 1981, and Spain and Portugal in 1986. After the collapse of the Eastern bloc of planned economies in 1990, Austria, Finland and Sweden were given membership in 1995. In 2004, eight former planned economies, Poland, the Czech Republic, Slovakia, Hungary, Estonia, Latvia, Lithuania and Slovenia, and two Mediterranean countries, Malta and Cyprus, became members, while Romania and Bulgaria followed suit in 2007.
 11. The transparency is especially true for the last eastern enlargement, because new member states must introduce new national laws or modify existing ones to conform to the *acquis communautaire*, the so-called 'Copenhagen criteria'.
 12. At the same time, Tinbergen insists that negative integration is intended to eliminate existing barriers. Therefore, the customs union and the SEM explained above can be included in the category of negative integration.
 13. With regard to environmental policy, Tosun and Knill (this volume, ch. 12) provide a new perspective for the present discussion.

14. As Baldwin (2008) insists, the historical conditions in Europe after the Second World War were eminently suitable to put in place a bolder scheme than in any other region.
15. We can follow the development of institutional economics during the last few decades. See, for example, Hodgson (1988), North (1990), Aoki (2001) and Hall and Soskice (2001), among others.
16. '[A] market needs institutions and a strong European market needs strong European institutions' (European Round Table, 2001, p. 1).
17. Internalisation theory is one of the main streams of international business research to advocate MNEs internalising transaction costs. Representative works are Buckley and Casson (1976), Caves (1996), Dunning (1988) and Rugman (1981), among others.
18. Dunning first proposed the eclectic approach in 1977, and there are many discussions on this model. Dunning himself was mindful of the discussion, and modified his approach to a paradigm rather than a model (see Dunning, 1977 and Dunning and Lundan, 2008).
19. With regard to the importance of the institutions set up by the EU and their configuration with business practice, see, for example, Whitley (1992).
20. The argument on the variety of capitalism by Hall and Soskice (2001) reflects this recognition, while international business scholars have also become aware of this issue (see, Jackson and Deeg, 2008).
21. Meyer and Peng (2005) summarise the implications of eastern enlargement on international business studies.
22. Rugman and Verbeke (2001) stress the importance of the combination of O- and L-advantages.
23. In order to confirm integration from below, we use all the related data and information of Japanese MNEs from various sources, which include the FDI value, the number, location and operation of subsidiaries, case studies and so forth.
24. Here, it must be recalled that the FDI value is sometimes much influenced by a few cases. For example, Japan Tobacco bought RJ Reynolds International (from the Netherlands), in 1999 with the acquiring price of \$7.8 billion, which accounted for more than half of Japanese manufacturing FDI in Europe. Data on Japan Tobacco's acquisition are from UN (2000, p. 234).
25. Sachwald (1995) is a good reference for the comprehensive analysis of Japanese FDI into Europe until the early 1990s.
26. According to the European Commission (2008b), Japan invested €13.6 million in the EU in 2006, which consists of 8.7 per cent of inward FDI from non-EU countries, and 2.3 per cent of total inward FDI.
27. The adjusting calculation is given in Appendix 5A. The calculation shows that if the figure is greater than 1, the country receives more Japanese factories than its population or GDP share in the EU.
28. Rugman and Oh (this volume, ch. 4) discuss the metrics of international business, and maintain that there is a limit to using the number of subsidiaries as the multinationality measure. The assessment here using the number of Japanese plants, may well avoid some limitations suggested by Rugman and Oh, since it mainly focuses on European cases, and is less biased by measuring the number of subsidiaries.
29. Yamawaki (1993) shows the diverse pattern of Japanese FDI in Europe in 1988.
30. The EU classifies the subnational region as the nomenclature of territorial units for statistics (NUTS) with the degree 1 to 3, and NUTS-2 is the most often used unit. Because the NUTS is based on the national method to classify the subnational region in each EU country, we must keep in mind that the size of NUTS-2 varies from one country to another.
31. From a different perspective, Fujita and Hamaguchi (this Handbook, Vol. II, ch. 11) discuss the regional disparity in Japan under the economic integration process of the Japanese economy.
32. Here, we set a three-year time span for the purpose of assessing the relocation, since the longer time difference between plant closure and reopening can be based on the different considerations for relocating the facility.
33. Amin (2000) points out that the SEM can be the basis for the MNE production network in Europe.
34. Some case studies on Japanese MNEs in Europe support this assessment. See, for example, Ando (2005) and Elger and Smith (2005).

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APPENDIX 5A

In order to adjust the different size of country, the following calculations are used:

$$\text{Concentration Index Pop (CIPOP)} = (FACNO_i/FACNO_j)/(POP_i/POP_j)$$

and

$$\text{Concentration Index GDP (CIGDP)} = (FACNO_i/FACNO_j)/(GDP_i/GDP_j),$$

where:

$FACNO_i$: number of Japanese factories in country i ;

$FACNO_j$: total number of Japanese factories in area j ;

POP_i : population in country i ;

POP_j : population in area j ;

GDP_i : GDP in country i ;

GDP_j : GDP in area j ; and

area j : EU15, EU12, and EU27.

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6 International mergers and acquisitions¹

A. Edward Safarian

1 INTRODUCTION

In recent years there has been a proliferation of types of international investors with increasing effects on the ideas of what constitutes appropriate corporate governance. Not so long ago the standard texts on international economics showed two forms of foreign ownership involving corporate control, namely foreign direct investment (FDI) with a sole or dominant owner and various types of joint venture with differing ownership and roles. Other forms of collaboration gradually came to receive close analysis.

Researchers were slower to pick up on the dominant role of international mergers and acquisitions (M&As) in FDI in the industrial and emerging countries. More recently a variety of investment groups apart from multinational enterprises (MNEs) have also come to play a significant role in such M&As. Governments have become concerned with both the economic impact of international M&As generally and how state-owned and state-influenced corporations and funds affect national security and corporate governance.

Such cross-border M&As have played an important role in international economic integration in conjunction with and often closely related to foreign trade, portfolio financing, migration of skilled and managerial workers, and in other ways (Jovanović, 2006, ch. 3). Note that this relationship is in both directions: economic integration can reduce some barriers to M&As while such M&As can increase country interdependence and also affect corporate policies. In many respects there are similarities between domestic and cross-border M&As, for example, in some of the motives. But there are risk elements which differ, including foreign exchange risks, political risks and cultural differences both corporate and societal. Comparison of domestic and cross-border M&As is a useful way to test competing hypotheses in this area (Swenson, 1993).

This chapter is structured as follows. Section 2 deals with the reasons for and the main characteristics of the four types of cross-border ownership and control, namely greenfield FDI, international M&As, investment groups of various types, and sovereign wealth funds owned or directly influenced by governments. Section 3 considers the effects on host countries, including particularly some economic and security issues emphasised in the literature on the most recent merger wave. Section 4 then comments on several policy issues which have been highlighted in the literature, specifically with reference to shareholder rights and governance, competition policy, restrictions on sovereign wealth funds and the pressure to increase regulatory review of cross-border M&As. Finally, Section 5 ends the chapter with a brief and tentative note on how the credit crisis since late 2007 may affect some of the conclusions drawn earlier.

2 MOTIVES FOR TYPES OF FOREIGN DIRECT INVESTMENT

FDI refers to a long-term relationship and effective voting control of an enterprise in one country by an investor or enterprise in another. Traditionally this has been contrasted with indirect or portfolio investment where voting control is not involved. This distinction has become blurred recently and perhaps was too sharply drawn in the past. We note also in passing that 'control' can be exercised in a number of ways other than stock ownership, such as ownership of a critical patent or technology or through a dominant buyer or supplier.

Country data on FDI define cutoff points for measuring effective control ranging from 10 to 50 per cent of voting stock with attention given at times to how widely the rest is distributed. The literature on FDI which is well developed and longstanding will be considered only briefly in so far as greenfield investments are concerned, that is where new plant and equipment are involved. The literature on international merger or acquisition of an existing firm or part of it has received close attention more recently and is more germane to the concerns addressed below. Both it and the even newer forms of investment groups and sovereign wealth funds will receive more emphasis below.

Greenfield FDI and Mergers and Acquisitions

Traditional explanations of FDI have revolved around three interrelated issues depending on which aspect one is considering.² First, to offset the costs involved in operating abroad a firm must have ownership-specific advantages not possessed by its domestic competitors. These advantages are of many kinds, from research through to distribution, and are embodied in the firm's human capital skills and other resources. Second, MNEs have a range of alternatives to FDI when going abroad, particularly exports and a variety of alliances with other firms such as licences, joint ventures and research consortia. The decision to use FDI, to 'internalise' within the MNE, may be because this is a more efficient way to organise various activities. For example, it may be difficult to transfer to other parties the intangible assets of the firm which are embodied in its human capital. The decision to internalise may also reflect higher profits from its advantages than will be possible from trade or alliances, for example because its advantage would be imitated more quickly in those cases. Third, decisions must frequently be made on where to locate or expand part or all of a firm's production facilities based on a variety of supply, demand, public policy and business strategy decisions applied to a set of countries or regions. One useful way to group motivations for location of FDI is resource seeking, market seeking, efficiency seeking and strategic asset seeking.

Some of the determinants of M&As may also apply to greenfield FDI but there are at least four important differences. First, if the pressure of competition and the shortness of the product cycle require speed in setting up production and distribution, the M&A is generally superior to greenfield entry or expansion. Second, acquisition of various proprietary advantages such as research and development (R&D), patents and brands may not be feasible through market purchase or may be more costly if done from scratch. A third difference is that the ownership–location–internalisation (OLI) paradigm outlined above does not work well with mega mergers between firms of about the same size so as to jointly exploit their ownership advantages. The paradigm better fits

greenfield investments and some types of acquisitions such as those between more and less advanced firms or those of very unequal size as well as capability (UNCTAD, 2000, 140–43).

Finally, the OLI paradigm does not explore M&A motives which do not maximise the firm's net present value. We note a range of such motives below. What should be underlined here is that the market for firms involves a variety of valuation, negotiation and financial issues rarely discussed in the standard OLI literature or in its international trade extensions. The decisions leading up to the deal between the parties can affect not only how the gains are divided between the various stakeholders but also the net impact in each country. For example, Rossi and Volpin (2004) explore cross-country variation in governance structures, showing that better investment protection and accounting standards correlate with more active markets for M&As. Shimizu et al. (2004) show that due diligence, negotiation and integration of the two firms' activities all involve a great deal of learning both before and after the cross-border M&A. The problems are different from domestic M&As; in cross-border negotiations due diligence and integration are usually more difficult and a higher premium typically results. The acquisition costs are not the only ones for an M&A as distinct from a greenfield investment. Even more challenging in some cases are the problems of integrating two firms with overlapping functions and often with very different corporate cultures.

Brachman et al. (2006) have drawn together some empirical observations on cross-border M&As using an extensive database.³ Some of their findings are as follows:

- By the end of the 1990s M&As accounted for about 80 per cent of the value of global FDI. Fully 97 per cent by numbers were acquisitions rather than mergers, of which 65 per cent were full acquisitions and 15 per cent were more than half acquired.
- About half of the number and value of deals were horizontal over the period examined, the latter being more volatile. This group might be dominated by the market-seeking motive.
- M&As occur in waves of which there were five in the twentieth century. A sixth wave started around 2003 and ended late in 2007. Such waves show a positive correlation with share prices, price/earnings ratios and the business cycle but the direction of causality is not clear.
- Most FDI and M&As occur between the relatively high-income countries. On average 55 per cent of the acquisitions were by European and 30 per cent by North American firms while the figures were 44 and 38 per cent, respectively, for targets. In each case the share of Western Europe has risen over time.
- The maximum size of the deals has tended to rise over time as has the inequality between them. Some mega deals in particular have attracted both attention and concern and led to consideration of public policy responses as noted below (ibid., Table 6). The UNCTAD database shows cross-border M&As valued over \$1 billion each rose from about 30–40 per cent of the total to 60–70 per cent both at the end of the 1990s and again in 2005–06 (UNCTAD, 2000, 10–19; 2007, 6). The most recent wave of cross-border M&As has also seen growing participation by collective investment funds, notably private equity groups and hedge funds.

There are two types of model which have been used to explain the increases in cross-border M&As.⁴ One is a macro model which focuses on such determinants as economic growth in the country of the investor and the target; real exchange rates; liquidity and low interest rates along with the depth of financial markets, allowing large leveraged buyouts; newer forms of finance beyond bank loans such as innovative debt and equity finance and share exchanges (UNCTAD, 2000, 152–5); differences in tax systems; the stage of the global wave in M&As; institutional quality; the differences in cultures in general and corporate cultures in particular; privatisation; deregulation of trade, FDI and merger review; and a portfolio of locational assets affecting competitive strength such as R&D, skills, brands, patents and networks.

More light is cast on motives if we consider further the micro-level studies of firms or industries or look more closely at particular determinants within general models. First, assume that the M&A is an attempt to maximise net present value of future profits, that is, the new owners believe that they can increase the return on investment. Scale and scope economies may be possible as the target is restructured and integrated with the investor's other assets and new markets are reached. The two firms may be worth more together than separately since synergies may arise from pooling resources such as distribution networks or various headquarter functions and reducing duplication in plants or products. Second, any increase in market power may allow larger profits at least for a time.

It is important to add that motives other than maximisation of net present value of future profits may be present and even dominant. In an oligopolistic framework the attempt to preserve domestic or international market positions can lead to extensive M&As both in space and time. In March 1998, for example, Alcan Aluminum bought Indian Aluminum and Ghana Bauxite. There were 13 cross-border M&As in this industry over the next five months (*ibid.*, 158, note 26). Caves and Mehra (1986) argued that FDI in the United States in the 1970s was partly due to catching up by foreign manufacturing firms which had experienced entry earlier to their markets by US and other foreign firms. Perhaps of more direct interest here are cases where ownership interests are weak; managers and the board in the acquiring firm may pursue growth as such and expansion of their own power and material rewards in ways not necessarily serving shareholder interests (Baumol, 1967).⁵ And managers may show hubris, that is, err in their sense of their capabilities, paying too much for the target and underestimating the costs of integrating the two firms.

The empirical tests often combine macro and micro variables in practice. Some of the tests are noted here – the list is not exhaustive. There are a number of literature reviews such as Andradé et al. (2001) and some recent papers have extensive bibliographies, for example, Coeurdacier et al. (2008).

There are a number of macro studies on how exchange rates and tax differences affect M&As. Thus Froot and Stein (1991) and Blonigen (1997) present evidence that a depreciation of the US dollar increased the flow of FDI to the United States in the 1980s. A study for Canada by Georgopolous (2008) agreed that depreciation raised the probability of foreign M&As but only in high R&D industries. In general, one would expect a lower tax rate to attract FDI. However, Hines (1996) examines how different forms of home-country taxation affect FDI to the United States.

An interesting paper combines an oligopolistic approach particularly relevant to

larger M&As with the general equilibrium approach common to international trade (Neary, 2007).⁶ Neary emphasises cost asymmetries between acquiring and target firms, with low-cost firms in one country acquiring and closing high-cost firms in the other. He notes that falling trade costs can explain horizontal FDI once FDI is taken to include M&As. The result is to increase specialisation and trade along the lines of comparative advantage. This approach helps resolve an issue in international integration since as Brachman et al. (2006) point out, falling trade costs should favour trade rather than FDI as a way to serve external markets. It is notable that intra-European M&As accounted for one-third of the value of global M&As in 1991–2005. This could be due in part to declining takeover costs in Europe as national legislation was harmonised in important respects (Barba Navaretti and Venables, 2004, ch. 3).

The gravity model for explaining trade has also been used to explain cross-border M&As. Head and Ries (2008) develop a multicountry model with a strong resemblance to a gravity model for 30 OECD and 32 other countries. They introduce frictions which can restrict cross-border M&As. Specifically, the subsidiary's management will not maximise the value of the subsidiary unless the owner undertakes monitoring costs which increase with distance. Thus the potential gains from the M&A can be offset by costs of distance. The model is more appropriate to conglomerates or some types of horizontal M&As rather than ones where trade and factor costs are important. The model fits well the patterns of FDI and M&A data. In particular, both origin and destination country effects are important to FDI but so are third-country effects.

The gravity model has been utilised to deal with financial forces in particular as they relate to cross-border M&As. Di Giovanni (2005) found that financially deep domestic markets had strong positive effects in stimulating M&A outflows in the 1990s. He also confirms, among other things, the importance of geographical and cultural proximity. Coeurdacier et al. (2008) focused on cross-border M&As at a sectoral level for 1985–2004, particularly the financial and institutional variables involved in European integration. They considered the integration gains both from the Single European Market in 1992 and the Third Stage of European Monetary Union (EMU) in 1999. As in other studies physical and cultural proximity aids cross-border M&As. Both the EU and EMU had positive effects on horizontal and vertical mergers (rather than conglomerates) and the acquiring sector's expected profitability was a key driver of cross-border M&As. These and other results favour an industrial restructuring and value-enhancing view of what was occurring except for the services sector where significant barriers were still in effect. Financial depth, lower corporate taxes and a lower degree of product market regulation all favoured cross-border M&As.

It was noted above that non-maximisation motives may prevail, favouring the attitudes and interests of management and directors. Seth et al. (2000) and Malmendier and Tate (2005) test for managerial hubris, that is, overpaying for the target and underestimating post-merger integration costs. Gorton et al. (2005) present a model of defensive mergers and merger waves reflecting managerial preferences to remain independent. If such preferences are strong there can be unprofitable defensive acquisitions (a form of poison pill) which set off a wave of such acquisitions. This outcome is more likely when firms in an industry are similar in size. Along with the problems noted earlier in integrating firms, the theory helps to explain why acquirers lose money or make small gains, on average.

There are a number of industry studies apart from those already noted which provide additional insights. For example, Danzen et al. (2004) examine determinants and effects of M&As in the pharmaceutical–biotechnology industry after allowing for firms' prior merger propensities. In the case of large firms the M&As are determined by excess capacity as patents are expected to end and also by gaps in the firm's product pipeline. For small firms it is financial problems and the need to exit the industry which drive M&As.

Private Equity Funds and Hedge Funds

Global private equity and venture capital activity rose rapidly in the 1990s to almost US \$300 billion in 2000, then rose to almost \$850 billion in 2006.⁷ The vast majority of the latter figure was in leveraged buyouts (LBOs) and related investments with a relatively small part in venture capital.⁸ North America and Europe have dominated these figures. The typical capital structure of listed companies contrasts with that of LBOs – 60 per cent equity and 40 per cent debt for the former, 30 and 70 per cent for the latter with senior debt only half of the latter. Hedge funds, banks and pension funds were the global investors in these leveraged loans. The exits of private equity investments were very largely by initial public offerings and trade sales with management buybacks and write-offs playing smaller but significant roles (Reserve Bank of Australia, 2007).

Private equity investing involves limited partners, usually wealthy individuals and institutional investors who provide capital, with the private equity firm as the general partner. The general partner usually has an agreed period of about five years to invest the capital and an agreed period of about 10–12 years to return it with any profits. The general partner will typically manage several such funds and seek new capital for new funds as earlier ones are completed.

