# Dutch Multinationals

## How do they function in Milan?

*A survey*

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Groningen, July 24th, 2006

# Preface

The last years, the media has paid much attention to the effects of foreign direct investments. The attitude towards foreign direct investments is quite negative. Many people fear that their jobs will be seized by low-wage countries. Nevertheless, a short introduction in the practice of FDI learns that Dutch multinationals mainly invest in countries that have similar economic standards. In my opinion, it was interesting to pay attention to this kind of FDI. I was planning to do a research on Dutch subsidiaries somewhere in Europe, on a location that possesses economic standards similar to The Netherlands. Therefore, Eastern Europe was not in the picture. When I made this proposal to my supervisor, Professor P.H. Pellenbarg, he told me about his contacts with the Technical University in Milan. The same week, in July 2005, I had an appointment with a representative of this university, Dr. I. Mariotti. She indicated she was willing to supervise me in the spring of 2006.

After finishing most of my tests in January 2006, I seriously started studying relevant literature. On March 6th 2006, I left to Milan to work out an interview program. In Milan, I was hosted by the Technical University of Milan and was supervised by Dr. Mariotti. I stayed here for six weeks and returned to Holland the third week of April. During these six weeks, I had some serious difficulties working out my interview program, but I came home with some relevant empiric and theoretical data.

For me as a master-student, it is the first time I write a report of this size. Sometimes it was difficult to maintain a correct overview over the report as a whole. Therefore, I want to thank my supervisor, Professor P.H. Pellenbarg, whose advices really helped me to write this report.  My thanks go out to Dr. I. Mariotti, who has really helped me during my stay in Milan. I want to thank her and the Technical University of Milan for using the database with information of Dutch multinationals in Italy.

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## Summary

The subject of this report is the functioning of Dutch multinationals in Milan. Multinationals are defined as “firms that own a significant equity share (typically 50 percent or more) of another company (henceforth subsidiary or affiliate) operating in a foreign country”. (Barba Navaretti & Venables, 2004) MNC’s capital flows are measured by flows of Foreign Direct Investment (FDI). These flows contain the costs of new investments, the profits of foreign subsidiaries, internal loans and border-crossing mergers and acquisitions (M&A’s). FDI can be divided in two categories. Vertical FDI, aimed at exploiting the differences of production costs between countries, and horizontal FDI, aimed at the infiltration of a foreign market. (CPB, 2005)

Dutch companies have invested relatively early in Milan. The proportion of Dutch firms founded before 1985 is significantly higher than this proportion in the rest of Italy. Because Dutch MNC´s have invested in Milan relatively early, the Dutch establishments in Milan are expected to be relatively large. Comparison with Dutch affiliates in the rest of Italy learns that this is true. Turnover and number of employees are significantly higher in Milan. There has also been a shift in sector distribution. Dutch establishments in Milan are becoming more and more service-based, while the share of industrial firms is decreasing. Although, the Dutch industrial sector in Milan still has the highest yearly turnover and the highest number of employees.

Dutch subsidiaries in Milan are present in a wide range of sectors. The sectors differ from consultancy to chemicals and from food-industry to the mechanical industry. In absolute number of establishments, the service-based sector is the largest sector for Dutch firms in Milan. The empiric finding that Dutch subsidiaries in Milan sell the major part of their production on the local market supports the hypothesis that their mother companies have invested with a market-seeking motive. Dutch investments in Milan are horizontal and horizontal FDI is connected with the market-seeking motive, as we have seen in chapter 3.

Assuming that the Dutch firms in Milan have a market-seeking strategy, it is expected that these firms focus on the domestic market. This idea is supported by the empirical findings. The interviewed firms all sell at least ninety percent of their production to the local market. Now it is presumable that the suppliers of Dutch affiliates in Milan are Italian in many cases. These local suppliers have the advantage of low trade costs, compared to foreign suppliers. Again, this idea is supported by the empirical data, which tell that the suppliers of the firms involved in the interview program are mainly Italian.

