



Who's afraid of a globalized world? Foreign Direct Investments, local knowledge and allocation of talents

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ABSTRACT

We study the distributional effects of globalization within a model of heterogeneous agents where both managerial talent and knowledge of the local economic environment are required in order to become a successful entrepreneur. Agents willing to set up a firm abroad incur a learning cost that depends on how different the foreign and domestic entrepreneurial environments are. In this context, we show that globalization fosters FDI and raises wages, output and productivity. However, not everybody wins. The steady state relationship between globalization and income is U-shaped: high- and low-income agents are better off in a globalized world, while middle-income agents (domestic entrepreneurs) are worse off. Thus, consistently with recent empirical evidence, the model predicts globalization to increase inequality at the top of the income distribution while decreasing it at the bottom.

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1. Introduction

Who opposes globalization? Who favors it? It is well-known that in a Heckscher–Ohlin context the process of globalization produces winners and losers as a consequence of the changes in the relative abundance of factors. Despite its obvious relevance, this issue has been so far hardly analyzed in the context of intraindustry trade models *à la* Melitz (2003), where gains from trade do not arise from international differences in factor endowments, but from consumers' love for variety and from the ability of the entrepreneurs to overcome the barriers that distance generates. So far this literature has focused on models with “heterogeneous firms” and “homogeneous agents”.

This paper is an attempt to analyze the distributional effects of globalization within a Melitz-type model with heterogeneous agents. Our main finding is that the effect of globalization on the individuals' well-being is non-monotonic. A higher degree of inter-connectedness

among countries has a U-shaped effect on the income distribution, improving the position of both those at the top and the bottom of the distribution and harming those in the middle. This prediction is consistent with recent empirical evidence showing that since the 1990s both in the U.K. and the U.S. inequality went up in the upper tail of the distribution and decreased in the lower tail (Autor et al., 2005; Autor et al., 2006 and Machin and Van Reenen, 2007).

We obtain this result in a model of Foreign Direct Investments (FDI), one of the most prominent (and debated) features of globalization. FDI grew dramatically over the last decades far outpacing the growth of trade and income.² Another salient feature of FDI is that they take place mostly between developed countries, i.e. between countries that are similar in terms of natural endowments and relative supply of inputs.³ We provide additional empirical evidence in line with this fact, documenting that bilateral FDI are also

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² Whereas world-wide real GDP increased at a rate of 2.5% per year between 1985 and 1999 and world-wide exports by 5.6%, world-wide real inflows of FDI increased by 17.7%.

³ For the period 1970–2000, Barba Navaretti and Venables (2004) report that more than 90% of outward flows of FDI originates from advanced countries. Over the same period, the share of the world FDI inflows directed to developed countries ranges between 58 and 78%.

higher between countries that have more similar *entrepreneurial environments*.⁴

Consistently, we propose a model in which *both* managerial talent and *knowledge of the local entrepreneurial environment* are required in order to set up a firm and earn positive profits. The main trade-off that arises in the model depends on how individuals with different abilities are allocated to the different types of jobs available in the economy. To be more specific, a first key feature of the model is that agents with different levels of managerial ability are allowed to select their occupation and choose whether to become entrepreneurs or workers. Those who become entrepreneurs may engage in FDI and set up a firm abroad. However, in order to become a successful entrepreneur in a given country, managerial ability is not sufficient: some *knowledge of the local economic environment* is also required.

A second key feature of the model is that agents are assumed to know more about the domestic economic environment (e.g. domestic consumers' tastes) than about the foreign environment. Domestic agents have to *learn* how the foreign economic environment works in order to profitably set up a firm abroad. Thus, both managerial ability and nationality affect career choices. The idea is that a certain level of managerial talent, though allowing agents to profitably produce within the domestic economic environment, may be of little help when setting up a firm abroad: the more different the foreign and the domestic economic environments, the more difficult it is to succeed in the foreign market. This *distance* between entrepreneurial environments is the only explicit barrier to capital movements that matters in the model. It may be overcome only at the cost of learning how the foreign environment works. Of course, in equilibrium, only the most talented entrepreneurs, who run – in line with the empirical evidence – the largest and most productive firms, have incentives to pay the learning cost and produce abroad.

The model endogenously determines the allocation of talents between (domestic and international) entrepreneurial activity and salaried work. It follows that FDI, Total Factor Productivity (TFP), GDP and wages depend on how efficiently talents are allocated. Talent allocation, in turn, depends on how hard it is to learn about the foreign entrepreneurial environment. A lower distance between entrepreneurial environments reduces the learning cost and raises the inflow of foreign-owned firms into the domestic market. This increases the domestic wage and makes the entrepreneurial activity less profitable, driving a fraction of low-ability domestic entrepreneurs out of the market. This general equilibrium effect improves the allocation of talents and increases both TFP and GDP.⁵ Conversely, a larger distance between entrepreneurial environments protects low-ability entrepreneurs from foreign competitors and reduces output, wages and TFP. Thus, globalization fosters *aggregate* efficiency.