Hedge funds are largely unregulated pools of capital whose manager has the right to short positions, to borrow and to use derivatives, functions denied mutual funds except for a limited use of the last. The number and types of investors are limited by law given the risks involved, and regulation is also limited. Managers receive 1–2 per cent of the fund's net asset value and 15–25 per cent of the return above a certain level.⁹ The manager will typically borrow funds to some multiple of the initial investment. The Long Term Capital Fund had capital of \$4.8 billion and assets of \$120 billion at the start of 1998; it lost almost all of its capital in one month after the Russian crisis of August 1998. While there are some similarities in private equity and hedge funds – both are lightly regulated and privately funded – there is an important difference in liquidity. Hedge funds are typically in liquid assets, hence investors can enter or leave with some notice. Private equity funds are in relatively illiquid assets for the term of the fund. Hedge fund strategies vary a good deal (Bookstaber, 2003). However, most look for pricing mistakes in markets and develop hedges to profit from these without being affected by other factors (Stulz, 2007).

Private equity funds will engage in a variety of activities including supplying venture capital to newer undertakings, but they are mostly involved in turnaround situations where they believe assets to be undervalued. The target firms often lack credible long-term strategies designed to maximise asset values or they fail to communicate such strategies especially with regard to investment, and are especially attractive if they have large cash reserves and low debt levels. If the buyout takes a public firm private, there

may be some advantages from the viewpoint of the private equity firm: managers have more power to deal with restructuring without worrying about the pressure of quarterly earnings reports, and the interest on the leveraged debt (while supplying a pressure of its own) is deductible for tax purposes where dividends are not.

What the investment leads to is active engagement in resolving problems in the firm, including possible changes in management and board and restructuring the operations, capital structure and incentive schemes. Depending on the situation the investor can work with the present management to restructure, rely more heavily on the board, engage in a private equity buyout, or attempt a buyout in cooperation with insiders to the company. Each of these involves different degrees of access to information, bargaining and friction, capital cost and risk (Cuny and Talmor, 2007). The buyout is usually leveraged by taking on debt, and, assuming a cash flow sufficient to finance it, locked in for up to 10 years before one of the exit strategies noted above is used.

It is important to add that a small number of 'activist' hedge funds pursue strategies similar to those of private equity funds. They will use their ownership of relatively small amounts of voting shares to campaign for changes in a firm's policies. Some will also engage in some aspects of private equity financing. Such funds, while less regulated than others, must like others disclose holdings once certain ownership thresholds are reached.

It is also important to note that unlike traditional FDI, whether greenfield or M&A, both private equity and hedge funds place limited terms on their investments, the latter being short and usually non-controlling. This is a critical difference we shall return to below.

Aizerman and Kendall (2008) use versions of the gravity model to show that distance is negatively related to the number of international venture capital and private equity deals, a result they ascribe in part to the monitoring and advisory roles required. Language and colonial relationships are significant predictors as well, perhaps proxying for networks, similar institutions and other factors. These results are similar to those in financial gravity models of international investment flows such as that in Portes and Rey (2005). The results of the regression tests also suggest fixed costs of establishment ('beachhead effects') and inter-firm networks ('follow the leader effect'). Ljungquist et al. (2007) examine the determinants of investment by buyout funds. Investment flows and earnings rise as investment opportunities improve, competition for deals eases, and credit conditions ease. However, the investment behaviour of first-time funds is less responsive to market conditions and the newer funds engage in riskier buyouts so as to get established. Funds, especially the newer ones, tend to be more conservative after a period of good performance. Kaplan and Strömberg (2009) also conclude that credit market conditions dominate the debt used in given leveraged buyouts.

Sovereign Wealth Funds¹⁰

The US Treasury Department has defined a sovereign wealth fund (SWF) as a 'government investment vehicle which is funded by foreign exchange assets, and which manages these assets separately from the official reserves of the monetary authorities'. A commodity SWF utilises foreign exchange earnings from commodity exports owned or taxed by government. This can be used to even out the economic effects of changes

in natural resource volume and price as well as smooth the intergenerational effects, and also to enhance a particular sector such as finance. A non-commodity SWF utilises excess foreign exchange assets from continuing current account surpluses (Das, 2008; Markheim, 2008).

SWFs have been around since at least the 1950s. What has given them prominence recently is their substantial increases reflecting the growing foreign exchange resources of countries like China and Middle-Eastern oil producers, and also the attempts by such countries to realise larger returns from these resources by broadening their investments. The non-commodity SWF moves beyond US treasury bills and similar EU investments to investments in infrastructure, industry and a wide range of other assets.

The size of SWFs in 1990 was estimated at \$500 billion. Estimates for 2007 put them at \$2–3 trillion with projections based on current account estimates to \$6–10 trillion by 2013. The top five funds account for 70 per cent of the total, with half of that in oil and gas-exporting countries. Private equity by comparison was estimated at \$2 trillion though it can be leveraged very highly as noted above. The global value of traded securities, debt and equity, was about \$165 trillion. While rising rapidly FDI flows by SWFs were still less than 1 per cent of global FDI in 2007 and much smaller than FDI by private equity funds (data from Johnson, 2007 and UNCTAD, 2008).

It is the broadening of investments by SWFs and especially the possible motives which have also raised concerns, however. There were a series of well-publicised cases involving SWF attempts to enter, for example, the energy and mining sectors (Canada and the United States), and, in the United States, a network technology company, ports management, and banking and finance. Two of these involved SWFs from Singapore and Abu Dhabi while the rest were from China. These proposals were all withdrawn in the face of widespread criticism from private and public sources. Significant but minority Chinese SWF stakes were allowed in major US banks and investment banks experiencing difficulties but on the understanding that the investment was passive, that is, below 10 per cent ownership and without a director on the board or voting rights. Nevertheless in 2005–07 there were large FDIs by acquisition or establishment from the Near East and Singapore in a variety of developing and developed countries (UNCTAD, 2008, 24).

Antkiewicz and Whalley (2006) discuss some of the controversial cases in North America and the EU in particular, noting three particular concerns. The first is the subsidisation of purchases as a result of low or zero interest charged by the Chinese Central Bank on such overseas investments. The second is concerns about national security when sensitive technology is acquired through FDI, an issue dealt with below under effects of SWF investments abroad. The third is the lack of transparency in such investments.

It is important to note that SWFs, like state-owned firms, vary widely on the issues of disclosure, governance, structure and accountability and transparency which have attracted criticism. One study of 44 pension and non-pension SWFs which focused on these issues gave New Zealand's Superannuation Fund and the Canada Pension Plan 95 out of a possible 100 per cent for best practices, with China's National Security Fund at 77 for the 10 pension funds studied. By contrast, Norway's Global Fund was rated at 92, the Hong Kong Exchange Fund at 51, the China Investment Corporation at 29, and two Abu Dhabi Funds at 15 and 9 (Truman, 2008).

Few SWFs publish regular and timely information on their assets, liabilities and investment strategies, for example. In that context a whole set of motives, some quite alarming,

have been ascribed to them including not only long-term investments focused on yield or on stabilising the effects of resource volatility but also attempts to promote their government's economic and political agenda abroad, business espionage and national security issues. Some of the funds are old and experienced and can make adjustments in response to demands for changes in governance and disclosure. Others are relatively new and caught up in a web of pressures with outcomes still unclear.

The new non-commodity SWF, the China Investment Corporation (CIC) is worth an additional comment given how investment from China has loomed so large in recent concerns. Heretofore, China had invested foreign exchange reserves surplus to its needs very largely in US government debt. The intent with the CIC apparently is to earn a higher return on a broader set of investments. Of the initial portfolio of \$200 billion, \$3 billion was invested in non-voting shares of the Blackstone Group and \$5 billion in Morgan Stanley. Two-thirds of the capital was used to restructure two state-owned banks, raising questions about how commercially driven and independent of government the CIC will be (Markheim, 2008). The fact that the CIC's board has representatives from all parts of the bureaucracy means that differences in their interests and views will complicate CIC's stated objective of increasing returns as well as raise difficulties in meeting some host-country demands on governance.

It is well to keep in mind that CIC is only one part of China's public investment abroad. Some observers believe that the Chinese government has made a decision to diversify the management of its assets abroad to include the CIC, state banks, and perhaps even large state firms. Its move into investments which give it more direct influence than basic foreign exchange-related debt could lead to further controversy. On top of all this it will take considerable skill to increase returns if the RMB keeps rising (Setser, 2008, 12, 28–9).

3 EFFECTS OF DIFFERENT TYPES OF FDI

In the last two or three decades we seem to have moved to a more positive view of the economic effects of inward FDI and a recognition that while policy capability may be reduced in some ways, in a more open economy it may be enhanced in other respects. The more favourable view on economic effects comes from a recognition of how FDI may contribute to the important goal of improving productivity.¹¹ However, much depends on whether complementary public productivity policies for firms and individuals alike are present.

First, FDI can transfer the various kinds of knowledge in the parent and other affiliates to the subsidiary. Even where this is not the case, the host country can still benefit from lower prices or increased product variety in ways which may not be possible through imports. Knowledge is transferred in many other ways but tacit knowledge and that in more complex technologies is much harder to do so through imports and some cooperative modes. Second, productivity growth is also increased where new knowledge develops in the host country because of FDI. This may be in R&D and other forms of knowledge improvement in the subsidiary both to borrow and adapt from the parent and sometimes to innovate more fully. The MNE faces a dilemma here in that there are gains to keeping some R&D centralised, for example to preserve links to other R&D units, and there

can be gains to some decentralisation, for example to form alliances with and capture spillovers from local R&D-intensive firms (Feinberg, 2000; Feinberg and Gupta, 2004). What we know is that R&D decentralises slowly from the United States and Japan, but much more quickly from other important home countries and, more generally, for newer R&D facilities (Eaton et al., 1994, 91–9; UN, 2005; Institute for Competitiveness 2008, 29–32). The outcome for the host country depends on a number of factors including a national innovation system which is friendly to innovation and particularly firms which are doing at least enough knowledge creation to be able to capture and adapt that from rivals, whether domestic or foreign.¹² Third, productivity may be stimulated by FDI when knowledge spills over to domestically owned firms and agents of production, for example, because innovations are imitated by suppliers and competitors, or because the benefits of labour and management training spill out to other firms. Competition is one key to such spillovers, investment in knowledge building and absorption by local firms is another. There may be other gains such as tax revenue where output increases and the revenue is not passed back to the firms in subsidies.

There are costs in income of various kinds paid abroad. A country's capacity to make and implement policy in its interest can be limited in some ways by greater openness to trade and FDI but it may be increased in other ways if the benefits from FDI increase the choices available to it and a country's governments are prepared to exercise leadership. It is worth noting, for example, that the 1945–75 period saw greater Canadian trade and investment integration with the United States, its dominant trade and investment partner, than has occurred in the subsequent 30 years which includes two major trade and FDI treaties with that country. Yet Canada's policies on such matters as social security and labour laws as well as a number of critical international issues have developed very differently from those in the United States. It is true that some studies have pointed to small economic gains or even overall losses from FDI (for example, Aitken and Harrison, 1999). Some of the cases in point tend to be in developing countries where institutions such as adequate tax systems do not exist to capture gains or the gains are dissipated by restrictive or inappropriate government policies, corruption and other characteristics which emasculate local firms as well. An all too familiar case is one where a high degree of trade protection and regulation of firms in small markets leads to a highly inefficient structure of industry whether in MNEs or domestic firms. There is a separate issue, often important in natural resource developments in particular, of how rents are divided between firm and state where the rents grow rapidly and unexpectedly and existing policy instruments cannot influence their distribution. As noted below, moreover, concern with anti-competitive effects from cross-border M&As has been a factor in the spread of M&A review in recent years.

There are newer issues regarding MNEs in more recent years such as the argument that some further international controls need to be placed on them to encourage respect for labour standards, human rights, and environmental controls. These are difficult issues to deal with for they apply to domestic firms as well as MNEs and because many governments are reluctant to cede powers over such matters to international organisations or non-elected groups. No doubt much more policy will be developed on such issues whatever happens in the World Trade Organization (WTO) and in other international organisations. For the moment it can be noted that most governments have liberalised policies towards MNEs and reduced restrictions on FDI while retaining powers for

review in selected sectors and introducing or strengthening review of M&As in particular. It is in this context that a strong new wave of international M&As until mid-2007 has raised some important newer issues in state–firm relationships. It bears noting that governments have always tended to favour greenfield over M&A investments, perhaps not always logically. The concerns about the latter carry more weight in the context of renewed questions about national security, particularly with regard to sovereign wealth funds.

Effects of Cross-border M&As

The effects of M&As should be related in part to the reasons for them. Seth et al. (2000) noted that synergy gains, where the value of the two firms combined exceeds the sum of each, was the most frequent outcome for foreign acquisition of US firms. Where cost reduction is the driving force, however, the spillover aspects may not be as strong as when acquiring valuable R&D facilities if those facilities are integrated and expanded in the context of the international firm. Other motives and outcomes are possible such as maximising the management's utility which may reduce shareholder value, while management errors can occur in overvaluing the target (ibid.).

Cross-border M&As differ from domestic M&As in several respects which increase risk. There is an extensive literature on exchange rate risk and on political and societal risk, the last two meaning either public policy discrimination against foreign-owned firms or differential and often cost-increasing country experience (for example, more regulation or corruption) compared with the home base. There is also the problem of integrating at least part of the operations and procedures for firms with different corporate cultures, a problem which can be very costly as evident from the Daimler–Chrysler merger (*The Economist*, 29 July 2000, 67–8). The due diligence, negotiation and expected integration issues make valuation of the acquiree more difficult than in domestic mergers, given these risks (Bodnar et al., 2003; Shimizu et al., 2004).

The most general view in the literature is that there have been widespread benefits from the wave of restructuring which has gone on for decades in response to trade and investment liberalisation, privatisation, financial innovation and other factors noted earlier. Governments have learned to work with MNEs using subsidies and other devices for steering effects and reducing foreign investment review as such while still not quite comfortable with cross-border M&As as noted partly by the spread of merger review. A minority of cross-border M&As are not value enhancing overall, for reasons already noted. Whether this more favourable view survives the financial excesses revealed by the recent collapse in credit markets, including those in the M&A boom, remains to be seen.

On a related note there is some data on M&As for Canada in the 1970s, suggesting that foreign- and domestic-owned firms promoted different types of productivity changes (Baldwin and Caves, 1991). Where foreign ownership was high there were few gains in productivity in natural resources, labour-intensive sectors or scale-based sectors: the gains were concentrated in product-differentiated and science-based industries. The highest domestically owned group had relatively more gains in resource- and scale-based industries. A paper by Baldwin and Gu (2005) found that foreign-controlled plants were more productive and more R&D intensive than domestically controlled plants, but there

was not much difference between them when the latter's parent had an international orientation. Bertrand and Zitouna (2008) use French manufacturing data for the 1990s to show that efficiency gains are stronger for cross-border than for domestic acquisitions but this is true only for extra-EU operations.

Earlier it was noted that Neary (2007) pointed to cost asymmetries with low-cost firms acquiring and closing high-cost firms abroad, and thereby increasing specialisation and trade along the lines of comparative advantage. Maksimovic et al. 2008 show that there is a great deal of restructuring after an acquisition, with acquirers selling 27 per cent and closing 19 per cent of acquired plants within three years. The results again tend to reflect comparative advantage in that the plants which are sold are likely to be in the acquirer's peripheral divisions unless the acquirer shows skill in these divisions. The authors note that these results are at variance with non-economic motives for M&As.

Much of the literature on the effects of trade liberalisation points to an adjustment process where resources are reallocated by the reduction or closure of low productivity establishments and the expansion of more productive ones. Breinlich (2008) notes that M&As present another option, namely to locate buyers for part or all of an operation. He confirms that the Canada–US Free Trade Agreement of 1989 significantly increased the number of domestic Canadian M&A transactions which were related to tariff cuts. However, there was little effect on domestic M&A activity in the much larger US market. There were substantial changes in cross-border M&As but the link to tariff reductions was not as clear. Resource transfers to more-productive firms through domestic M&As were quantitatively important compared with exit and contraction.

A main potential social cost of M&As are the anti-competitive effects. Where barriers to entry exist and sunk costs are high, small numbers of producers can lead to collusion and welfare costs. It is difficult to predict in detail what happens here since it depends on the feasible types of collusion. Oligopoly without collusion allows more specificity depending on the model of competition used and other assumptions. It should be noted that cross-border M&A may set off a chain of events which appear to be anti-competitive in that the surviving firms have more market power. However, one would have to consider any gains brought by the merger through any price reductions where costs fell, or a wider range and higher quality of product, or new management and other techniques. The number of national merger review mechanisms expanded significantly in the 1990s along with the wave of M&As. The corresponding spread of pre-merger review was particularly effective in limiting and regulating M&As (Evenett, 2003, 10, 19, 34). A study in this Handbook (Buiges and Meiklejohn, Vol. II, ch. 3), shows that liberalisation in the EU after 1993 spurred both overall M&As and cross-border deals in the network industries – telecommunications, postal services, air and rail travel and electricity and gas. The actual integration which resulted depended heavily on whether the regulatory authorities could ascertain and avoid possible anti-competitive effects of M&As.

One critical point is that a target firm and perhaps the acquiring firm as well may look very different if value creation is the goal and if it is successfully carried out.¹³ In other words, the subsidiary's competitive position and performance may improve over time depending on the parent firm's objectives including diversification, a more reliable supply, a more timely and effective penetration of a market than exports would allow and more generally a higher return on its value creation capabilities. In the process the subsidiary may go through a large or small amount of reorganisation depending on how

well it was operating and how far it complements the other operations of the new owners. Japanese investment in the US film-making industry, for example, was unlikely to lead to major changes in those parts where the Japanese had no experience and no comparable facilities.

Two further issues are the possible effects on different stakeholders and on the target firm's new role as part of an MNE. One of the strongest findings in the domestic literature is that M&As benefit significantly the shareholders in target firms but those in acquiring firms gain little and could lose (Andradé et al., 2001). In cross-border acquisitions by contrast, as noted above in Shimizu et al. (2004), most studies show that shareholders in both target and acquiring firms gain. Morck and Yeung (1992) show that firms with information-based assets were the ones which experienced significant stock price increases when announcing foreign acquisitions. Swenson (1993) also found a foreign premium in that target shareholders benefited more if their firm was the object of a foreign rather than domestic takeover. As with domestic takeovers the shareholders in the target can lose from some cross-border M&As (Seth et al., 2000). Also, some cross-border M&As like their domestic counterparts are partial or outright failures over time.

Some studies, especially with a financial emphasis, give the impression that shareholder wealth effects are all you need to know about the welfare effects. There are theories of the corporation which support such an approach. All that needs to be emphasised in this case is that there is a significant host-country gain when the target shareholders are paid a premium over the market. Whether it is the maximum gain possible is another matter: it will be higher for such reasons as a competing bid and whether the board and managers negotiate effectively. Moreover, the financial, managerial and other resources released by an M&A may go on to exploit other opportunities to the host's benefit. But there are often also layoffs of some less mobile types of worker and hiring of other types, changes in supplier and customer relations and effects on taxes paid to the host government, all of which can substantially affect any net gains or losses to the host. Pointing to net shareholder and overall productivity gains does not deal with income and employment distribution effects explicit in the restructuring of firms.