Describing the customer and relationship relations leads us to the embeddedness of Dutch establishments in Milan. The fact that Dutch investments in Milan are mainly horizontal, results in many relations with local suppliers, retailers and customers. This is in line with the empirical data, which tells us that Dutch subsidiaries serve the local Italian market. The result of this is a relatively high degree of integration, or “embeddedness”. There are two incentives mentioned in theory, that make firms focus on internal networks, instead of focusing on external relations. The first incentive is “external uncertainty” caused by geographic and cultural distance. This incentive does not play a huge role, since Milan is relatively close by and its culture is quite similar to west-European standards. The second incentive to focus on internal networks might play a larger role. This factor, *behavioural uncertainty*, plays an important role for companies that have a short history of investment on a certain market, that little knowledge of a certain market and that have not yet developed relations of trust with local firms. This factor seems to put a break on the integration of companies that are established for a short time. The longer firms are established, the easier it will become for them to become embedded in Milan, since they develop more knowledge of the local market.

The degree of sovereignty a foreign subsidiary is given has a huge impact on its ability to become embedded in a local context. Castellani and Zanfei state that there exists a positive relationship between the degree of sovereignty and the degree of embeddedness. A sufficient degree gives an affiliate the ability to constantly adapt themselves to changing circumstances. This is especially important in challenging and dynamic regions as Lombardy. Information given by some Dutch establishments shows that these firms often have frequent contact with their mother company. In most cases, these firms have a strong influence on the day-to-day business, while the mother company is in charge of the long-term strategy. It is important to bring the affiliate in charge of the day-to-day business. This company is in the middle of the local context what gives the possibility to react properly on sudden changes. Second, decentralizing decision-making makes it easier for affiliates to develop relations with local actors. This brings the advantages of increased embeddedness, what results in an increasing competitiveness.

The positive impact of embeddedness in local institutions is discussed by Martin (2003). They that argue that trust, reciprocity, cooperation and convention play a key role in successful regional development. This implies that a foreign company has to relate to the local social networks, in order to gain the advantages of embeddedness.

A theoretical concept connected to embeddedness is the concept of the “double network structure”. In short, this concept means that an MNC company has two kinds of relations. The first kind of relations is internal relationships, with units inside the MNC. The second one is external relationships, with units outside the multinational. Sufficient internal networks enable a subsidiary to benefit from the fact that it is part of a MNC. For example, an affiliate can benefit from the high R&D expenses of the mother company. A firm that has a high degree of embeddedness has many external relations with local actors. These relations make it possible to inject specific knowledge in the local economic environment, what increases economic development of a region. This is a spillover effect of multinational firms. There is one condition; internal networks have to be sufficient to enable a proper flow of knowledge from the mother company to the affiliate.

In case of Dutch subsidiaries in Milan, the condition of sufficient internal networks seems to be fulfilled. Based on theory and empirics, we might assume that Dutch subsidiaries in Milan have a relatively high degree of embeddedness. This combination of embeddedness with sufficient internal networks enables us to assume that the presence of Dutch multinationals in Milan has a positive influence on the local economy.

This leaves us with the question: what can we say about the functioning of Dutch subsidiaries in Milan? The Dutch subsidiaries in Milan are earlier established than other Dutch subsidiaries and they are larger than Dutch subsidiaries in Italy. Dutch multinationals might have invested in Milan first, before they spread their wings over the rest of Italy. These companies mainly invest here to infiltrate the large internal market. The Dutch firms have a rather negative opinion about the local business environment, but they argue that if you want to be present on such a market, you have to accept that market conditions are not of Northern European condition. The idea that the business environment in Milan is not of northern European standards is confirmed when Porter’s location theory is used to judge the local location factors. The Dutch subsidiaries in Milan combine sufficient internal networks with many external relationships with local actors and in this way, they may cause a positive spillover effect on the local economy. It is important to make sure these internal relations stay sufficient, because the transfer of knowledge is important for the subsidiary as well as for the mother company.

