

Expansion Strategies of U.S. Multinational Firms

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Summary

In the current process of globalization, multinational enterprises play a starring role. The share of cross-border capital flows accounted for by the foreign direct investment (FDI) of multinationals has been rising in recent years, particularly for many developing countries for which FDI is now the largest type of capital inflow. FDI links financial and product markets across countries via transfers of physical capital, technology, and management techniques.

Although the general role of multinationals in globalization is well recognized, what seems less noted is that these firms display a wide range of expansion strategies. In this paper we revisit the question of why multinationals go abroad. To date, most research has focused on two answers: to gain access to host-country markets (i.e., horizontal FDI), or to exploit international factor-cost differences (i.e., vertical FDI). Most empirical research has concluded that market-seeking FDI matters more than FDI motivated by wage differentials. For example, for decades most FDI flowed from large, rich countries to other large, rich countries: that multinationals locate most production in similar, high-wage economies is consistent with FDI being driven more by market access than by wage differences. And sales by foreign affiliates of U.S. multinationals are higher in countries with higher tariffs and transport costs on U.S. goods. This is consistent with FDI motivated by market access.

In this paper we challenge prevailing academic views about the relative importance of horizontal and vertical FDI. We do this by analyzing data that offer, relative to the recent literature, both more current and more detailed information on the foreign operations of U.S.-headquartered multinationals. The first novelty is timing. As we will show, FDI patterns in the 1990s were much richer than just the three findings discussed above. Previous research overlooked this richness partly because most of it excluded data from most of the 1990s, a period in which factors other than market access may have

played a larger role in the strategies of U.S. multinationals. The second novelty is detail. We document and analyze multinational expansion strategies that have received little attention in the literature: as export platforms that produce in but then sell outside host countries, as producers adding value to inputs outsourced from their U.S. parents, and as wholesalers distributing goods into foreign countries. We have three main findings.

First, there is strong evidence of vertical FDI. Overall, U.S. parents outsource a small but growing share of production to their foreign affiliates, in terms of exporting intermediate goods to affiliates for further processing. This share is substantial in specific regions and industries. Most of this activity is concentrated in North America and in various emerging economies: e.g., imported inputs for further processing account for over 30% of affiliate sales for affiliates in Canada and Mexico. This activity is also concentrated in industries involving separable high-skill and low-skill tasks: e.g., over 20% of total sales for affiliates in electronics and transportation equipment.

Second, even where FDI looks to be horizontal, U.S. multinationals tailor their entry strategies—specifically, their destination of sales—to reflect host-country conditions. In larger, more-protected, and higher-tax economies, affiliates target most of their sales to the domestic market. But in smaller, less-protected, and lower-tax economies, U.S. multinationals set up export platforms that devote more of their sales to export markets in nearby regions and beyond.

Third, U.S. parents in manufacturing serve each foreign market either through affiliates that produce goods locally or through wholesale trade affiliates that resell goods produced elsewhere, but rarely through both means. Multinationals appear to face a decision between *production-oriented* and *distribution-oriented* FDI. This choice does not reflect the export-versus-FDI decision common to standard models in the literature, as that decision is only about alternative production modes. We offer some evidence that this production-distribution choice turns partly on aspects of U.S. tax policy.

Our findings suggest that viewing FDI as either horizontal or vertical partly misses the point. The data seem to show evidence of *both* types of FDI. The relative importance of motivations for FDI will depend on a host of industry and country factors. More broadly, our findings suggest that the benchmark distinction between horizontal and vertical FDI does not capture the range of strategies that multinationals use. Conditional on choosing to become a multinational, a firm appears to face three overlapping choices about its global operations. First, should the foreign affiliate produce goods itself or should it distribute goods produced elsewhere? Second, for cases where the multinational chooses production-oriented FDI, should the affiliate be vertically integrated or vertically specialized? Vertically integrated affiliates can be stand-alone operations, but vertically specialized affiliates are presumably linked into the multinational's outsourcing network. Third, should an affiliate sell goods locally or export?

A key motivation for distinguishing different modes of FDI is to identify how specific multinational expansion strategies respond to government policy. Previous research has focused on how trade and tax policies affect aggregate FDI. Our research finds that trade and tax policies are very important not just in terms of aggregate affiliate activity but also in terms of the mix of affiliate expansion strategies.

Recent research on horizontal FDI has been extremely useful in describing broad patterns of multinational behavior. However, this research misses important variation in the range of activities that multinationals perform and in the sensitivity of these activities to host-country policies and characteristics. We have tried to provide some initial evidence on this range of activities and on the role of policy. Future work should examine these issues in greater detail.