Studies of the effects on other stakeholders are not as plentiful as one would wish. It seems clear that there will often be job losses from cross-border M&As, at least in the short run, given that most such M&As are horizontal, hence seeking synergy gains. These job losses may be part of the process of locating some types of production to lower-cost centres abroad, a process in which both domestic and foreign MNEs are involved. It is very difficult to assess the longer-term employment effects of cross-border M&A since one would have to assess what would have happened to employment if the firm had not been acquired. If the domestic firm was experiencing slower growth or even decline, for example, acquisition by another firm could (not would) reverse this process. We return to this issue in considering private equity acquisitions below.

Effects of Private Equity and Hedge Funds

Private equity (PE) firms attempt to capture value in a number of ways such as buying undervalued assets, tax benefits in any reorganisation, increasing debt and selling off part of the asset. The focus here will be on three types of effect, financial and real returns and employment effects, neglecting, for example, any net tax effects. It will be recalled that

the time horizon is shorter than for FDI, typically much shorter for hedge funds than LBOs. A large-scale study of PE investments noted that only 12 per cent exited in under two years (the ‘quick flips’), 42 per cent in under five years, and 58 per cent in over five years. Almost 40 per cent of LBOs were in that organisational form even 10 years after the initial buyouts (World Economic Forum, 2008, viii).

The first point is that changes in governance are an almost inevitable result of a PE acquisition. Some have argued that a key objective is to take the firm out of the need for quarterly reports and other public pressure in order to allow a fundamental restructuring and pay the enlarged debt costs. Hence a private company or something similar to it will be found in this phase and a reformed governance structure could result afterwards depending partly on the type of exit strategy involved (OECD, 2007; Wruck, 2008).

Second, nine studies published in 1996–2006 show significant financial returns to buyouts, in particular using various measures of these across various countries (Wright et al., 2008, pp. 4–12 and Table 6.1). Some studies have raised doubts about the size of financial returns, concluding that they are lower on average after fees than those in the S&P 500 (Kaplan and Shoar, 2005, Phalippou, 2009). Phalippou argues that PE funds continue to attract investors in good part because the information available to them is difficult to interpret, a problem which also affects mutual funds and hedge funds. Kaplan and Strömberg (2009) also find that while average returns net of fees are less than those for the S&P 500 the private equity funds add value since they outperform the S&P gross of fees. While there is a problem here for the average fund investor, they point to evidence on mainly positive operating performance after buyout. Kaplan and Strömberg also caution that such evidence before the latest boom may not be a good guide to returns over time from transactions completed in the later stages of the boom. They also point to a strong boom and bust cycle in private equity. A negative finding appears in Leslie and Oyer (2008) based on a comparison of companies owned by PE investors and similar public companies. Despite strong management incentives and higher debt in the former, they find little evidence of better profitability or operating efficiency. For both financial returns and real returns (below) there are significant problems of measurement as well as comparability of studies in terms of coverage, timing and other factors.

Lichtenberg and Siegel (1990) was the first study to show how productivity was affected by LBOs and management buyouts in the United States. They found substantial increases in total factor productivity after the buyouts and also that employment and compensation declined for white-collar workers but not for blue-collar ones. Wright et al. (2008, pp. 12–18 and Table 6.2) review a number of studies on productivity and broader measures of performance, emphasising measurement problems but concluding that the effects are generally positive. For example, Amess (2002, 2003) and Harris et al. (2005) show positive productivity effects from LBOs/MBOs (management buyouts) in the UK.

The effects of PE on employment and work practices have been matters of contention, notably in European countries where there has been a relatively high degree of job security and unionisation. Davis et al. (2008) provide a literature review then a very detailed test of employment effects in PE transactions in the United States from 1980 to 2005. They use US census data on firms and establishments for this purpose and construct a control group not subject to PE transactions. The following are the results

Table 6.1 *Cross-border M&As valued at over \$1 billion, 1987–2008^a*

| Year | Number of deals | Percentage of total | Value (\$ billion) | Percentage of total |
|-------------------|-----------------|---------------------|--------------------|---------------------|
| 1987 | 19 | 1.6 | 39.1 | 40.1 |
| 1988 | 24 | 1.3 | 53.2 | 38.7 |
| 1989 | 31 | 1.1 | 68.2 | 40.8 |
| 1990 | 48 | 1.4 | 83.7 | 41.7 |
| 1991 | 13 | 0.3 | 31.5 | 27.0 |
| 1992 | 12 | 0.3 | 23.8 | 21.0 |
| 1993 | 18 | 0.5 | 37.7 | 30.5 |
| 1994 | 36 | 0.8 | 72.6 | 42.5 |
| 1995 | 44 | 0.8 | 97.1 | 41.9 |
| 1996 | 48 | 0.8 | 100.2 | 37.9 |
| 1997 | 73 | 1.1 | 146.2 | 39.4 |
| 1998 | 111 | 1.4 | 408.8 | 59.0 |
| 1999 | 137 | 1.5 | 578.4 | 64.0 |
| 2000 | 207 | 2.1 | 999.0 | 74.0 |
| 2001 | 137 | 1.7 | 451.0 | 61.7 |
| 2002 | 105 | 1.6 | 265.7 | 55.0 |
| 2003 | 78 | 1.2 | 184.2 | 44.8 |
| 2004 | 111 | 1.5 | 291.3 | 51.5 |
| 2005 | 182 | 2.1 | 569.4 | 61.3 |
| 2006 | 215 | 2.4 | 711.2 | 63.6 |
| 2007 | 300 | 3.0 | 1,161.0 | 70.9 |
| Q1 | 54 | 2.1 | 153.7 | 53.7 |
| Q2 | 98 | 3.7 | 359.4 | 76.1 |
| Q3 | 73 | 2.9 | 251.3 | 67.1 |
| Q4 | 75 | 3.1 | 396.9 | 78.7 |
| 2008 ^a | 137 | 3.1 | 439.4 | 70.7 |
| Q1 | 77 | 3.3 | 259.7 | 73.8 |
| Q2 | 60 | 2.9 | 179.7 | 66.6 |

Note: ^a First half only.

Sources: UNCTAD, cross-border M&A database. UNCTAD (2008, 6).

at the establishment level: employment growth in the controls is greater than that in the targets both before and after the PE transaction; the post-transaction differences in employment growth are largely due to greater job destruction in the target group, a difference concentrated outside manufacturing; and the larger job losses in the target group after PE transactions are partly offset by greater greenfield job gains in this group afterwards. At the firm level it is clear that PE targets are involved in more acquisitions and more divestitures than the controls. The authors also note that what one makes of the welfare outcomes depends on at least two other factors: first, what types of job are being destroyed and created; second, issues such as workplace benefits, practices and compensation for layoffs.

Some further information on this is available in Bruining et al. (2004). Data from the UK and the Netherlands showed that MBOs yielded higher levels of employment,

Table 6.2 Cross-border M&As by PE firms and hedge funds, 1987–2008^a (number of deals and value)

| Year | Number of deals | | Value | |
|-------------------|-----------------|--------------------|------------|--------------------|
| | Number | Share in total (%) | \$ billion | Share in total (%) |
| 1987 | 158 | 13.5 | 13.4 | 13.7 |
| 1988 | 203 | 10.8 | 12.6 | 9.2 |
| 1989 | 292 | 10.7 | 26.2 | 15.7 |
| 1990 | 531 | 15.8 | 41.0 | 20.5 |
| 1991 | 648 | 16.6 | 28.1 | 24.0 |
| 1992 | 652 | 17.5 | 34.9 | 30.9 |
| 1993 | 707 | 17.8 | 45.3 | 36.7 |
| 1994 | 720 | 15.8 | 35.5 | 20.8 |
| 1995 | 722 | 13.1 | 33.6 | 14.5 |
| 1996 | 715 | 12.2 | 44.0 | 16.6 |
| 1997 | 782 | 11.6 | 55.4 | 14.9 |
| 1998 | 906 | 11.3 | 77.9 | 11.2 |
| 1999 | 1,147 | 12.7 | 86.9 | 9.6 |
| 2000 | 1,208 | 12.0 | 91.6 | 6.8 |
| 2001 | 1,125 | 13.9 | 87.8 | 12.0 |
| 2002 | 1,126 | 17.2 | 84.7 | 17.5 |
| 2003 | 1,296 | 19.6 | 109.9 | 26.7 |
| 2004 | 1,613 | 22.2 | 173.7 | 30.7 |
| 2005 | 1,707 | 19.9 | 211.0 | 22.7 |
| 2006 | 1,649 | 18.2 | 282.6 | 25.3 |
| 2007 | 1,813 | 17.9 | 461.0 | 28.2 |
| Q1 | 441 | 17.1 | 75.1 | 26.2 |
| Q2 | 520 | 19.7 | 181.8 | 38.5 |
| Q3 | 417 | 16.6 | 115.4 | 30.8 |
| Q4 | 435 | 18.0 | 88.8 | 17.6 |
| 2008 ^a | 715 | 16.4 | 193.7 | 31.2 |
| Q1 | 338 | 16.8 | 131.5 | 37.4 |
| Q2 | 327 | 15.9 | 62.2 | 23.1 |

Note: ^a first half only. Private equity firms and hedge funds refer to acquirers whose industry is classified under 'investors not elsewhere classified'. This classification is based on that used by the Thomson Finance database on M&As.

Sources: UNCTAD cross-border M&As database. UNCTAD (2008, 6).

employee empowerment and wages. The effects were stronger in the former country. Davis et al. compared a large number of US PE transactions from 1980 to 2000 with employment outcomes at firms without such transactions, standardising also for various variables. They found that the former post-buyout involved greater job creation at new establishments as well as greater job loss at existing establishments with little difference between the two groups in net job growth, but there was 'creative destruction' in the labour market because of PE transactions. Amess and Wright (2007) found that employment grew in MBOs in the UK but fell in management buy-ins after a buyout. Harris et

al. (2005) also found that plants which were involved in an MBO in the UK had a large fall in employment.

Finally, it is well to differentiate the types of investment group. Some researchers believe that hedge funds (except perhaps for the small number of 'activist' hedge funds) are unlikely to take longer positions or have the capabilities to restructure firms. Nevertheless, the review by Stulz (2007) concluded that an investor in the hedge fund index would have done twice as well as the S&P 500 provided that the measure is per unit of volatility, for the former had been much less volatile as measured by the standard deviation. Moreover, a review of various studies concluded that picking a hedge fund randomly should yield a positive (but statistically insignificant) alpha after fees, and that being able to pick a good hedge fund should be very rewarding (*ibid.*, 183–7).¹⁴

Stulz goes on to note several regulatory risks for the economy. One is investor protection: about 10 per cent of hedge funds die annually. There can also be risks to financial institutions through credit transactions with hedge funds given an especially sharp drop in illiquid asset values. There can be liquidity risks if many funds attempt to sell assets at the same time. And there is somewhat contradictory evidence on how far such funds create or add to volatility in market crises.

Effects of Sovereign Wealth Funds

As noted above, there are a variety of motives for SWFs in addition to seeking returns higher than those given by foreign exchange reserves. Some of these motives are economic; it is the alleged non-economic objectives which have elicited concern in some quarters, as noted in the next section.

At one level what has been happening should be of benefit to investors and recipients since net saving countries are investing in net dissaving countries, with the former trying to achieve a higher return than otherwise possible. The IMF and others have pointed out that SWFs have had a stabilising influence on international finance at a time of great volatility. From November 2007 on, global banks reported losses of \$193 billion. About \$41 billion of the \$105 billion new capital found for financial institutions in difficulty came from SWFs. The IMF notes the SWFs can help absorb short-term shocks since they typically have long-term investment horizons and limited needs in terms of liquidity. Perhaps this is one reason why affected countries such as the United States have largely welcomed such financial investments, as distinct from those in several other sectors (Johnson, 2007; IMF, 2008a).

Some of the SWFs aim for significant ownership stakes, thereby moving from relatively passive portfolio investors to something closer to direct investors. The distinction between these two types of investment becomes blurred here as it does with hedge funds, even activist, which usually have relatively short investment horizons. Even private equity funds, which typically exit a buyout in 10–12 years, differ in this respect from FDI where firms usually enter a market with the intention of staying, barring major unforeseen economic or policy problems or opportunities. One other difference to FDI is that SWFs are less likely to transfer technology since many are not in the business of producing it themselves. However, some of them have accumulated management experience in certain lines which should yield specialised transferable knowledge as well as permitting scale and scope economies.

Shapiro and Globerman (2007, 37–9) note that state-owned enterprises (SOEs) often have governance problems, such as political interference in favour of other objectives, which will reduce efficiency. The problems involved in efficiency terms may affect the parent only. If they affect the operation of the investment abroad, the host-country stakeholders can suffer from management problems such as lack of transparency where contracts are in dispute. Moreover, positive local spillovers may be less than in the case of private sector FDI and local competitors can be damaged from subsidies which are well hidden.

It is the secrecy about many aspects of SWFs that is a root cause of the suspicions about their effects, especially the negative ones. It is also, as many observers have noted, the source of what could become a protectionist backlash against them even though the evidence on the more negative effects is very limited. The irony is that the foreign governments involved already hold huge amounts of short-term securities of the developed countries which could be used to exert economic and political pressure by threats to securities and currency markets. They do not need to buy shares in particular firms to assert such pressure (Rodrik, 2007; Maidment, 2008). One area where a more reasoned important case is possible in the post-9/11 world is security, a topic discussed below.

4 RECENT CONCERNS: HEADQUARTER EFFECTS, NATIONAL SECURITY, AND SECTORAL OR FIRM PROTECTION

These issues are not new, the first and third reflecting some of the earlier emphasis on closed sectors and support for national champions while the second became prominent in both world wars. They warrant separate treatment because of debate during the M&A wave of the 2000s and some related policy impact. To gain some specificity in these large topics, the emphasis in this section will be on Canada for headquarter effects, the United States for security issues, and Europe and other countries in support for particular firms subject to a cross-border M&A.

Headquarter Effects

A major recent criticism of foreign acquisitions has been that they decrease the number, size or scope of the target countries' headquarters. With that, the demand for the services of senior management and of a number of professions and services linked to the existence of such headquarters could decrease or shift abroad, as will the contributions such people make to their communities. These changes are popularly known as 'hollowing out', a term used earlier with regard to surges in imports. This concern was apparent in many countries in the 2000s cross-border merger wave, leading to new or renewed restrictions on foreign acquisitions of some large firms in sectors considered to be sensitive. The focus here will be on the experience of one country which has had considerable though fluctuating experience with foreign control of industrial assets. Such control in Canadian manufacturing, for example, fell from a high of about 60 per cent in 1970 to 40 per cent in the late 1980s, only to rise again to 52 per cent 15 years later. Several points arise when looking at the issue in a comprehensive way.¹⁵

First, it is clear that head offices have a significant positive effect on their city regions involving significant demands for high-value jobs and various business services. This is examined in detail for Canada in a recent paper (Institute for Competitiveness and Prosperity, 2008). The same source finds that Canadian-owned head offices are not very different in terms of their regional effects from those owned by foreign firms.

Second, a report by Statistics Canada noted that, far from declining, the number of head office jobs in Canada grew by 11 per cent and the number of head offices by 4 per cent from 1999 to 2005. Foreign-owned firms accounted for two-thirds of new head-office jobs and all of the gains in the number of head offices. About one-fifth of the head offices in firms which were taken over were closed, but this was offset by new head offices in Canada by foreign firms new to Canada (Baldwin and Brown, 2005).

These conclusions have been criticised because the data include divisional and regional offices which have some head-office-like functions but not those of the corporate centre. Some types of decision such as some senior appointments and major project approval and financing will typically require the approval of the parent.

While this qualification is correct, account must also be taken of how the organisation and decision making in many MNEs has changed with economic liberalisation, deregulation and communication changes which have spread regionalism and globalisation. Many firms have moved from simple integration strategies where subsidiaries replicated the parent's products and processes to more complex network types of organisations reflecting both specialisation of product and service functions among affiliates and decentralisation of some of the related headquarter functions. The corporate centre approves or creates and coordinates such a structure but operates much of it as if it was a cooperative network rather than simply a hierarchy of unquestioned decisions. One result is that a wider range of subsidiary locational advantage can be drawn on by the MNE. Another is that it is easier to attract and keep the critical management and related technical personnel than if their roles are overly restricted (UNCTAD, 1998, 108–15). Andersson et al. (2007) model the headquarters–subsidiary relation as a perpetual bargaining process with the latter's influence reflecting the degree to which it provides technology within the MNE.

Third, there is no comprehensive study of the effects on Canadian headquarter operations of *outward* FDI which would offset to some degree the negative headquarter effects claimed for inward FDI. Rugman and Li (2008) have argued that the emphasis on head-office jobs in Canada is misplaced. They could not perceive performance differences in a set of larger Canadian and foreign-owned firms located in the North American Free Trade Agreement (NAFTA). From a performance perspective they argue for the need to locate head-office functions wherever corporate strategy and firm processes demand. On a related point, Baldwin and Gu (2005) showed that foreign-controlled firms in manufacturing accounted for two-thirds of Canada's growth in labour productivity from 1980 to 1999, but where Canadian-owned firms had plants abroad they were just as productive as the foreign-owned plants in Canada. These points are underlined and put into a broader context by the Institute for Competitiveness and Prosperity (2008, 2009) which found that the number of Canadian-owned and headquartered companies in the top five globally in their particular lines had grown from 33 in 1985 to 77 in 2008, despite major M&A waves. For firms with global sales of at least \$1 billion the figures were 15 in 1985 and 39 in 2003.

Fourth, not even acquisitions by a company in the same or related field should be considered as 'for ever' although that is a frequent concern where losses of larger or well-known firms are involved. Statscan has long published annual data on both foreign takeovers and repatriations, and the US Survey of Current Business publishes such data from time to time. Put briefly, there is a significant market for both purchases and sales of firms internationally, inward and outward, which should be factored into any attempt to measure and analyse international M&As. In a recent six-year period, outward flows from Canada reflecting the repatriation of foreign-owned firms amounted to 26 per cent of the value of gross inward FDI flows, while the equivalent percentage on outward FDI was also 26 per cent.

Fifth, a related issue is the use of the proceeds from sale of firms. Something must happen to the increased liquidity available to the sellers, for example, paying off debts or buying domestic or foreign bonds, thereby affecting the exchange rate and returns on bonds and stocks, hence investments in real assets. Or the former owners, managers and technical staff could enter, buy or create other firms in existing or newer sectors, thereby offsetting part of any job or other losses from the M&A. No comprehensive study on this has been located to date.

Complicating all of this is the increasing participation of PE groups, both foreign and Canadian, so that it is difficult at times to know if voting control has changed and for how long. This is so, for example, where Canadian equity firms are brought in by the foreign firm in order to keep the legal sectoral limit for Canadian ownership while the Canadian target is restructured, and even beyond that period. It can also occur where the foreign equity firm decides to keep both the Canadian head office and at least part of the management intact, perhaps as part of an eventual exit strategy.