Still, not everybody wins when the degree of globalization increases. The welfare of the individuals with the lowest and highest levels of entrepreneurial talent (who choose to become workers and multinational entrepreneurs, respectively) increases as learning costs go down and GDP, TFP and wages rise. Differently, the welfare of the

individuals with an “intermediate” level of talent is decreasing in the degree of globalization. The reason is that, in a globalized world, domestic entrepreneurs pay the cost of tougher competition without enjoying the benefits of accessing to wider markets. In a non-globalized world they enjoy higher entrepreneurial profits as they are sheltered from foreign competition. Even in the absence of any pro-competitive effects of FDI working through lower prices,⁶ the general equilibrium effect through wages is sufficient to expel mediocre entrepreneurs from the market when the difference between economic environments becomes smaller. As a result, globalization increases inequality in the upper tail of the distribution and decreases it in the lower tail of the distribution.

As the model is based on the idea that globalization reduces the distance between economic environments and therefore leads to higher FDI, we test this relationship against the data. We proxy the distance between economic environments exploiting measures of Product Market Regulation and interpret the difference between languages as an additional *qualitative* proxy of the distance between economic environments. Our results indicate that, controlling for the *levels* of regulation, GDPs and populations in both countries, host and source countries fixed effects, time effects, and a set of geographical variables, a higher distance between economic environments negatively affects the size of bilateral FDI stocks.

This paper is obviously related to the recent trade literature that, since Melitz (2003), develops dynamic industry models with heterogeneous firms, in which only the most efficient firms engage in cross-border activities and where more openness forces the least productive firms out of the market. The key difference with Melitz (2003) is that in this paper firms' heterogeneity stems from the heterogeneity (in managerial talent) of the agents who are allowed to make career choices. This feature of the model allows us to emphasize the (endogenous) mechanism by which exposure to foreign competition improves the allocation of talents and, most importantly, to discuss the distributional implications of globalization.

Another strand of literature related to this paper is the one that analyzes the distributional effects of decreasing trading costs. While this issue has been widely studied in the context of models *à la* Heckscher–Ohlin, the literature on the distributional effects of globalization in the context of intraindustry trade models is much thinner. Closest to us is Helpman et al. (2010) that study the distributional consequences of international trade in a model with heterogeneous firms and workers in which labor markets are imperfect.⁷ In their context, the distributional effects of globalization in developed economies are akin to those derivable in Heckscher–Ohlin models: the most efficient workers benefit from globalization because their firms (the most efficient ones) do, while the least skilled workers suffer because their firms (the least efficient ones) also suffer. One key difference between our approach and their model is that we allow for endogenous career choices and learning of the foreign environment. Thus, in our context the welfare effects of globalization are U-shaped. The individuals at the low-end of the income distribution improve their position because the demand for their labor services is larger when foreign firms have access to the local market.

We finally relate to the extensive (theoretical and empirical) literature that studies the driving factors of FDI.⁸

⁴ Broadly speaking, one may think of the entrepreneurial environment as representing the complex set of circumstances, generally different across countries, entrepreneurs need to deal with: identification of consumers' tastes, communication with costumers, relationship with the bureaucracy, comprehension of the legal environment, purchase of inputs, relationship with other firms, setup of the production process (hiring and firing procedures, salary structure, technology choices, ...). This is very well explained in the statement that used to appear on Unilever's website (citation taken from Barba Navaretti and Venables, 2004): “Many of our brands have international appeal, while others are leaders in local markets. It is our keen understanding of cultures and markets that allows us to anticipate consumers' needs and to provide them with what they need, when they need it.” (Unilever, emphasis added)

⁵ This is consistent with a growing body of empirical evidence pointing to the existence of a positive relationship between FDI and both wages and productivity. Baldwin et al. (2005) show that FDI positively affects wages using industry-level data for seven OECD countries. Keller and Yeaple (2003) provide firm-level evidence from the US showing that FDI spillovers account for about 14% of productivity growth in U.S. firms between 1987 and 1996. Javorcik (2004) provides similar evidence for Lithuania. See Lipsey (2002) for a review of the micro evidence on the home and host country effects of FDI.

⁶ The competition effect is present in almost all the standard IO-based FDI models, since Horstmann and Markusen (1992). In our model product market competition does not increase in the domestic country as a consequence of foreign competition. We rule this effect out by assuming monopolistic competition and Dixit–Stiglitz preferences. See Melitz and Ottaviano (2008) for a model of trade with firm heterogeneity and endogenous mark-ups.

⁷ Related papers are also Coşar et al. (2010), Egger and Kreickemeier (2009), Epifani and Gancia (2008), Felbermayr et al. (2011) Davis and Harrigan (2007), and Manasse and Turrini (2001).

⁸ See, among many others, Horst (1972), Deardorff (1998), Ekholm (1998), Lipsey (2001), Razin et al. (2004), Shatz (2003), and Fumagalli (2003).

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