# Chapter 1

# Introduction

Italy, as a member of the European Union, offers large opportunities for Dutch firms. The country has a large national market with almost sixty million consumers. The integration of the European internal market has stimulated Dutch investments in Europe the last decade. (DNB, 2006) In Italy, there are large socio-economic differences, the northern part of Italy is far more prosperous than the south. (OECD, 2001) More specific, the most prosperous part is the 'golden triangle' Milan-Turin-Genoa. (Infoplease, 2006) Therefore, it is interesting to investigate the functioning of Dutch firms in this area, in this case in Milan, and to explore if these Dutch firms in Milan have different characteristics than Dutch subsidiaries in the rest of Italy.

The last decade, there has been an institutional turn in economic geography. A recognition developed among economic geographers that the form and evolution of the economic landscape cannot be fully understood without giving due attention to the various social institutions on which economic activity depends and through which it is shaped. (Martin, 2003) Because of this development, proper integration of foreign establishments in the local economic context is seen as an important success factor. The type of investment influences the degree of integration. There are many motives to invest abroad, and these different types of motives lead to different types of investments.

The goal of this survey is to understand why Dutch multinationals invest in Milan and why they act as they do. There is a lot of theoretical information available about foreign direct investment. The functioning of Dutch firms in Milan is explored with support of this information. The first step of the research will be to understand the motives of Dutch firms that invest in Milan. The second step is to study the way the established subsidiaries act there. The last step in this research is to study the possible effects of Dutch multinationals on the local economic context in Milan.

The following questions are formulated in order to discuss the topics mentioned above. The central research question of this master thesis will be split in seven questions. The central research question of this research is as follows:

***"How do firms owned by Dutch companies function in the Milanese economic context?"***

I will try to answer this central question by answering the following questions:

1) Which activities are transferred to Milan and for what reason?

2) What are the attributes of the firms (partially) controlled by Dutch firms in Milan?
   -Year of establishment in Italy?
   -Sector?
   -Number of employees?
   -Turnover?
   Do these attributes differ by sector, period of establishment and geographic location?

3) Which customer and supplier relationships do subsidiaries of Dutch multinationals in Italy have?

4) In which degree are these companies embedded in the regional context? And which factors influence the degree of embeddedness?

5) What is the degree of sovereignty of the firms involved? Which factors influence the competivity of a firm, and what is the influence of sovereignty on the competitiveness of a firm?

6) Is Milan an attractive region to invest in? This question will be answered by using the location theory of Porter (1990) and the constraints to direct investment in Europe that were mentioned by Dutch scholar Westerman (2003).

7) The last question has to do with the institutionalist approach. The economic geographer Ron Martin (2003) formulated the embeddedness hypothesis. This hypothesis argues that trust, reciprocity, cooperation and convention play a key role in successful regional development. Is regional economic development in Milan stimulated by increased embeddedness of foreign multinational firms?

The conceptual scheme of the rest of this report will follow in the next chapter.

# Chapter 2

## Methodology

This essay starts with an exploration of the theoretical background of foreign direct investments. In the second chapter I will define foreign direct investments and multinational firms. After this, the characteristics of world wide FDI flows will be descrided. Then focus will be moved to the characteristics of specific Dutch outgoing FDI. The chapter moves on with an exploration of literature in which different types of FDI and different motives for FDI are discussed. The location factors that influence the direction of FDI are discussed in paragraph 3.3. This chapter ends with a discussion of the concept of “embeddedness” and its relation with the functioning of MNC´s.

Now the theoretical background behind the subject of this essay has been discussed, we can move on with the discussion of the empiric data, as well quantitative as qualitative. A very important source of information for this report is the extensive database in which information on Dutch subsidiaries in Italy is enclosed. It comes from the Technical University of Milan, where professor Mutinelli has collected information about foreign establishments in Milan. This database supplies me with information about the specific geographic location of Dutch subsidiaries in Italy, their activities, their turnover and their number of employees. This database makes it possible to compare the functioning of Dutch firms in Milan with other Dutch subsidiaries in Italy. A statistical method called the *difference of proportions test* is used to find out whether there exist statistically significant differences between the population of Dutch subsidiaries in Milan and the population of Dutch subsidiaries in the rest of Italy.The analysis of the quantitative data can be found in chapter 4.