A final issue which has attracted attention in Canada is the differential rules between countries. It has been argued that more defences are possible abroad against hostile takeovers and a longer time exists to activate them than is true in Canada (Government of Canada, 2008a: 76–8; SECOR, 2008, 25–36). There are defences in Canada, of course. It is estimated that 30–40 per cent of Toronto Stock Exchange listed firms are sheltered by controlling shareholders, dual class shares or special voting rights. For the others a 'poison pill' defence is limited to 45 to 75 days and Toronto Stock Exchange rules require shareholder approval of any shareholder rights plan within six months. The position of the Canadian security authorities is essentially that shareholders, not directors, make the final decision where a hostile takeover occurs. However, the courts have also ruled recently that directors must treat stakeholders equitably and fairly and not just maximise shareholder returns (*Globe and Mail*, 20 December 2008).

In the EU there were so many national laws protecting firms from hostile bids that the Union approved a directive in 2003 attempting to harmonise laws in this area with a view to favouring shareholder power. It has proved difficult to move strongly in this direction. Driven by the Delaware courts the United States moved sharply towards a model where the board is presumed to be acting in the interests of the shareholders except where there is evidence of fraud or self-dealing. Managers and boards can use a wide range of protective devices very effectively as a consequence and have not hesitated to do so; in other words, they can 'just say no' to an offer even when shareholders disagree. This has raised some important issues, notably whether the courts have allowed the agents of the owners the unilateral power to change control rights (Jensen, 1988, 31–6). Recent court

judgments and shareholder activism have moved the situation back somewhat to where shareholder approval is necessary but still well short of the situation in Canada.

Much depends on which model one favours in principle, that in Ontario, for example, where final shareholder decisions are given more emphasis or one where the emphasis is on the board and management's power to prevent or greatly slow a hostile takeover. These are fundamentally different views of capitalism with quite different economic effects in terms of the role played by M&As in disciplining boards and management, among other issues. The other point to note here is that Canada already has a high degree of protection against takeovers given the relative prevalence of family-controlled shareholder wealth. Morck et al. (2005) have documented the decline of freestanding widely-held firms in Canada after the mid-twentieth century until late in the century and a matching increase in family-controlled pyramidal firms, trends which could reflect the development of more restrictive policies towards FDI and rent seeking by domestic elites.

National Security

In terms of national security, most states have long retained the power to prevent international M&As usually under national laws and sometimes under international investment treaties (UNCTAD, 2006, 225–6). The exception to national treatment which is involved here may be explicit in a reference to national security or even to listing particular military sectors and infrastructure, or it may come under some broader heading such as public order. One well-known national security exemption, that of the United States, has recently been broadened to take into account the more complicated security issues since September 2001. Some important developments have also occurred with regard to cross-border investments by SOEs prompted partly by investments in sectors considered sensitive by host governments.

National security concerns have long been a factor in US policy towards inward FDI as witnessed by sectoral restrictions from both world wars and earlier (Safarian, 1993, ch. 2). The Trading with the Enemy Act, for example, goes back to 1917. The Committee on Foreign Investment in the United States (CFIUS) was established in 1974 as a research and advisory group but also to ensure consultation in advance when foreign governments undertook major investments in the United States, this latter provision having in mind the Organization of the Petroleum Exporting Countries (OPEC) countries in particular. The decisive steps were the Exon–Florio provision of the 1988 Trade Act and the Byrd amendment of 1991. The former required notification to CFIUS and possible review where merger or acquisition of US firms involved inter-state commerce and could damage national security. The latter required heightened security review where foreign government-owned or government-controlled firms were involved. Actual or intended acquisitions by Japanese firms played an important role in leading to these changes in the role of CFIUS. The possible export of sensitive technologies soon became a major issue in CFIUS cases, although it can occur in many ways other than new foreign M&As and can be (and was) monitored in other ways. Importantly, the issues raised by the terrorist attacks of September 11, 2001 quickly became dominant. CFIUS has scrutinised foreign investment more thoroughly and imposed stricter conditions and security agreements since then.

Graham and Marchick (2006, 56–8) note that the small number of CFIUS notifications which led to investigation, formal withdrawal or presidential decision can be misleading given the unknown number of decisions to withdraw after informal consultation or before investigation and given the conditions imposed.¹⁶ More important, there has been huge pressure from Congress to expand the role of CFIUS in response to such proposed acquisitions as that in energy by a Chinese state-controlled agency and the *Dubai Ports World* case. The Foreign Investment and National Security Act of 2007 has broadened the scope and clarified and standardised the procedures of CFIUS to take account of these new concerns, while leaving room for case-by-case interpretation. CFIUS must decide whether or not a transaction involves a threat to national security. That concept now includes: the effects of the transaction on critical infrastructure, major energy assets, critical technologies, long-term projections of the US needs for critical resources and material, the foreign acquirer's record regarding non-proliferation and control regimes (regarding valuable technology and information), and US counter-terrorism activities. For each investigation one member of CFIUS is the lead agency. It can negotiate, monitor and enforce provisions which modify any risk to US national security. A national security investigation is now mandatory if a foreign government or agency acting for it is involved. Once an investigation is made and the president notified, there is written notice to Congress. The regulations proposed by the Treasury to implement these powers were issued on 21 April 2008 for comment over a 45-day period before being put into effect on 22 December of that year. Clearly a new phase has begun which will be more time-consuming and far-reaching for some types of firms.

Investments by SWFs and SOEs in some sectors considered to be sensitive had attracted private and public criticism both on potential security grounds and in some cases, because of lack of information on objectives, accountability, operations and other issues. Some host governments had already proceeded to act in these respects while others have introduced restrictions on FDI which also appear to have an economic motivation. Marchick and Slaughter (2008) note that in 2007–08, 11 larger economies accounting for 40 per cent of inward FDI in 2006 have introduced or were considering laws to restrict or monitor some types of FDI. They consider SOEs and SWFs to be only one of the reasons, the others being a variety of new source countries such as the BRIC group (Brazil, Russia, India, China) and also the strong economic position of a number of the new hosts. The strengthening of CFIUS in the US has already been noted. Canada issued guidelines for assessing net benefits for proposals by SOEs (Government of Canada, 2008b). Subsequently, in March 2009 the government amended the Investment Canada Act to allow the agency to reject a foreign takeover on grounds of national security. This phrase was not defined but a spokesman for the industry minister noted that it will include economic and energy security (*Globe and Mail*, 26 March 2009, B4). Marchick and Slaughter outline a CFIUS-like review introduced in Russia for 43 industries considered strategic and a ban on SOEs acquiring control in areas of national security. China has not only added a national security test to its foreign investment review but also issued a broad set of 'critical economic sectors' where foreign participation is restricted and strong state control will be kept. Germany has produced legislation to allow review of certain FDI especially where SOEs are involved. France now requires prior authorisation for FDI in 11 sectors, largely defence related, where the national interest is involved. Both France and Greece drew warnings from the EU that such restrictions might be

inconsistent with EU Treaty rules on movement of capital and the right of establishment. South Korea and Japan have also moved to limit FDI on grounds of national security.

The move to such restrictions and especially the vague nature of some of the concerns and of the review criteria have led to attempts towards a more coordinated response. The major initiative in this respect was by the IMF. Twenty-six member countries with SWFs acted as an International Working Group on SWFs and succeeded in 'drafting a framework of generally accepted principles and practices that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis' (IMF, 2008b, 4). This is a voluntary set of 24 principles which have been or are being implemented while recognising that some SWFs are relatively new and will need more time. The principles cover a wide range of topics in governance, accountability, investment and risk management, and the legal framework. A permanent body will be set up in 2009 to represent SWFs. It is not yet clear whether this initiative and similar efforts by the OECD to clarify the issues will yield new general rules on cross-border M&As or special ones for SOEs and SWFs. Many government leaders still appear sensitive to investments by foreign governments, particularly those from China, the Middle East and Russia.

Sectoral and Key Firm Protection

More broadly, there are two basic policy approaches to the set of issues involving cross-border M&As. One is to rely on removing fiscal and regulatory obstacles to the development of efficient world-scale domestically controlled firms. Some of these obstacles lie abroad, hence involve the cooperation of foreign governments. One sometimes hears that such firms cannot be as large as those with home bases in larger markets but the experience of international firms from countries such as the Netherlands, Switzerland, Finland and Sweden suggests otherwise. It is true that policies supporting specific firms or sectors have played a role in these countries, but such policies are not unknown elsewhere. Besides, if the firms are among the best in their specialised lines and thus enjoy a significant share of regional or even global markets they can be dynamically competitive even if not as large as more broadly based firms. Also, as noted earlier, financial innovations now allow even smaller firms to enter the M&A game.

A second policy approach targets larger cross-border M&As. This can be done by blocking or limiting such M&As in sectors considered sensitive or key in some sense. It can also be done by a general review of FDI of larger firms to block those deemed negative in terms of net benefits or/and to impose and monitor conditions, including the retention of headquarter activity. Many other policies can be developed such as to handicap cross-border M&As by tax, subsidy or regulatory means. This second approach which targets particular firms merges into industrial targeting, strategic trade policy and the development of national champions. The substantial literature on successful strategic trade policy and similar approaches points to some strong conclusions, for example, that governments require great skill and will in directing such support only to firms within certain industry structures, where the support is not spread over other firms in the industry and beyond, where the international nature of the industry does not lead to the gains being captured abroad, where retaliation does not occur, and where strong regional governments do not undo what the central government is attempting.¹⁷

One should add that most countries utilise both broad-based and targeted policies in coping with inward FDI and especially M&A waves, the mix depending on the period of history and the country's preferred policy approach (Safarian, 1993). In the period from 1960 to 1980, all industrial countries had a variety of sectors wholly or partially closed to FDI, apart from publicly owned sectors, as well as a varying set of other regulatory and fiscal restrictions. Some also had relatively well-defined formal review of inward FDI, while others achieved the same result in less formal ways. In the next two decades the existing sectoral limitations were loosened or abolished, privatisation (often with a golden share allowing a state veto of cross-border control) opened publicly owned sectors to FDI, and review of inward FDI was abandoned or significantly reduced. At the same time many states without merger review for competition policy purposes introduced such review including that for cross-border purposes. The spread at the same time of pre-merger review was particularly effective in limiting and regulating M&As (Evenett, 2003, 10, 19, 34).

While every country continues to maintain some traditional closed sectors, relatively few have attempted to use a national champions approach in coping with cross-border M&As in recent years. Perhaps France, Spain and Italy might be thought of as exceptions in the EU in the sense that each has tended to encourage mergers of domestic firms in order to ward off a cross-border merger. Many of these individual cases have been in utilities, however, often previously public in many countries, and must withstand scrutiny by the EU to protect competition (Institute for Competitiveness, 2008, 64–6). Otherwise, it is existing or intended policies on national security which have been used to ward off undesired cross-border M&As, or policies encouraging innovation and competitiveness by all firms but sometimes targeted to domestic firms or sectors.

5 THE CREDIT CRISIS AND THE M&A WAVE

In June 2007, Martin Wolf observed that national élites practising managerial capitalism were giving way to global financial capitalism. He added that how much of the change was short term and how much structural would become known only when the long period of monetary ease ended. The credit crisis which struck a few months later in the United States centred on a host of problems which had developed initially in the sub-prime mortgage market accompanied by weaknesses in the 'shadow banking system' of largely unregulated investment banks and non-banks, private equity and hedge funds and new securities.¹⁸ In the background one should take into account huge international deficits in the United States and Britain, among others, reflecting large fiscal deficits in such countries and cheap credit at home and abroad; a vast expansion in absolute and relative terms of the role of the finance sector; and a rapid increase in income inequality due in part to the increased wealth of higher-income individuals in finance including the private equity and hedge fund sectors.

The credit crisis involved the unwinding of the large amounts of leverage involved as loans were called, the accompanying forced merger or bankruptcy of some major financial institutions, and instability in financial markets through 2008 and early 2009. All of this was complicated further as a real recession got under way in the United States, as the financial and real shocks spread abroad, and as financial weaknesses appeared

in the EU and elsewhere.¹⁹ It is too early for conclusive analysis of the effects of these developments, much less the ultimate public policy changes which will result. Some brief and tentative comments can be offered on how these developments have affected or may affect the major topics discussed above.

Falling and volatile stock prices, lowered profit expectations, the sub-prime mortgage crises, all put pressures on banks and shadow-banks and led to a general reluctance to lend amid such uncertainty. All of this put huge pressures on those who had paid high prices only recently to effect M&A, among others. For six of the leading acquisitions globally in 2006 and 2007, four-fifths of the net debt reflected funds spent on acquisitions (*The Economist*, 13 December 2008, 73). Managing this debt in a period of financial and real pressures will be a major ongoing challenge. Many of the very large deals made a year or two earlier suddenly looked far too optimistic, some fell apart, many negotiations for M&As simply ceased. The US \$39 billion debt which Rio Tinto had on its balance sheets, US \$38 billion of which reflected the acquisition of Alcan, came to exceed Rio Tinto's own market capitalisation, and forced it to agree to a major investment by Aluminum Corporation of China. The \$35 billion acquisition of BCE (formerly Bell Canada) led by a Canadian pension plan joined by domestic and foreign banks was undone when the company's auditors declared that the company would be technically insolvent if the transaction was completed. The large investment in and breakup of the Dutch bank ABN Amro in 2007 by (among others) Royal Bank of Scotland, Spain's Santander and Fortis, the largest banking and insurance group in the Benelux countries, soon led to a series of problems in which Royal Bank and Fortis found themselves under state control. In the United States the major investment banks became bankrupt, were merged or were rescued by government or took on commercial banking business to create a broader depositor base. A particularly difficult problem arose with American International Group which had to be rescued by the US government because of the systemic effects arising from insurance of poor-quality financial assets – the chairman of the Federal Reserve referred to it angrily as 'a hedge fund basically that was attached to a large and stable insurance company' (*Globe and Mail*, 4 March 2009, B9). Thus, M&A activity was sharply reduced, many of the firms found themselves facing difficult debt financing obligations, many banks and other investors found themselves with sharply reduced asset values. For banks, private equity and hedge funds as well as their customers the need to undo the leveraged loans was often the most painful part of the process.

This ongoing process has raised a number of questions apart from specific policy issues noted below. One which comes directly from the preceding analysis is the weights given to the different determinants of M&As. Future tests of this period may well place more emphasis on non-wealth-maximisation motives, such as management desire for growth or size *per se* and the partly related miscalculation of an appropriate asset price. As *The Economist* put it, 'Most big firms paid silly prices for companies using sillier levels of debt' (29 November 2008, 74). There is also likely to be a strengthening of the debate over how much deregulation and internationalisation, and the benefits they can bring, is compatible with the need for some degree of financial stability. Nevertheless, most of the determinants of M&As are unchanged. Many firms will respond to the difficulties they face by focusing further on their core business and selling off the rest, for example, and the large privatisations in the non-bank sectors are unlikely to be rapidly reversed.

The private equity (or LBO) industry's problems will continue for some years

since they generally bought firms by using loans repayable in five years. Kaplan and Strömberg (2009) conclude that the returns to such investments are likely to be disappointing since some transactions in the boom reflected the ease of debt financing more than operating or governance improvements. Standard and Poor's index for leveraged loans, which are senior loans from banks for LBOs, had fallen to 70 cents on the dollar late in October 2008 from 88 one month before (*Globe and Mail*, 23 October 2008, B11). However, despite current difficulties with high leveraging, sharply reduced financing and distressed M&As, Guo et al. (2008) conclude from a sample of LBOs, completed from 1990 to 2006 that these were more conservatively priced and had less leverage than LBOs from the 1980s.

The hedge fund industry has had a worse experience to date in many ways. Its heavy reliance on short-term loans from investment banks and other lenders who can call the loans or exit the fund has made it very vulnerable to the financial turmoil, although many funds have limited the permitted withdrawals. It also faces problems with the basic model – that the funds would produce consistent absolute returns no matter what the situation was in the markets. This performance 'would justify' the large fees collected. Through net withdrawals, exit and merger the industry has shrunk substantially. The basic model needs to be reconsidered, particularly towards longer-term expectation of returns and of commitments by investors. It also appears from the size of the losses that not enough advantage was taken of the ability to hedge through short-selling, although for a period late in 2008 they were unable to do so because of a ban on short-selling of many stocks. There are larger consequences from all of this. Despite the problems, the funds had played a significant capital allocation role for some types of borrowers as well as supplying market liquidity and arbitrage functions (*Financial Times*, 12 January 2009, 6).

We have already commented on the main global initiative for sovereign wealth funds in the form of a voluntary charter on performance as well as various additional restrictions on FDI for security reasons, partly aimed at some SWFs. The financial crisis has somewhat softened the opposition to such investments, but their losses in banking in particular have also cooled their interest in these particular investments.

The collapse of credit in general and of the shadow banking system in particular is causing very large problems for industry and government. The scale of the adjustment can be realised by noting that shadow banking had provided close to 45 per cent of all credit financing in Canada. Its collapse will force a return to stricter credit requirements as prevailed earlier in traditional banking and investments. It will probably also involve more reliance on domestic financing as both financial institutions and other firms focus more on core business and home markets.²⁰ The financing of international M&As will be much more difficult given the caution in financing generally, although this will be offset to some degree in firms and sectors with little debt and strong cash positions which can exploit the asset sales required by those in the reverse situation. The results for FDI are also going to depend on country and sector. For example, more public ownership and control in finance and selected other sectors, perhaps for a limited period, will also limit control by private firms including FDI. In general one would expect a net decline in FDI by industrial countries whose firms are engaged in winding down international M&As and focusing on core and home business, while firms in countries with strong foreign exchange or cash positions and some FDI experience should have opportunities to expand FDI.

As for public policy, many issues under discussion will clearly impact on international M&As even though their focus is often broader than that. There are calls for regulating, or better enforcing regulations, for the shadow banking system including limits on leveraging. Early in 2009, for example, the US government proposed legislation to regulate bank holding companies and unregulated subsidiaries as well as other parts of the shadow banking system, powers which are now largely limited to commercial banks. There is discussion of measures to define and delimit product risk more fully. There are suggestions about creating more universal standards (Dobson, 2008) including an IMF proposal for national governments to provide comparable and enhanced regulatory oversight for larger hedge funds, PE and other financial firms whose failure could pose major global risk. Whatever develops, the likely effect will be to reduce somewhat the volatility of both domestic and international M&As as seen in recent waves. Whether it will go further to reduce the volume of international M&As depends on whether the changes involved are aimed more at them than at the domestic variety, and in particular on the nature of any long-term restrictions on international capital movements. There is already evidence of differentiation between foreign and domestic actors in the emergency plans for the financial crises in a number of industrial countries, differences which appear to go against guarantees against discrimination involving foreign investors (van Aaken and Kurtz, 2009).

SUMMARY

During and after the 1990s international M&As far outstripped greenfield foreign direct investment as a form of foreign market entry or expansion. This chapter considers the nature and importance of such M&As, mainly by traditional business firms but also those by private equity firms, hedge funds, and state-owned enterprises and funds. The main part of the chapter considers the literature on motives for each type of investment and the economic impact, including integration effects, both at the macro and micro levels. It goes on to consider specific policy concerns, namely headquarter effects (Canada), national security (United States) and sectoral or firm protection (European Union). The chapter concludes with a brief section on the credit crisis and the recent M&A wave.

Keywords

International mergers and acquisitions, sovereign wealth funds, national policies.

JEL Classification

F21, F23, G34, L5.

NOTES

1. An earlier version of this chapter with more emphasis on Canada's experience was presented on 16 May 2008 in Ottawa to Industry Canada in its Distinguished Speakers in Economics Series. See A.E. Safarian,

'Newer types of international direct investors: motives, effects, policies', available at: <http://www.rotman.utoronto.ca/facbios/viewFac.asp?facultyID=safari>. I have benefited from comments by various persons at the Industry Canada presentation and discussion with my colleagues Laurence Booth and Eric Kirzner. The usual disclaimer applies.

2. Internalisation and ownership-specific advantages remain at the core of such an approach but a number of extensions and qualifications have been introduced as the literature has developed (Buckley, 1988; Buckley and Casson, 1998). The literature is summarised in Safarian and Hejazi (2001, ch.3); note particularly the seminal contributions of John Dunning (1993, 1995).
3. Thompson's *Global Mergers and Acquisitions*, for M&As exceeding one million US dollars, beginning in 1979. The authors focus on 1986–2005 and deals of \$10 million or more. A somewhat less detailed database is published by UNCTAD in its annual *World Investment Reports*.
4. For reviews of the literature, see UNCTAD (2000, part 2); Chapman (2003); Evenett (2003); Shimizu et al. (2004); and Blonigen (2005).
5. McGraw (2008) notes that Alfred D. Chandler, Jr. was very critical of US business developments in the 1960s partly because of conglomerates and the M&As driven by large rewards to managers and investment bankers rather than real economies.
6. Modelling oligopoly with general equilibrium has proven to be a challenge. Neary avoids the problems involved by using a continuum of oligopolistic factors with economy-wide factor markets. Thus firms have market power in their sectors but cannot affect factor prices or national income (p. 2).
7. Some sources give figures well below these. For extensive analysis of private equity and 'activist' hedge funds, see OECD (2007), World Economic Forum (2008), Kaplan and Strömberg (2009) and Phalippou (2009).
8. Aizerman and Kendall (2008) distinguish private equity deals in buyouts, buy-ins and other activities involving functioning firms from venture capital at an early stage of investment. While such venture capital deals are a relatively small part of the total, they have played a large part in innovation. Venture capital deals were mainly a US phenomenon until the 1990s, but spread internationally especially after 2000.
9. See Phalippou (2009) for a detailed discussion of private equity compensation contracts and the returns to the funds.
10. State-owned enterprises, while encompassing SWFs, go well beyond them to reflect a wide range of motives such as compensating for market failure, aiding economic development, limiting foreign ownership, and many other goals. This chapter will not consider the international effects of SOEs. They are analysed thoroughly in Shapiro and Gliberman (2007).
11. See Safarian and Hejazi (2001, ch. 2) and Stehrer and Woerz (2009) for a fuller discussion, measures and some qualifications. Jovanović (this Handbook, Vol. I, ch. 11) presents a wide range of views of globalisation seen principally as a process driven by multinational corporations with important policy effects. For a thorough review of the welfare effects of firms' responses to globalisation as reflected in recent trade models, see Behrens et al. (this Handbook, Vol. II, ch. 8). When multinationals are introduced the authors find lower productivity gains from multilateral trade liberalisation than when only exporters are active. They also find, however, that multilateral FDI liberalisation raises productivity gains by a larger amount than does multilateral trade liberalisation.
12. See Nelson (1993) for a comparative analysis of national innovation systems.
13. Note the use of the term 'value creation', as distinct from 'capture' (Haspeslagh and Jemison, 1991). The latter will be dealt with later though it also applies here in some senses.
14. The return net of fee is partly the return from exposure to broad markets, or beta risk, with the remainder representing alpha. More generally, Lo (2008) notes that active investment management involves alpha, beta, tracking error and the Sharpe and information ratios. These are static characteristics of marginal distributions at a point in time. He proposes a measure of the value of active management which includes dynamic contributions as well.
15. For a review of issues and policy on hollowing out, see Institute for Competitiveness and Prosperity (2009, especially pp. 56–61).
16. In 1988–2005 there were 1,593 notifications with CFIUS, or about 10 per cent of all reported FDI. This resulted in only 25 investigations, 13 notices which were withdrawn, and one actual rejection in the 12 presidential decisions.
17. There is very extensive literature on all of this which can be easily accessed under terms such as strategic trade and investment policy or national champions. In countries with less-developed market, tax and other institutions, there can at times be a stronger case, particularly in capturing natural resource rents, provided they have or can acquire the required policy skills.
18. While problems with mortgages were central, it is important to add that banks passed on risk by pooling loans of various kinds, sliced them into tranches, and sold them to investors with different risk capability. The collapse of these portfolios and related leveraging amplified the crisis (Brunnermeier, 2009).

19. Apart from sources cited below, the events leading to the crisis are discussed in Felton and Reinhart (2008); Hull (2008); Booth (2008), *The Economist* (October 11, 2008), 'What Went Wrong' (22 March 2008); and 'Greed and Fear' (24 January 2009) and Brunnermeier (2009). The failure of the hedge fund Long Term Capital Management, involving many of the same players, was a startling precedent to the general financial collapse (Lowenstein, 2001).
20. See the comments by Professor Ian Lee as outlined in the *Globe and Mail*, 15 April 2009, B9.

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Section 2

Labour migration

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7 Migration, ethnicity and economic integration

*Amelie F. Constant and Klaus F. Zimmermann**

The purely economic man is indeed close to being a social moron. Economic theory has been much preoccupied with this rational fool decked in the glory of his one all-purpose preference ordering. To make room for the different concepts related to his behavior we need a more elaborate structure.
(Amartya Sen, 1977, p. 336)

1 INTRODUCTION

Migration as ‘factor mobility’ and migrants as a ‘factor of production’ are of paramount importance in economics. The different skills and education that are embodied in immigrants, while valuable in the production process, may not be appreciated by all members of the host country. In addition, migrants as human beings are an integral part of the human development in a society and country. Yet, resistance to the spreading of diversity and concerns about the growth of the immigrant population from several groups make immigrants feel unwanted. The imbroglia of migration touches and raises problems in the social, economic, political, cultural and religious spheres, not only domestically but also internationally. Migration scholars, pundits and policy makers alike are deeply divided over the responsibilities and the best concepts for analysing or solving the issue of international migration.

The issue of how immigrants fare in the host country especially in terms of their labour force participation and remuneration occupies the minds of social scientists, politicians and the general public. Using natives as the gold standard, immigrants have always been compared to them. If immigrants fare as well as the natives, then they are economically assimilated. Of equal importance is the question of whether immigrants socialise and mingle with the natives, if they feel comfortable in their new country or they create parallel societies, and if natives and immigrants have the right attitudes about each other. Terms such as cultural or social assimilation, acculturation, integration and so on, have been used to capture and describe these concerns.

This chapter is structured as follows. The focus is on economic migrants, that is, individuals who leave their country and loved ones to go abroad to a new country in search of a job and other economic opportunities to better their lives and their children’s lives. Section 2 reviews the economic status quo theories on immigrant performance dealing with what is sometimes called ‘economic assimilation’: how do migrants become like natives in economic terms? Section 3 then presents recent advances in economics about the formation of ethnic identity and its role in the economic and social spheres: how are identities shaped and how are they related to economic success? Section 4 discusses the importance of attitudes and perceptions in the integration process: are they affected by economic conditions and do they influence economic performance? Section 5 concludes.

2 THE ECONOMICS OF ASSIMILATION

Starting with the pioneering work of Chiswick (1978) on the assimilation of immigrant men in the US, the overarching research that has preoccupied the literature deals with the economic performance of immigrants relative to that of comparable natives. The literature is set within the Mincerian human capital framework,¹ whereby immigration is perceived as an investment in human capital (Sjaastad, 1962), the young and the better educated are more likely to migrate, and migration yields higher returns to the more able and the more highly motivated; assimilation is a labour market phenomenon.² The conjecture is that immigrants are rational individuals who want to maximise their lifetime utility; they are a self-selected group of individuals characterised by a strong incentive to invest in human capital, and who have a ferocious drive to succeed in the host country's labour market. They have set preferences that they reveal in a rational ranking order. Migrants with higher levels of human capital will command higher wages in the labour market since investment in human capital raises productivity.

Chiswick's (1978) hypothesis as well as that of many others who followed his lead was that the earnings of newly arrived immigrants are significantly lower than those of natives with the same observed socio-economic characteristics, mainly because immigrants' skills are not always or perfectly transferable to the host country's labour market. However, as immigrants gain information about the functioning of the new labour market and invest in human capital in the new country, their earnings increase rapidly and can reach and even exceed the earnings of natives. When the catching up of earnings occurs, then economic assimilation is achieved, meaning that immigrants and natives are indistinguishable in terms of their earnings.

Therefore, assimilation is the rate at which the earnings of immigrants converge to the earnings of comparable natives due to their accumulation of human capital in the host country's labour market with additional years of residence (Chiswick, 1978).³ Assimilation is attributed to the positive selection of immigrants, that is, their innate ability, their high motivation for labour market success, and their higher incentives to invest in the host country's specific human capital. Indeed, this generation of studies⁴ found that immigrant earnings reach parity with native earnings within 10 years of residence, and after 10 years, immigrant earnings exceed the earnings of natives.

The main drawback of these studies was that the models were estimated based on a single cross-section of data that includes individuals of all ages. A new generation of studies was stimulated by Borjas's (1985)⁵ seminal paper which questioned the empirical validity of the above results from cross-section data on the grounds that the assimilation effects were confounded with cohort effects. That is, based on one cross-section, the estimated earnings of immigrants of different ages are overstated if the quality of more recent immigrant cohorts is lower than that of older cohorts. Borjas (1985) attempted to estimate the selection bias which may contaminate cross-sectional comparisons and to establish a relationship between cohort quality and immigrant self-selection.

Borjas's contribution was to track the progress of a particular cohort over successive waves of cross-sectional data and to identify cohort and assimilation effects by creating synthetic cohorts.⁶ Borjas and subsequent research suggested that immigrants in the US were not necessarily positively selected. As a result, and despite the fact that earnings increase with additional years of residence, immigrants may not assimilate as rapidly as

the traditional view hypothesised, and the earnings of more recent cohorts may never reach parity with the earnings of natives.

Meanwhile, other researchers demonstrated that the age of immigrants at the time of arrival in the new host country plays a decisive role in their earnings assimilation. Indeed, the profiles of those migrating as children resemble the profiles of the native-born rather than the profiles of immigrants migrating later in life (Kossoudji, 1989; Friedberg, 1992). Assimilation for these immigrants is, therefore, not a labour market phenomenon but the result of acculturation.⁷

Most studies agreed that the assimilation process is very slow and the earnings of male immigrants will probably never reach parity with natives. The declining skills of more recent immigrant cohorts (within cohort differences), as well as the changing national origin composition of immigrants (across cohort differences), retard assimilation (Chiswick, 1986; Borjas, 1992). Some disparity in these findings was documented in other studies. LaLonde and Topel's (1991, 1992) different results are due, however, to the different variables chosen and to the different comparison group – whether intra-ethnic or ethnic-native. They found that the assimilation of immigrants is mainly inter-generational and that estimates are sensitive to the choice of the base group. Yet, all these studies are subject to additional biases related to the comparability of the samples gathered across decennial censuses.

Extra selection biases exist because of the highly selective return migration, which was overlooked in the estimation of earnings assimilation. In theory, return migration is non-random and depends on the immigrants' performance in the host country's labour market, whether successful or failing. Assimilation estimates based on the pool of stayers will be under- or overestimated depending on whether or not the successful immigrants emigrate. Empirical studies can answer these questions. Some find higher return migration by skilled immigrants (Jasso and Rosenzweig, 1988), others by less successful immigrants (Borjas, 1989), and others find little evidence of any selectivity with respect to schooling (Chiswick, 1986).

Constant and Massey (2003) in their 14-year longitudinal study on immigrants in Germany find that emigrants are negatively selected with respect to occupational prestige and to stable full-time employment, but there is no selectivity with respect to human capital or gender. Return migration is strongly determined by the range and nature of social attachments to Germany and origin countries. It is also bimodal, that is, it is very high during the first five years after arrival, and grows higher again towards retirement. Selective emigration, however, does not appear to distort cross-sectional estimates of earnings assimilation in any relevant way.⁸

Finally, selection with respect to labour force participation, occupational attainment, labour market success by female immigrants, and the performance of the children of immigrants are some aspects neglected by the literature. A study on the relative earnings of native- and foreign-born women in turn-of-the-century America revealed that immigrant women 'fared somewhat better relative to the native-born than men did', earning from 102.2 to 113.2 per cent of the native women's wages (Fraundorf, 1978, p. 213). Long (1980), among the first to study female immigrants, found that the earnings of recent female immigrants were higher than those of natives, but this advantage declined over time. In particular, married female immigrants increased their labour force participation initially to subsidise their husbands' investments in human capital, but, later,

as their husbands' earnings increased, they switched to non-market activities and their earnings declined.

In contrast, other studies on female immigrants found strong evidence of assimilation, which varied considerably across countries of origin (Field-Hendrey and Balkan, 1991). Studying life-cycle patterns of immigrant women's labour force participation in the US, Schoeni (1998) finds that the cross-sectional approach significantly overestimates assimilation. None the less, he finds that immigrant women's assimilation measured with cohort effects is still sizeable and occurs within 10 years of arrival. Japanese, Korean and Chinese women have the highest degree of assimilation in the labour market. Parallel research in Canada presented evidence that the initial earnings differential for Canadian immigrant women is likely to be permanent, and may be even worse for highly educated women (Beach and Worswick, 1993).

Many researchers try to explain the earnings disparity between immigrants and natives by adding more characteristics to the theoretical and empirical estimation. Others like Piore (1979) argue that labour market performance is not a function of the duration of residence in the host country, but a function of when an individual came. For example, immigrants who arrived in Germany during the prosperous years of the mid-1960s until the first economic recession of the early 1970s should fare better than more recent immigrants. Miller and Chiswick (2002) corroborate this by showing that the business cycle of the host country plays an important role in the assimilation process.

More refined studies on earnings assimilation control for additional characteristics of the host-country labour market, institutional variables, network effects and demographics in their quest to solve the earnings assimilation debate. Even after adding ethnicity and legal status, results show that earnings assimilation is a rather elusive realisation and varies widely by nationality; immigrants earn less than comparable natives when they work as employees. In some countries such as Germany and France, for example, earnings assimilation does not take place at all.

Nevertheless, immigrants who are self-employed not only exhibit higher earnings than comparable immigrants in the paid employment sector, but they earn substantially more than comparable natives (Borjas, 1986). A study in Germany shows that the earnings of self-employed Germans are not much different from the earnings of the self-employed immigrants. However, immigrants suffer a strong earnings penalty if they feel discriminated against, while they receive a premium if they are German educated (Constant and Zimmermann, 2006). New facets of immigrant performance are important and can offer key insights into an operative migration policy; for example, immigrant performance with regard to housing, wealth, education, even crime, as well as intergenerational assimilation.

3 THE ROLE OF ETHNIC IDENTITY IN ECONOMIC INTEGRATION

The Identity-based Theory of Utility Maximisation

Personal identity is what makes individuals unique and different from others, including the self-definition of one's self. How identity forms and manifests is a dynamic process

linked to social interactions. Norms, values and rules binding members of a social group are inherent in the formation of social identity. When conflicts arise, identities may result in suboptimal behaviour. Sociologists are well aware of these issues. Massey and Denton (1993) suggest that segregated neighbourhoods can create the structural conditions for some individuals to develop 'an oppositional culture that devalues work, schooling and marriage' and impedes success in the larger economy.

While identity has occupied a central role in other social sciences such as psychology, sociology, anthropology and so on, it has not been fully incorporated into economic theory and empirics. In his avant-garde piece about the rational egoistic man of Edgeworth, Sen (1977) talked about psychological issues that underlie choice and relate to consumer decisions and production activities. He introduced the concepts of sympathy and commitment as part of the utility-maximising function, arguing that commitment as part of behaviour can result in non-gains-maximising answers, even when answers are truthful. Economic theory should therefore accommodate commitment as part of behaviour. While commitment does not presuppose reasoning, it does not exclude it either. Over the last decade, economists started looking at the concept of identity as a determinant of labour market attachment, performance and earnings. This is along the strand of literature that places identity, behaviour and personality traits in the heart of labour markets and the performance of individuals. The quest is to explain schooling performance and economic labour market integration and unexplained wage differentials.

Some researchers have considered personality and behaviour traits as part of the individual human capital, which counts differentially for men and women and for different ethnic groups (Bowles et al., 2001). In another empirical work that tries to improve human capital models and gain a greater understanding of the behavioural determinants of occupational success, Groves (2005) finds that traits such as locus of control, aggression and withdrawal are all statistically significant factors in the wage determination models of white women.

Akerlof and Kranton (2000) offer a novel theoretical framework of the utility-maximisation function by incorporating an individual's self-identification as a powerful motivation for behaviour. They imply that if individuals achieve their 'ideal self' and are comfortable with their identity then their utility increases, otherwise their utility decreases. In this framework, it is then possible that even rational individuals choose non-optimal occupations because of identity considerations. For instance, a rational individual's decision may very well be influenced by other social considerations as this person chooses a social category or affiliation, or a group to belong to, or an occupation to self-identify with. As an example, suppose that someone identifies with and aspires to be part of the armed forces. If this person fails in his or her ambition, then his or her utility decreases. This in turn may affect the identity and behaviour of others around that individual, and so on and so forth. The choice of an individual to be a particular type of person then becomes a powerful economic decision with substantial changes in the conclusions in comparison with traditional economic analysis.

Bénabou and Tirole (2007) model a broad class of beliefs of individuals including their identity, which people value and invest in. They also study endogenously arising self-serving beliefs linked to pride, dignity or wishful thinking. Norms about 'fitting in' or not, differ across time and space (Akerlof and Kranton, 2005). Modelling identity and

work incentives, Akerlof and Kranton (2005) envisage corporate culture as the division of the workers into different groups, the prescribed behaviour for each group and the extent to which workers identify with the organisation or with the workgroup and adopt their respective goals. They argue that identity is an important supplement to monetary compensation and enterprises that inculcate in employees a sense of identity and attachment to an organisation are well functioning.

These emerging important contributions can very well explain labour market integration and wage differentials. Accordingly, while some individuals have the drive and human capital to integrate and succeed in the labour market, they may not reach their goal because of behavioural norms and unfulfilled or confused self-identity images.

In an empirical setting, Russo and van Hoof (2009) link identities, conflicting behavioural norms and job attributes. They find that because individuals can adhere to multiple identities, when they experience conflicting norms in the labour market, they tend to value and choose job characteristics that can reduce the degree of conflict (that is, favourable working hours and good relationships with colleagues and managers). An interesting gender split shows that while men usually resolve any conflict between career and leisure by favouring a career, for women the presence of role conflict is not associated with the importance of a career. While there is a large potential of these frameworks for the analysis of ethnic, racial and immigrant identity along with the quest for economic inequality explanations, they have not been further applied.

Ethnic, Racial and Cultural Identity

Ethnic identity is 'developed, displayed, manipulated, or ignored in accordance with the demands of a particular situation' (Royce quoted in Ruble, 1989, p. 401). It is whatever makes individuals the same or different in comparison to other ethnic groups. But, it may also encompass a network of strong beliefs, values and what people hold dear; it builds and shapes people's lives. Fearon and Laitin (2000) argue that ethnic identities are socially constructed, either by individual actions or by supra-individual discourses of ethnicity. Some studies develop economic theories of ethnic identity and explicitly explore their implications for economic behaviour. Kuran (1998) has created a theory of reputational cascades that explains the evolution of behavioural ethnic codes that individuals follow to preserve social acceptance. The speed of acting ethnic is chosen under the influences of social pressures that the individuals themselves create and sustain. It is fostered by interdependencies among individual incentives that crucially affect personal choices. This theory can explain why similar societies may show very different levels of ethnic activity.

Darity et al. (2006) provide a long-term theory of racial (or ethnic) identification formation. Their evolutionary game theory model may result in equilibrium where all persons follow an individualist identity strategy, another where all persons pursue a racialist (or ethnic) identity strategy, or a mixture of both. Consequently, race or ethnicity may be more or less significant for both market and non-market social interactions. A positive impact of racial identity on economic outcomes, that is, the productivity of social interactions, is the cornerstone of the theory. This also explains the persistence of racial or ethnic privileges in market economies.

In sum, if there is a dominant or majority group or culture and a subordinate or minority group or culture in a country, individuals in the minority group will either

identify with the majority (in the hope that they will be recognised and accepted by the majority) or they will develop what is called 'oppositional identities' and fight the majority culture because they know they will not be accepted by the majority anyway. Sociologists and anthropologists know this all too well. Ogbu (1999) argues that non-immigrant minorities in the US constructed an oppositional collective identity after white Americans forced them into minority status and mistreatment. He finds that a black speech community in Oakland, CA, face a dilemma in learning and using proper English because of their incompatible beliefs about standard English. However, since identity is multidimensional, science should allow for more than 'either with them or against them' identities.

It is also possible, as Anderson (1999) shows, that some residents of segregated communities develop the capacity of 'code switching' that enables them to go back and forth between the predominantly white mainstream culture and the culture of their neighbourhoods in order to navigate neighbourhood perils. Levels of attachment to or detachment from, the dominant culture of the country of residence can therefore be extremely pertinent and crucial for policy design.

In the Battu et al. (2007) model – where non-whites identify with their social environment, their culture of origin, and where social networks can find them jobs – they find that individuals, who are otherwise identical, end up with totally different choices. Depending on how strong peer pressures are, non-whites choose to adopt 'oppositional' identities because some individuals may identify with the dominant culture and others may reject that culture, even if it implies adverse labour market outcomes. In another empirical study, Battu and Zenou (2009) investigate the relationship between ethnic identity and employment. They find that in the UK, individuals' identity choice is very much influenced by their social environment, that there is considerable heterogeneity in the non-white population in terms of preferences and that those non-whites who develop and manifest oppositional and extreme identities are penalised in the labour market, experiencing a 6 to 7 per cent lower probability of being in employment.

Mason (2004) establishes a stable identity formation among Mexican-Americans and other Hispanics. He shows that these ethnicities are able to increase their income substantially through acculturating into a non-Hispanic white racial identity. Bisin et al. (2006) find that, in line with their theoretical analysis, identity with and socialisation to an ethnic minority are more pronounced in mixed than in segregated neighbourhoods. The strength of identification with the majority culture regardless of strength of (ethnic) minority identity is important for labour market outcomes (Nekby and Rödin, 2007). Aguilera and Massey (2003) provide a better understanding of societal and economic behaviour.

Expanding on the concept of ethnic human capital, Chiswick (2009) shows that economic determinants of 'successful' and 'disadvantaged' group outcomes are sensitive to the relationship between ethnic and general human capital, especially with regard to externalities in the processes by which they are formed. Policies that welcome ethnic diversity within the larger society without encouraging separation would be desirable. A genuinely inclusive policy of multiculturalism would also be beneficial.

Note, however, that while there is a general understanding of flexible ethnic identity among many social scientists, there is still no consensus on all the elements that compose ethnic identity. In the aforementioned studies, some use a self-reported identification

question, others use religion and language, and so on. Reviewing the relevant literature outside economics, we find that among the suggested and widely used key elements of ethnic identity are the subjective expression of one's commitment to, sense of belonging to, or self-identification with the culture, values and beliefs of a specific ethnic group and social life (Masuda et al., 1970; Tzuriel and Klein, 1977; Makabe, 1979; Unger et al., 2002). Most frequently employed are cultural elements such as language, religion, media and food preferences, celebrated holidays and behaviour (Phinney, 1990, 1992; Unger et al., 2002; Laroche et al., 2005; Constant et al., forthcoming).

A Theory of Ethnic Identity

While ethnic identity exists even when migrants are in their home country,⁹ it surfaces and manifests when they arrive in a host country that is dominated by a different ethnicity, culture, language and so on. Typically, immigrants come from countries where they are part of the majority and become part of the minority in the host country.¹⁰ Ethnic identity is then like an attribute that an individual can have for some time, he or she can lose it and acquire a new one, or lose it and never take on or assume another one. While it is unique to the individual – in the sense that even people from the same country of origin can have different ethnic identities – ethnic identity can create feedback loops as individuals interact with other or the same ethnicities.

In contrast, ethnicity is what people are born with, is static as well as permanent and usually denotes segments of the host-country population with economic and social inequality between the dominant and minority groups, with political and social repercussions. As UNECE (2006, p. 100) put it, 'ethnicity is based on a shared understanding of the history and territorial origins (regional, national) of an ethnic group or community as well as on particular cultural characteristics: language and/or religion and/or specific customs and ways of life'. Ethnicity is thus more related to people's roots, their ancestry, the actual territory and physical boundaries of a country. Here the reference is the group, a shared sense of peoplehood and not the individual.

Ethnic identity, ethnicity and culture are very much related, but yet they designate different things. While the role of ethnicity or country of origin is documented to be a significant determinant of labour force participation and earnings as well as other socio-economic areas concerned with integration (that is, homeownership, citizenship, voting, entrepreneurship and so on), the role of culture and ethnic identity on economic outcomes is less widely accepted.

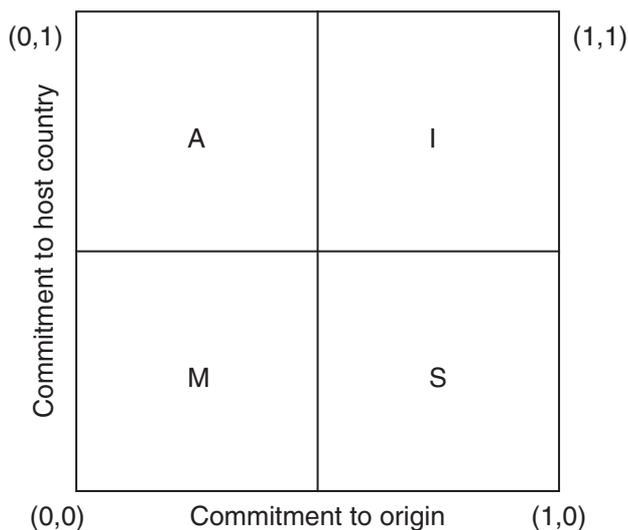
Recently, there has been a growing literature on the effects of culture on economic outcomes. Guiso et al. (2006) (using beliefs about trust) show a pervasive impact of culture in many economic choices. The value of cultural diversity is evidenced in US cities through its net positive effect on the productivity of natives (Ottaviano and Peri, 2006). Bellini et al. (2009) confirm that diversity is positively correlated with productivity in 12 of the EU15 European countries, and causation runs from the former to the latter. In Germany, the cultural diversity of people fosters the recognition, absorption and realisation of entrepreneurial opportunities and has a positive impact on new firm formation, even more than the diversity of firms (Audretsch et al., 2008). Zimmermann (2007a), Constant and Zimmermann (2009) and Zimmermann et al. (2009) have documented the rising interest of economists in the field of ethnicity and identity.

In 2006, Constant et al. (2009a) were the first to introduce the multidimensional concept of ethnic identity in economics, by borrowing literature from social psychology and other social sciences. Following the original work by Berry et al. (1989),¹¹ they developed a framework of ethnic identity and tested it empirically with German data. Specifically, they created a two-dimensional quantitative index – the ‘ethnosizer’ – that measures the degree of ethnic identity of immigrants. Ethnic identity is how individuals perceive themselves within an environment as they categorise and compare themselves with others of the same or a different ethnicity. It is the closeness or distance immigrants feel from their own ethnicity or from other ethnicities, as they try to fit into the host society; it can differ among migrants of the same origin, or be comparable among migrants of different ethnic backgrounds. In stark distinction to ethnicity, ethnic identity attempts to measure how people perceive *themselves* rather than their ancestors. The authors allow for the individuality, personality, distinctiveness and character of a person in an ethnic group to prevail, to differ from one person to another, and to alter and evolve in different directions. They define ethnic identity to be the balance between commitment to, affinity to, or self-identification with the culture, norms, and society of origin and commitment to or self-identification with the host culture and society.

Constant et al. (2009a) conjecture that an immigrant moves along a plane formed by two positive vectors normalised from 0 to 1, with 1 representing maximum commitment. The horizontal axis measures commitment to and self-identification with the country of origin, and the vertical axis commitment to and self-identification with the host country. The origin of the Cartesian coordinates (0,0) shows that an immigrant has no commitment to either the home or the host country. Point (1,0) exhibits maximum commitment to the culture of origin and no identification with the host country. Diametrically opposite is point (0,1) which indicates immigrants who achieve full adaptation to the new culture and norms while they deny their own heritage.

If commitments to the home and host countries are linearly dependent and mutually exclusive and they sum up to one, then immigrants move along the diagonal (1,0) to (0,1).¹² This is the case of the one-dimensional ‘ethnosizer’. That is, if immigrants retain their ethnic culture and norms, they must not identify with the host country, and vice versa if they adopt the persona of the host country, they must shed their ethnic and cultural identity related to the home country.

Confronted with both cultures, which combination of commitments do migrants choose to uphold? The two-dimensional ‘ethnosizer’ of Figure 7.1 answers this question and shows where exactly migrants are positioned in the positive quadrant. As illustrated in the figure, the ethnosizer contains four states or regimes of ethnic identity differentiated by the strength of cultural and social commitments. Quadrants A, I, M and S correspond to: *Assimilation* (A), a pronounced identification with the host culture and society, coupled with a firm conformity to norms, values and codes of conduct, and a weak identification with ancestry; *Integration* (I), an achieved amalgam of both dedication to and identification with the origin and commitment and conformity to the host society – this is the case of a perfect bi-cultural state; *Marginalisation* (M), a strong detachment from either the dominant culture or the culture of origin; and *Separation* (S), an exclusive commitment to the culture of origin even after years of emigration, paired with weak involvement in the host culture and country realities. Starting at point (1,0), a migrant can undergo a more complicated journey through the various states,



Source: Constant et al. (2009a).

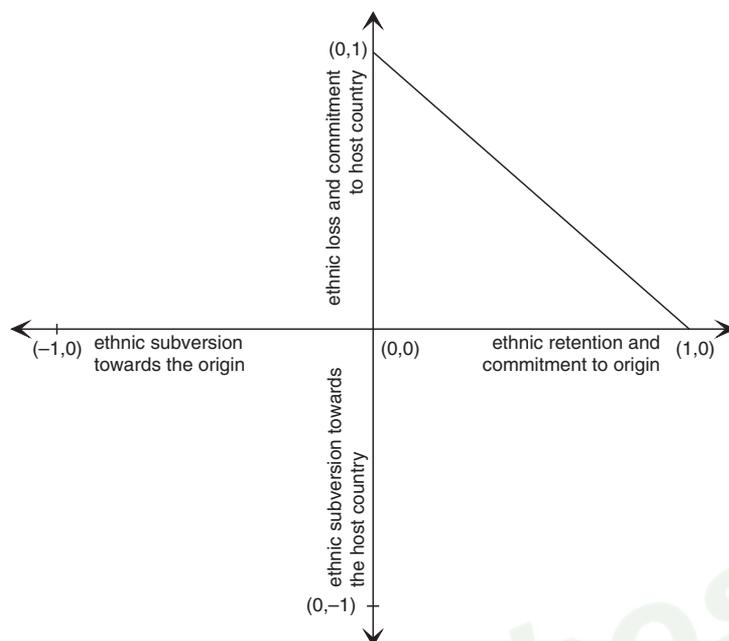
Figure 7.1 *The two-dimensional non-negative ethnosizer*

leaving separation towards integration, assimilation or marginalisation, or remaining separated.

Constant and Zimmermann (2008) augment the theoretical possibilities of the formation and manifestation of ethnic identity to include negative commitments. Assuming a plane formed by two axes representing commitment to the home and host countries, an immigrant has four quadrants to express his or her ethnic identity. Commitment to and self-identification with the country of origin is measured along the horizontal axis, and commitment to and self-identification with the host country along the vertical axis.

Figure 7.2 illustrates the theoretical model of a complete multidimensional ethnic identity of positive, fanatical and subversive ethnic identity. Point (0,0) represents the stance of immigrants who have lost all ethnic identity related to the country of origin. A movement to the right along the positive part of the horizontal axis (or in the north-east quadrant) indicates ethnic retention and increasing commitment to the country of origin. Moving beyond point (1,0), suggests that immigrants not only identify with the country of origin but they do so more fanatically by practising extreme views. Moving in the other direction along the negative part of the horizontal vector indicates immigrants who can turn against their own heritage and culture.

With respect to commitment to the host country, point (0,0) exhibits no identification with the host country either. Immigrants going north on the vertical axis to point (0,1) evince increasing identification with the host country. Moving beyond point (0,1) indicates the case of overzealous migrants, who over-identify with the host country. Going down south on the negative part of the vertical axis, shows dissatisfied and disgruntled immigrants with the host country who can develop a subversive self-identification towards it. Note that, when migrants move along the negative part of the vertical axis,



Source: Constant and Zimmermann (2008).

Figure 7.2 Complete illustration of ethnic identity: retention, relinquishment and subversion

they can be either in the south-east or the south-west quadrant. The south-east quadrant represents immigrants who retain the ethnic identity of the home country and oppose the host country. While being in the south-west quadrant is a valid theoretical possibility for individuals to turn against both countries, it is rather unlikely to happen in the real world (if we assume rational and mentally sound individuals).

In reality, individuals may exhibit strong association with, commitment to, and malcontent to either or both the culture of ancestry and the host culture. The two-dimensional model of the measurement of ethnic identity suggests that commitments to two different societies can coexist and influence each other in several ways. In other words, the level of dedication to the origin does not preclude the degree of the commitment to the host society. This assumption recognises that a migrant who strongly identifies with the culture and values of his or her ancestry may or may not have a strong involvement with the dominant culture. Similarly, a migrant with a strong affinity to the values and beliefs of the host country may or may not totally identify with the culture of ancestry. At the same time, migrants may also be completely detached from the home or host country. The two-dimensional ethnosizer of Constant et al. (2009a) allows for this case as well.

While they are theoretically possible, the negative parts of Figure 7.2 are impossible to examine empirically. As yet, no survey to our knowledge has examined any questions on negativity towards either the home or the host country culture.

'Ethnosing' migrants and economic integration

To empirically test the ethnic identity of immigrants, Constant et al. (2009a) developed the ethnosizer index. They define the verb 'ethnosize'¹³ to quantify how ethnic an individual is. Based on data from the German Socio-Economic Panel (GSOEP) they construct the four states or regimes of the two-dimensional ethnosizer by identifying pairs of questions that transmit information on personal allegiance and commitment to both the German culture and society and to the culture and society of origin. They choose five essential elements of cultural and societal commitment that compose the ethnic identity, as they are widely accepted in social psychology. These elements pertain to both the country of origin and the host country and give us a multidimensional view. They are: (i) language; (ii) visible cultural elements; (iii) ethnic self-identification; (iv) ethnic interactions with natives; and (v) future citizenship and locational plans. In some cases, individuals may be clearly classified with one concept, in other cases not at all. In most cases, people will fall into several different regimes at the same time.

For example, with respect to element (iii), immigrants who answered that they self-identify with Germany but not with the country of origin are considered assimilated. Immigrants who self-identify with both the country of origin and the host country are classified as integrated. Those with total identification with the country of origin and little or no identification with Germany are labelled separated, and those who cannot self-identify with either country are classified as marginalised. The same classification is applied with respect to the other four elements of ethnic identity. Providing equal weights to the five elements, each of the four measures or regimes of the ethnosizer can take a value between zero and five, and add up to five for each individual.

The idea of the index of ethnic identity is that it can be used to test the performance of immigrants in the host country's labour market and possibly explain unexplained differences and deficiencies. Potentially it can also be used to compare immigrants with natives and revisit the earnings assimilation literature.

Zimmermann et al (2008) find that human capital acquired in the host country does not affect the attachment and affinity to the receiving country. Instead, it is pre-migration characteristics that dominate ethnic self-identification. In particular, human capital acquired in the home country leads to lower identification with the host country for both men and women immigrants, while men have only a higher affiliation with the original ethnicity and culture. However, Aspachs-Bracons et al. (2008) have shown that a compulsory language policy implemented in Catalonia has an effect on identity.

Constant and Zimmermann (2008) argue that while ethnic identity should affect work participation and cultural activities like human capital formation does, the ethnic identity of those working should not be influenced by work intensity and education from the receiving country. Applying the ethnosizer on a sample of working men, they find that the ethnosizer mainly depends on pre-migration characteristics, suggesting that ethnic identity is predictable through characteristics measured at the time of entry in the host country. They also find that the ethnosizer is de facto independent of measured economic activity and significantly affects economic outcomes.

Zimmermann (2007b) deals with the role of ethnic identity in earnings. Adding the two-dimensional ethnosizer to standard Tobit regressions to examine the particular contribution of ethnic identity, he finds that ethnic identity matters significantly and that

the findings are very robust with respect to the concrete model specification. That is, the inclusion of the 'ethnosizer' does not change the parameter estimates of the standard variables in any relevant way. Nevertheless, the parameter estimates of ethnic identity have a strong impact on economic behaviour.

Constant and Zimmermann (2009) extend this framework to model the labour force participation and earnings of both men and women immigrants, because men and women may have a completely different understanding and expression of their ethnic identity.¹⁴ This is based on the idea that immigrants are mostly useful in the host country when they bring different talents and skills than those natives possess. If the resulting diversity reflects ethnic characteristics that are relatively scarce, the labour market functions smoothly. In the case of a homogeneous population, there is always the risk of lost creativity. 'Successful migration implies integration, assimilation, loyalty and good citizenship but also diversity and multiple identities' (Hieronymi, 2005, p. 132). There are costs and benefits associated with this cultural capital embodied in immigrants. When immigrants and natives complement each other, there can be a win-win situation; immigrants and natives can profit, and the economy and society can benefit from creativity, dynamism and greater prosperity.

Constant and Zimmermann (2009) find that the ethnic identity of immigrants is a strong determinant of their labour force participation. They also find interesting gender dynamics, whereby separated or marginalised men have a much lower probability of working when compared to immigrants who totally identify with natives and demonstrate a strong commitment to German society. However, being assimilated does not offer a particular advantage to the working probabilities of men compared to the identity state of being integrated. In contrast, women who identify with both cultures (are integrated) have a much higher probability of working than women who only identify with natives (are assimilated). Separated or marginalised women have lower chances of joining the labour force than those who are assimilated. Unexpectedly, the authors find that once immigrants start working, ethnic identity does not affect their earnings in a significant way. This is consistent with other studies on the effect of identity and personality on occupations and earnings. Therefore, the findings reported in Zimmermann (2007b) on earnings using Tobit regressions are driven by the decision to work.

Dealing with other forms of economic integration, Constant et al. (2009c) study the homeownership and wealth of immigrants. They find that immigrants with a stronger commitment to the host country are more likely to achieve homeownership for a given set of socio-economic and demographic characteristics, regardless of their level of attachment to their home country. Namely, assimilated and integrated immigrants move up to homeownership.

Other forms of immigrant integration can also offer valuable insights in their economic integration. For example, immigrants who integrate in the political arena by naturalising may follow different paths of economic integration in the host country. Naturalisation, in turn, may very well be influenced by ethnic identity. Zimmermann et al. (2009) study how ethnic identity can affect the probabilities of actual naturalisation, future naturalisation and refusal of naturalisation. They find that integration in German society has a stronger effect on naturalisation than ethnic origin and religion, and women immigrant household heads are more likely to want to acquire or to already have acquired German citizenship.

The risk proclivity of immigrants and individuals in general in a society is important to study as it affects many socio-economic facets, from gambling to obesity, to crime, to labour market performance. Bonin et al. (2006) explore the role of ethnic identity in the risk proclivity of immigrant and native Germans. Specifically, they use measures of immigrants' ethnic persistence and assimilation. They find that assimilation or adaptation to the attitudes of the majority population closes the immigrant–native gap in risk proclivity, while stronger commitment to the home country or ethnic persistence preserves it. As risk attitudes are behaviourally relevant, and vary by ethnic origin, these results could also help explain differences in the economic assimilation of immigrants.

Empirical Ethnic Identity Issues

This subsection provides two empirical examinations to support the usefulness of the ethnic identity approach. The first is: to what extent does the ethnosizer differ from the direct measure of ethnic self-identification¹⁵ provided by survey data? The self-identification question is subjective, and hence open to debate. People are asked, for example, how native or foreign do they feel and how much do they identify with one or the other country. The 'ethnosizer', however, uses another four elements besides the self-identification question: elements that are objective such as what people did or are actually doing. This can balance the judgement provided by the self-identification question. Table 7.1 uses data from the GSOEP optimised for the purpose of comparison of the 'ethnosizer' with the direct measure of ethnic self-identification. We observe 1,339 individual migrants and generate 6,695 observations that are cross-classified according to the four regimes (assimilation, integration, marginalisation and separation). The cells on the main diagonal of the contingency table contain the cases where self-classification coincides with the judgement of the ethnosizer. The agreement is, in general, small: 45.9 per cent for integration, 53.6 per cent for assimilation, 54.9 per cent for separation and 31.9 per cent for marginalisation (percentages from the column totals). From those who consider themselves to be marginalised, in 23.7 per cent of the cases we find evidence of integration. In 32.5 per cent of the cases for those who self-report integration, we find evidence of assimilation. Self-classified assimilation goes with 12.6 per cent cases of marginalisation, and self-reported separation coincides with 21 per cent of cases of integration. This provides support for the attempt to balance out the self-evaluation question through the ethnosizer.

The second example demonstrates the differences that the ethnic identity regimes have for economic performance. Here, we choose data from a new frontier survey, the German IZA Evaluation Dataset (Caliendo et al., 2009), which collects data on ethnic self-identity of immigrants and natives who are unemployed and who receive unemployment benefits. The assumption is that for immigrants the alternative to the home culture is German, and for the native Germans the alternative culture is international. Table 7.2 contains raw data on the net hourly reservation wages for natives and immigrants and the reservation wage ratio (reservation wage divided by the respective wage in the last job) for all four ethnic identity regimes. For immigrants, reservation wages are the highest if they are integrated, followed by those assimilated, marginalised and separated. Assimilated and integrated immigrants report reservation wages which are roughly 10 per cent higher than their previous hourly wages. However, separated and marginalised

Table 7.1 Direct measure of ethnic self-identification and the ethnosizer

| Ethnosizer: four regimes | Self-identification | | | | Total |
|-----------------------------|-------------------------------------|--------------------------------------|--|--|------------------------|
| | Integration | Assimilation | Separation | Marginalisation | |
| Assimilation | 143 <i>32.50</i> 2.14 | 488 <i>53.62</i> 7.29 | 435 <i>12.52</i> 6.50 | 378 <i>20.21</i> 5.65 | 1,444 21.58 |
| Integration | 202 <i>45.91</i> 3.02 | 219 <i>24.07</i> 3.27 | 729 <i>20.98</i> 10.89 | 444 <i>23.74</i> 6.63 | 1,594 23.81 |
| Marginalisation | 33 <i>7.50</i> 0.49 | 115 <i>12.64</i> 1.72 | 403 <i>11.60</i> 6.02 | 597 <i>31.93</i> 8.92 | 1,148 17.15 |
| Separation | 62 <i>14.09</i> 0.93 | 88 <i>9.67</i> 1.31 | 1,908 <i>54.90</i> 28.50 | 451 <i>24.12</i> 6.74 | 2,509 37.48 |
| Total | 440 <i>100.00</i> 6.57 | 910 <i>100.00</i> 13.59 | 3,475 <i>100.00</i> 51.90 | 1,870 <i>100.00</i> 27.93 | 6,695 100.00 |

Notes: Own calculations on the basis of the GSOEP. Number of individuals: 1,339. **Bold** numbers are cell counts, followed by percentages of the column totals (*italic*) and the relative frequencies of the total sample size.

Source: Zimmermann (2007b).

Table 7.2 Ethnic identity regimes and reservation wages

| Ethnosizer: four regimes | Reservation wages | | Reservation wage ratio | |
|-----------------------------|-------------------|---------|------------------------|---------|
| | Immigrants | Natives | Immigrants | Natives |
| Assimilation | 7.29 | 7.10 | 1.10 | 1.08 |
| Integration | 7.61 | 7.73 | 1.12 | 1.12 |
| Marginalisation | 7.16 | 6.72 | 1.19 | 1.12 |
| Separation | 6.98 | 7.15 | 1.15 | 1.20 |

Notes: Sample sizes are 1,515 migrants and 5,975 natives. Net hourly reservation wage in euros measured about 3 months after unemployment entry. Reservation wage ratio is defined as the reservation wage divided by the last net wage from (self-)employment before entering unemployment.

Source: IZA Evaluation Dataset (wave 1: 2007–2008), own calculations.

immigrants' reservation wages exceed their previous hourly wages by 15 and 18 per cent, respectively.

This picture is somewhat different for natives: while those who are integrated have the highest reservation wages, those who are marginalised have the lowest, and the others rank in between. Assimilated, integrated and marginalised natives report reservation wages which are between 8 and 12 per cent higher than their previous hourly wages.

However, the reservation wages of separated natives exceed their previous hourly wages by 20 per cent. This suggests that identity matters for labour market behaviour.

4 ATTITUDES FROM AND ABOUT IMMIGRANTS IN THE INTEGRATION PROCESS

Attitudes are extremely relevant in the integration setting, as they represent the position that a person has towards others. Attitudes could be feelings or emotions towards a fact, a negative mindset, or the way people respond to a stimulus. They reflect complex historical, psychological and social processes, can change according to experience and stimuli and can be positive, negative or neutral ranging from xenophilia or allophilia to xenophobia.

Attitudes and sentiments towards migrants, foreigners or ethnic minorities vary widely across countries. They may arise from ethnic or racial antipathy and xenophobia, or may be based on economic fears regarding the labour market and the welfare state, and one's own economic outlook. Since immigration is the consequence of policy, migration policy is partly responsible for the types of immigrant a country receives, their economic performance, the functioning of the economy, and hence natives' perceptions towards immigrants. While attitudes and perceptions form or influence our behaviour, they are also the outcome of a complex social, political and economic process, shaped through the engagement of individuals in social and working life and influenced by public discourse and the media. This suggests that attitudes are only partly predetermined, and are also the outcome of a complex economic, political and social reality.

In the scientific literature, the concepts of ethnicity, ethnic identity, multiculturalism, social exclusion and xenophobia are relatively well researched by sociologists, social psychologist, cultural anthropologists and political theorists. Lewin (2001) studies economic integration, ethnic identity and attitudes among Iranian men and women in Sweden. She finds a strong gender disparity, where identity crisis among Iranian women in Sweden is less grave and deep than it is among men; Iranian women have an improved position in Sweden compared to their situation in Iran, have a positive attitude towards the Swedish society, and an increased desire for integration in the new country.

Phinney et al. (2001) argue that ethnic and national identity are interrelated and play a role in the psychological well-being of immigrants. They perceive this as an interaction between the attitudes and characteristics of immigrants and how the host society responds to them. That is, ethnic identity strongly interacts and changes with the immigrant policy a country has and with the attitudes of natives. The strengths of ethnic identity vary according to the support immigrants receive to maintain their ethnic culture, and the pressure immigrants receive to assimilate and relinquish their ethnic values and norms. The authors find that the best adaptation is achieved by a combination of a strong ethnic identity and a strong national identity. When the host society accepts multiculturalism and immigrants want to keep their ethnic identity, then ethnic identity is strong. When immigrants are pressured to assimilate but they are accepted, then the national identity is strong. When immigrants face real or perceived hostility towards them, then some may reject their ethnic identity while others may over-exhibit their ethnic identity. For example, they find that immigrants in Finland have largely marginalised identities, in the

Netherlands have overly separated identities and in Israel half of the immigrants were assimilated and half integrated. Overall, integrated ethnic identities are associated with higher levels of well-being than are other ethnic identity states.

There is also a burgeoning literature in economics on the attitudes towards immigrants and ethnic minorities. Bauer et al. (2000) study the effect of different immigration policies in OECD countries on attitudes towards immigrants, and document the relevance of economically motivated migration policy for the social acceptance of immigrants. Analysing the role of labour market competition, immigrant concentration, racial/ethnic bias, educational attainment and a set of other variables that potentially determine attitudes towards immigrants, Gang et al. (2002) find that negative attitudes towards foreigners have increased and those who directly compete with immigrants have stronger negative attitudes towards foreigners. About 12 per cent of the increased anti-foreigner attitudes are explained by differences in people's characteristics and 88 per cent of the rising anti-foreigner sentiment is related to behavioural changes among the population that has strengthened the impact of various individual characteristics on negative attitudes towards foreigners. Key among these behavioural changes is the fact that the strength of the ameliorating impact of education on anti-foreigner attitudes diminished over time. Overall, people with higher levels of education and occupational skills are more likely to favour immigration and cultural diversity regardless of the skill attributes of the immigrants in question, and they are also more likely to believe that immigration generates benefits for the host economy as a whole (Hainmueller and Hiscox, 2007).

Dustmann and Preston (2004) show that in the UK, attitudes towards foreigners depend on where immigrants come from. Those from other European countries face more favourable attitudes than those from Asia or the West Indies. Looking at the formation of attitudes towards future immigrants, they find evidence that economic matters such as welfare and labour market performance contribute to negative perceptions. However, it is striking that the most important determinant, after all, is non-economic; rather, it is racial intolerance. Moreover, high concentrations of ethnic minorities are associated with more hostile attitudes towards immigrants in Germany (Gang and Rivera-Batiz, 1994). Continuing on the quest on the determinants of attitudes, Card et al. (2005) show that attitudes towards immigration vary systematically with age, education and urban/rural location, and that there is substantial variation in the strength of anti-immigrant opinion across European countries.

If immigrants are to switch identity in the light of different attitudes from natives, this may very well result in different economic integration patterns. Manning and Roy (2007) in a theoretical and empirical exercise, discuss the cultural assimilation of immigrants in the UK, the British identity and the views on rights and responsibilities in societies. They find that almost all UK-born immigrants see themselves as British and others feel more British the longer they stay in the UK. However, not all of the white UK-born population thinks of these immigrants as British because they are more concerned about values than national identity. For example, they are worried that Pakistanis who feel British are causing problems but are not worried about Italians who do not feel British and cause problems. How people see others and how they see themselves is the interesting question.

Epstein and Gang (2009) acknowledge the three elements required to bring minorities

into line with the majority: assimilation efforts, time and the degree to which the majority welcomes the minority. They set up a theoretical model to examine the consequences for assimilation and harassment of growth in the minority population, time and the role of political institutions. They find that as the size of the minority increases, assimilation and the effort to assimilate also increases. But growth in the minority also increases harassment by the majority. If the groups are very asymmetric, the best thing would be for the minority to fight harassment and continue with assimilation. If the asymmetry between the abilities of both groups to affect the minority's productivity is less than the ratio between the effects of the marginal efficiency of their investments on their rents, then the minority will give up on assimilation. Lastly, the minority will give up on its assimilation efforts if the majority is strong and united against the minority.

The role of culture and family attitudes towards employment rates in OECD countries is studied by Cahuc and Algan (2007). They argue that family labour supply interactions and cross-country heterogeneity in family culture are the key to explaining divergent employment rates and employment gaps. The emphasis is on employment disparities that mostly affect specific demographic groups such as women. In particular, they show that people facing a priori the same economic environment by living in the same country – but who differ by the national origin of their ancestors – have significantly different family attitudes, even after controlling for all their relevant socio-economic individual characteristics. That is, they confirm cultural foundations of family attitudes. In addition, their family attitudes are perfectly in line with those currently expressed in their country of origin. They show that the stronger preferences for family activities in European countries may explain both their lower female employment rate and the fall in the employment rates of younger and older people. As valuable as explaining the facts is, it is a different matter from implementing recommendations such as the Lisbon Agenda. Cahuc and Algan (2007) wonder if this implementation can be achieved and if it can be welfare improving, given the cultural forces that reign in some segments of the population.

Constant et al. (2009b) study opinions and attitudes towards immigrants and minorities and their interactions with other barriers to minorities' economic integration. They use a unique dataset that gauges the perspectives of expert stakeholders and of ethnic minorities on their integration situation and the main barriers that hinder it. In this survey, both immigrants and natives were asked about attitudes and perceptions towards others and about themselves. They find that ethnic minorities face integration problems and the natives' general negative attitudes are a key factor of the challenging situation of minorities. While discrimination is acknowledged as the single most important integration barrier, low education and self-confidence as well as cultural differences also hinder integration. Lastly, minorities do want change and want it to come about by policies based on the principle of equal treatment.

5 CONCLUSIONS AND OUTLOOK

This chapter has reviewed the economic assimilation of labour migrants, the evolution of bi-ethnic identities and the value and relevance of perceptions and attitudes, within the broader framework of the economic integration of immigrants. There is evidence

that 'soft' factors such as attitudes, perceptions and identities affect economic behaviour more than they are driven by them. However, most of these findings are still based on cross-sectional evidence and are available only for a few countries. We need to expand our analysis to the available panel datasets and to employ cross-national comparisons, especially of the performance and adaptation of specific ethnic groups in different cultural settings. A major difficulty here that future research should try to tackle is to model the endogeneity of the processes of economic performance and social and cultural interactions.

The often expressed societal norms and even political innuendos that migrants should assimilate is not a conclusion that can be derived from economic reasoning. First, migrant groups hardly ever achieve economic assimilation, at least not the first-generation migrants. If people with a migration background, such as second generation migrants, are performing like natives in an economic sense, they are often also ethnically assimilated. Second, labour migrants brought in by the host country are in demand because they exhibit scarce characteristics – in the short or the long run. Hence, they are wanted because they are different, either because they are talented or have skills which are in short supply at a particular time or because they bring with them ethnic capital that is valuable for the global competitiveness of the receiving economy. Research is needed to better understand and empirically validate ethnic capital and its potential use in the economy.

Globalisation and demographic changes will lead to a higher level of permanent and temporary labour migration around the world. Circular migration, the movement of workers back and forth as well as onwards will become even more regular and standard than it is currently. This increases the demand for individuals with a multi-ethnic identity and generates more diversity within migrant-receiving countries. Coping with increasing ethnic, cultural and religious diversity, especially in societies with either a history of conflict between certain groups, or a strong tradition of cultural homogeneity, is not an easy task. Hence, this will also increase the importance of attitudes. Observing and understanding future labour migration trends and their interactions with cultural and societal conditions is therefore a future research agenda of great importance.

SUMMARY

This chapter deals with the economic and ethnic diversity caused by international labour migration, and their economic integration possibilities. It brings together three strands of literature dealing with the neoclassical economic assimilation, ethnic identities and attitudes towards immigrants and natives, and provides analysis to understand their interactions. The issue of how immigrants fare in the host country especially in terms of their labour force participation and remuneration has been at the core of research in the labour migration literature. If immigrants fare as well as the natives, then they are economically assimilated. While some immigrant groups do, most do not, especially in Europe. Of equal importance is how immigrants identify with the culture of their home and receiving countries, and if natives and immigrants have the right attitudes about each other. Ethnic identities and attitudes seem to be less affected by the economic environment but have implications for economic performance.

Keywords

Ethnicity, ethnic identity, acculturation, migrant assimilation, migrant integration, work, cultural economics.

JEL Classification

F22, J15, J16, Z10.

NOTES

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1. Human capital theory, as formulated by Becker (1962) and Mincer (1974), evaluates how improvement in the skills and talents of workers influences future real income. Investment in human capital includes education, labour market experience (with specific or general on-the-job training), health (both mental and physical), and knowledge about the labour market. An increase in skill increases productivity and earnings, but at the cost of foregone income. Human capital theory posits that wage differentials result from differences in human capital accumulation and specialisation. Investment in human capital in the host country should help disadvantaged groups (immigrants) increase their earnings and reach parity with the earnings of natives.
 2. Another theory that can explain the economic assimilation of immigrants is the segmented labor market theory, as first formulated by Doeringer and Piore (1971). Here, the labour markets are divided into a primary or capital-intensive sector with skilled workers and secondary or labour-intensive sector with mostly unskilled workers assigned menial jobs. Earnings differentials across the primary and secondary sectors are significant, and market forces are unable to erode these differentials. Consequently, immigrants who are in the second tier, earn lower wages than natives, their wages increase slowly over time, wages are rigid upwards but flexible downwards and can fall if supply increases (Piore, 1979). The wage gap between immigrants and natives is expected to widen over time and additional years of residence in the host country do not affect the economic process of the assimilation of immigrants.
 3. Alternatively, some researchers define assimilation as the increase in immigrants' earnings brought about by additional years of residence in the host country. Others measure assimilation as the rate at which the earnings of newly arrived immigrants converge to the earnings of other ethnically similar immigrants residing in the host country for more than 25 years.
 4. These studies include Carliner (1980), Borjas (1982), Abbott and Beach (1993), to name a few of the early contributors.
 5. Jasso and Rosenzweig (1986, 1990), Bloom and Gunderson (1991), Schoeni (1998), to name just a few of the first longitudinal studies.
 6. This is an alternative method to longitudinal data analysis and is typically used with decennial Censuses or Current Population Survey (CPS) data.
 7. In contrast to the first and second generation immigrants, these immigrant children are often called the 'half generation'.
 8. Allowing for other theories, such as the new economics of labour migration, studies on return migration show that there may not be a unitary process of return migration, but several (Constant and Massey, 2002). The authors also caution against an over-reliance on single theories in understanding and explaining international migration.
 9. Constant and Zimmermann (2007) consider the ethnic identity of natives in Germany. Inevitably, natives are also affected by the incoming migrants in several dimensions. For example, they can become more cosmopolitan and open to new cultures, stay locked in their own ethnic identity or even develop an identity opposing immigrants or their own culture.
 10. An exception is the case of Jews, who are usually a minority in the home country and become part of the majority when they migrate to Israel.
 11. Also Berry (1980) and Phinney (1990, 1992).
 12. See Figure 7.2 for this illustration.

13. The word comes from the combination of the terms 'ethnic' and 'size' (ethno/size), where 'size' indicates its status as a form of measurement of the ethnic identity.
14. Ethnic identity, much like personality and other individual characteristics, influences labour market outcomes. We know, for example, that preferences affecting earnings, efficacy and other psychological aspects of individuals are significant influencers of earnings (Bowles et al., 2001). Moreover, cultural hypotheses are economically important for fundamental economic issues like national rates of saving (Guiso et al., 2006). Beliefs that people value and invest in have important economic implications (Bénabou and Tirole, 2007).
15. See Zimmermann et al., (2007) and (2008) for an econometric analysis of ethnic self-identification using GSOEP data.

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8 Reforming the system of international migration

Slobodan Djajić

1 INTRODUCTION¹

Among the striking features of the world economy today is the persistence of large international wage differentials for labour of similar skill and quality, in spite of the ongoing globalisation. A construction carpenter who earns \$2 a day in a poor developing country such as India, could easily get 20 to 50 times more for the same services if authorised to work in an advanced country at the same wage as its native workers.² With such huge differences in the value of a worker's productivity across countries, the potential gains from liberalising international trade in labour services are estimated by Rodrik (2002) to be roughly 25 times larger than the potential gains from further liberalisation of international capital flows and trade in goods. According to Walmsley and Winters (2005), even a relatively small increase in international migration, amounting to 3 per cent of the OECD countries' labour force, would raise the income of people from the developing countries by \$156 billion per year.

Complete removal of barriers to international migration, however, would not be an attractive option for either the host or the source countries. In the host countries it would result in a redistribution of income at the expense of workers who compete with migrants, and in favour of owners of factors of production complementary to migrant labour. For host countries with highly segmented labour markets and a long history of documented and undocumented immigration, with migrants concentrated in certain sectors of the economy, further moderate inflows need not be harmful to the native workers. New immigrant arrivals in such cases primarily affect the wages of previously arrived immigrants, while also contributing to lower prices of goods and services consumed by native workers.³ For countries with small immigrant populations, however, the redistributive impact on the income of native workers can be a significant problem.

There are also congestion effects, other negative externalities, and the burden on infrastructure, housing and public services that can lower the quality of life of host-country residents. Here again, the impact will differ across countries. It is not likely to be very important in host countries with low population densities or when the economy is experiencing an exodus of population from the countryside and the migrants are merely replacing the natives to revitalise the local economies.

Another problem relates to the welfare state: the generous benefit programmes that exist today in many of the advanced countries can potentially result in net transfers from natives to immigrants. This is sometimes the case if the latter are relatively less skilled and have family structures that tend to absorb large volumes of public services. Massive immigration would strain such programmes and most likely trigger revisions with respect to eligibility, scope and magnitude of the benefits that would be detrimental to the relatively less fortunate segments of the existing population.⁴

From the perspective of a source country too, unrestricted migration is not an ideal

option. It would drain the most capable, young and productive members of the labour force, with negative implications for the age structure of the population, the dependency ratio, and the productive potential of the economy. International migration therefore needs to be properly managed. Proper management, however, means different things to different people. Landowners may have one perspective, potential migrants will have another, fiscal authorities of the host country yet another, remaining residents of the source country another, and so on. This is because international migration entails income redistribution among owners of different factors of production and consumers of different consumption bundles in both the host and source countries.

I should also emphasise that the fine print of immigration policy matters a great deal. The precise conditions under which migrants are allowed to work affect the way the gains from international migration are distributed in both countries. They matter especially when it comes to income distribution between the migrant and his or her employer, but they also influence how the other factors of production and the consumers are affected by international migration. In this respect, some of the important questions are: does the migrant have to be sponsored by an employer? Does the employer have to offer a written contract, specifying the wage and the conditions of work? Does the migrant have the right to change employers? Does the employer have to pay a fee for the right to hire a foreign worker? Is the employer required to first look for a native worker? What is the duration of the work permit? Does the migrant have the right to renew the work permit or become a permanent resident of the host country? What is the role of the employer in this process?

The devil is very much in the detail. How the potential gains from international migration, as well as any of the associated costs are divided among various economic agents depends on the very precise details of immigration policy. I shall not go into these details, as there is very little space for an adequate treatment on this occasion. I shall focus, instead, on the broader aspects of immigration policies and ways of increasing the benefits of international migration for both the host and source countries.

This chapter is structured as follows. Section 2 discusses key criteria. Section 3 explores various recommendations. Section 4 examines the failure of existing policies. Section 5 discusses the issue of skilled workers and Section 6 that of dissatisfaction with immigration. Section 7 concludes.

2 KEY CRITERIA

From the point of view of the host, immigration policy should meet certain key criteria:

1. It should bring about orderly, predictable migration rather than illegal, undocumented inflows which are out of control.
2. It should generate migration flows that adequately address labour market shortages, without imposing any unnecessary fiscal burden on the host country. To some extent, the problem of labour shortages can be addressed by increasing imports of labour-intensive goods, outsourcing of production, increasing participation of women in the labour force, encouraging automation and other methods of reducing the demand and increasing the supply of labour. None the less, foreign labour remains an essential part of the solution.

3. It is also desirable to have flexible immigration flows that can be adjusted up or down, depending on the cyclical and seasonal fluctuations in the demand for labour. In addition, immigration policy should be able to reverse the flows when the migrants are no longer needed. Switzerland of the 1960s and 1970s provides an example of how the flexibility of a guest-worker programme can play an important role in supporting macroeconomic stability at times when the economy is subjected to external shocks (see Sheldon, 2001).
4. A host country should also have a well-defined policy of integration with clearly established rights and obligations of immigrants. If the host country is to enjoy fully the potential benefits of international labour mobility, immigrants must feel welcome. There should be no discrimination. For this reason, immigration should not exceed the country's absorption capacity.⁵ Rapid growth in the stock of foreigners in economies with ethnically homogeneous populations can produce tensions between immigrants and the natives. This is particularly true if the inflows seem to be imposed by external factors and the benefits of immigration are not clearly understood by a large part of the population.
5. Immigration policy must also take into account the demographic challenges of population ageing, the problem of paying pensions, growth of the dependency ratio and low fertility rates.
6. Finally, it must address specific shortages in certain segments of the skilled and unskilled labour market by designing specific programmes that generate an adequate supply of documented migrants to the targeted sectors.⁶

3 RECOMMENDATIONS

Addressing all these issues requires a major overhaul of immigration policies and enforcement strategies in the advanced countries. To be successful, any new policy initiative would have to account fully for the market forces that have been fuelling undocumented migration over the last few decades. To take the United States and to some extent the European Union (EU) as an example, establishment of substantial guest-worker programmes should be a cornerstone of a policy package that deals with labour market shortages, reduces the stock of illegal immigrants, and lowers migration pressures in the long run. A key element of such a programme must be the incentive for migrant workers to return to, but also consume and invest a larger part of their foreign earnings in the source country.

To reduce migration pressures, it is essential that the non-migrants of the sending countries benefit in the process. Migrants' remittances are an important channel in this respect. The spending of remittances on locally produced goods and services creates trading opportunities and income flows for the non-migrants.⁷ In 2004, for at least 20 developing economies, reported remittances amounted to more than 10 per cent of GDP (Lueth and Ruiz-Arranz, 2006). These are very large injections into a country's income flow. On top of the recorded flows, we should also add the unreported flows of funds and merchandise sent or brought back to the source countries by migrant workers. For developing countries of Latin America, the Caribbean, Africa, Asia, the Pacific, the Middle East, and even some European countries, remittances have a profound impact on

the standard of living and the incidence of poverty.⁸ They also have a significant positive effect on investment in education and health within the households of emigrants.⁹

The transfer of technology and skills through return migration and investments by migrants in local businesses also contribute to development and improve the prospects for economic growth in the sending countries. Repatriated savings play a key role in the creation and expansion of small businesses and in generating income and employment opportunities for the non-emigrants. According to Woodruff and Zenteno (2001), in those regions of Mexico that experienced significant emigration to the USA, over one-third of new small businesses were started by returning migrants with their repatriated savings. They estimate that about 20 per cent of the capital invested in small businesses in urban Mexico is remittance based. The role of return migration and repatriated savings in the process of capital accumulation in the developing countries has long been recognised in the literature.¹⁰ Without that growth and development, the expanding migration pressures and illegal immigration flows cannot be addressed in the long run.

A well-functioning guest-worker programme requires that the host countries enter into bilateral or multilateral agreements with the source countries to set up recruiting centres that would play a key role in regulating migration flows. These centres should have the authority to check the background and qualifications of applicants and match them, as employment agencies do, with requests from employers in the host country. Recruiting centres should also be able to issue a guest-worker identification card (GWID) to those authorised to work in the host country. A fee should be charged for the GWID, in lieu of the fees currently charged by alien smugglers. This fee, however, should be refunded with interest to returning migrants in the source country on the condition that they respected the guidelines of the guest-worker programme. Pension benefits should also be payable to guest workers in the source country, with at least some possibility of obtaining credit for an investment in a small-business activity by using part of the scheduled pension benefits as collateral.

To further encourage guest workers to return and contribute to development at home, there would have to be some restrictions on bringing family members to the host country. This could be in the form of a ban for at least the first two to four years of participation in the guest-worker programme. While such a restriction can impose a considerable limitation on the potential benefits of international migration enjoyed by a migrant household, the net benefits for the source country for any given volume of guest-worker migration are likely to be larger. This is not only because the restriction helps to keep in place strong ties between a migrant and the source country, but it also affects the profile of workers likely to take part in the programme. It favours participation of younger, single individuals with longer time horizons, who have greater potential to accumulate a larger amount of savings and human capital while working abroad in relation to older household heads who support a spouse and children in the source country. Return migration of these younger participants is likely to have a greater positive impact on the development prospects of the source country.

In addition to influencing the profile of the participants in the programme, the restriction on mobility of family members also serves as a rationing device. One form or another of a rationing mechanism is likely to be required in order to maintain a balance between the supply and demand for guest-worker permits under any programme that is designed to be fair and rewarding to the foreign workers. Rationing solely on the basis

of a refundable GWID fee would surely exclude the poor, liquidity-constrained potential migrants. There are both positive and negative implications of that for the development prospects of the source country. On the one hand, if temporary migrants are drawn from the middle of the income distribution, it is more likely that the repatriated saving will be larger and invested in a small business. In that sense, making temporary migration more accessible to those who are not facing severe liquidity constraints can contribute to capital formation in the source country and a decline in migration pressures. On the other side of the coin, it serves to worsen the distribution of income in the sending country. This certainly needs to be taken into account when considering various policy options.

A guest-worker programme must also feature a mechanism that encourages employers to first seek unemployed permanent residents and citizens. Small levies should therefore be imposed on hiring guest workers, with part of the revenues redistributed to returning migrants in the form of return benefits payable in the source country. The remainder should be used to cover the operational costs of recruiting agencies in the source countries and to subsidise training of native workers. The latter could be part of an effort to reduce any possible negative impact of the guest-worker programme on low-skilled natives, but also to reduce labour shortages in various skilled occupations.

It is also important to note that border control and the goal of reducing illegal immigration can be achieved more economically and more effectively with the cooperation of the country's neighbours.¹¹ Neighbouring countries should be given privileged status in any guest-worker programme to facilitate cooperation in regulating guest-worker flows and controlling unauthorised immigration, including that from third countries. The existing stock of undocumented workers should be given priority to participate in the new guest-worker programme, provided they are employed and have not committed a criminal offence. Participation should be conditional on registering for the programme in the source country, just like any other candidate for a GWID.

In addressing the growing migration pressures and the problem of illegal immigration, the advanced countries must also recognise that they are not competitive in many of the labour-intensive manufacturing and agricultural activities. Protection of those sectors by means of restrictive trade policies and subsidy schemes deprives developing countries of markets, growth opportunities, and jobs for workers who would prefer to remain in their country of origin rather than do the same jobs abroad as illegal aliens. Phasing out of agricultural production and export subsidies and tariffs on imports of labour-intensive manufactured goods would not only help reduce the supply of migrants (by stimulating employment in the source countries), but it should also reduce the demand for undocumented labour (by removing some of the incentives for production of labour-intensive goods in the host countries).

4 FAILURE OF EXISTING POLICIES

Current immigration policies concerning low-skilled workers are characterised by very limited access through official guest-worker programmes, tolerance of illegal immigrants in some segments of the labour market, and tight border controls in an effort to limit further inflows. These policies have evolved over the last couple of decades in reaction to

what were perceived to be growing migration pressures, but they have not been successful in achieving the objectives, defined above in Section 2, that immigration policy should aim to attain. In some ways, the measures have turned out to be counterproductive. For example, the efforts by the US authorities to make it more dangerous and costly to cross the US–Mexico border has transformed many of the *temporary* illegal aliens into *permanent* illegal residents (Djajić, 1999). Prior to tightening of border controls in the late 1980s and early 1990s, Mexican migrants moved back and forth, responding to seasonal and to some extent cyclical factors that influence the demand for labour in the south-west of the United States. After the tightening, they switched to a strategy of staying longer in the US, moving further inland to avoid deportation, and bringing their families to the US as well. What used to be flows of primarily young men looking for jobs north of the border are now flows that include a sizeable proportion of women and children trying to reunite with husbands and fathers. Roughly one-quarter or perhaps a third of those currently crossing the USA–Mexico border illegally are women and children.¹²

The tightening of border controls in the USA, the EU and other advanced countries has increased the cost of entry for undocumented workers and asylum seekers to levels that have not been seen in real terms in over a century. With respect to migration flows, this has a much more profound effect than just converting some of the temporary undocumented workers into permanent immigrants. The bulk of migration costs represent a burden for the source countries. This drains their savings, reduces their capacity to invest in physical and human capital, lowers employment opportunities and contributes to an increase in emigration pressures over time. If the elasticity of migration flows with respect to migration costs is sufficiently low, it can be shown that an increase in migration costs can actually *stimulate* migration flows in both the short and long runs (Djajić, 2009). The deterrent effect of higher migration costs is then dominated by the increase in migration pressures due to lower capital stock and wages in the source country.

Internal enforcement measures have also proven to be ineffective, particularly in the US, but also in Western Europe.¹³ In practice, it is very difficult to penalise politically powerful employers and industries for hiring illegal aliens when they have difficulty in finding documented workers to fill the jobs. This is particularly true when undocumented workers are employed to meet seasonal labour shortages, as in the agricultural sector or in the construction and tourism industries. In some sectors, such as food handling, employers have a choice of either hiring workers that include those who show fake documents or get driven out of business by less scrupulous competitors. With the establishment of a well-functioning guest-worker programme, it becomes both technically and politically feasible to enforce restrictions on hiring undocumented workers and deny labour market access to both illegal aliens and their employers. An effective electronic verification system, requiring all employers to screen out unauthorised workers quickly and efficiently, should be fully implemented shortly after the guest-worker programme becomes operational.

A substantial temporary migration scheme that constrains migrants to retain strong ties to the source country would not only be more effective in supporting orderly migration, it would also reduce migration pressures by channelling earnings and investments of migrants back to their countries of origin. By contrast, today's irregular movements provide very little support for the development efforts of the source countries and hence do little to alleviate migration pressures. This is because of:

1. the high migration costs and fees paid to smugglers, which serve as a tax on foreign earnings of undocumented workers;¹⁴
2. the low wages received by undocumented workers in the host country, due to their status, which reduce the flow of benefits back to the source country;
3. the weaker ties to the source country that illegal aliens have because of the high costs of going back and forth;
4. the strong incentives to bring family to the host country when the worker cannot cross the border with ease; and
5. the higher cost of sending remittances back to the family or accumulating savings abroad because an undocumented worker has less access to banking services in the host country when compared to those available to a legal guest worker.

For all these reasons, the flow of remittances, repatriated savings and other benefits back to the source country are much lower in the context of illegal immigration than they are in the context of orderly, temporary international migration of labour. Accordingly, a well-structured guest-worker programme would be much more beneficial than the current system, not only for the host country (by providing orderly, controlled inflows of labour and reducing immigration pressures in the long run), but also for the migrants and the remaining residents of the source country.

An example of a guest-worker programme that meets many of the objectives noted above is the one between Canada and Mexico, which has been in operation for more than three decades, with 12,500 workers participating last year. Under the programme, the government of Mexico recruits workers for temporary jobs arranged for by the Canadian employer's association. The two sides certify and monitor both employers and workers, making sure that the rights of the workers are protected and that the workers return to Mexico as scheduled. Many of these workers come back to Canada in the following year to work for the same employer under the same programme (see Martin, 2003).

By contrast, guest-worker programmes set up unilaterally by the authorities of the host country, with too few resources allocated for enforcement, often result in a wide range of worker abuses. In the case of H-2A and H-2B programmes in the USA, a major criticism is that it gives employers too much power in relation to workers who are subject to abuse by both the recruiters and the employers. Similar and even harsher criticisms have been raised in relation to guest-worker programmes operated by a number of labour-importing countries on the Persian Gulf. Programmes that are run in close collaboration with the source countries are likely to be more effective in preventing abuse of workers and assuring circularity. Such programmes must also have a clearly defined and accessible dispute-settlement mechanism. They should make use of the existing technologies to facilitate matching between workers and employers as well as to monitor compliance. Finally, they must be flexible enough to respond to market conditions quickly and efficiently.

5 SKILLED WORKERS

Competition for skilled immigrants, with an emphasis on meeting shortages in certain occupations, was led in the 1980s by Canada, Australia and New Zealand. In the early