In the following chapter I will summarize and analyze the interviews held with local managers of Dutch subsidiaries. In this chapter, the qualitative data will be discussed. This interviews help in understanding the functioning of local Dutch subsidiaries and they show the way in which local managers perceive the local Milanese economic environment. In chapter 6, the theoretical information is integrated with the qualitative and quantitave data, in order to answer my research questions and understand the functioning of Dutch multinationals in Milan. The construction of this report is shown by the following conceptual scheme.

| | |
|---|---|
| Chapter 1 | Definition of the research question and formulation of the research questions |
| Chapter 2 | Explanation of the methodological procedure |
| Chapter 3 | Elaboration and theoretical background of the problem: summary of state-of-the-art literature that explains the spatial diffusion of MNC´s. Explanation of theoretical concepts that will be used in the report |
| Chapter 4 | Analysis of the quantitative data: this data comes from the database supplied by the Politecnico di Milano |
| Chapter 5 | Analysis of the qualitative data: this data comes from the interviews held with managers of Dutch establishments in Milan |
| Chapter 6 | Integration of theory and empirics: in this chapter the research will questions will be answered. This chapter ends with the final conclusions of my research and recommendations for further research. |

*Figure 2.1: Conceptual scheme of the research report*

# Chapter 3

## Elaboration and theoretical background of the problem

In this chapter, the theoretical background behind the subject of this thesis will be discussed. I will start this chapter with a description of the geographic focus of my research. This research focuses on Dutch foreign investment in the province of Milan. In paragraph 3.2, I will define the characteristics of multinational companies and foreign direct investment. After this, I will define the development of the flow of worldwide FDI, and more specifically, the development of FDI flows from the Netherlands to Italy. Paragraph 3.3 contains information about the incentives for companies to directly invest abroad, and about the benefits and constraints connected with foreign direct investments. The different types of FDI will also be described in this paragraph. The question which location factors are attractive to different categories of foreign investors is answered in paragraph 3.4, together with the effects of foreign direct investment on host and home economies. Eventually, the theoretical concept of embeddedness is discussed in paragraph 3.5.

## §3.1

## Geographic focus of the research

This research is focused on the province of Milan in Italy. This province is part of the North-Italian region Lombardy. The province of Milan is about 2000 square kilometres and is inhabited by approximately 4 million inhabitants. Milan is known as one of the three poles of the “golden triangle”, in the north of Italy. This triangle is formed with the cities of Turin and Genoa. Milan is considered the economic capital and financial centre of the country. (EU, 2006) The city is located in the most industrialised and populated part of the country, Lombardy. This is the richest region of the country. (The Economist, 2006) The location in this area causes the commercial prominence of the city. Milan lies at the heart of an extensive network, is surrounded by two large airports, Malpensa and Linate, and is located close to other countries in Europe. (The Economist, 2006) The city also possesses an extensive subway system, called the *Metropolitana*.

There are several reasons why Dutch multinationals tend to focus on Milan when they decide to invest in Italy. As mentioned, the city is surrounded by extensive infrastructure, the city is relatively close by relative to other Italian cities and there is a relatively high level of education. Moreover, there is the simple fact that Milan is the economic centre of the country.

The economy of Milan is characterised by its mixed structure. Some of the most important groups at the national level have their headquarters and plants located in the Milanese metropolitan area. However, the last decades there has been a reduction in the number of large firms, and an increasing importance of the service sector. This resulted in a concentration of “white collar” functions concentrated in the centre of the city. This sector shift will also be observed at Dutch multinationals, in chapter 3. Nowadays, the leading economic sectors in Milan are trade, the financial sector, research and development, the fashion-sector and the publishing and communications sector. (EU, 2006) The well-known city’s stock exchange is the largest of the country.

*Regional context*

As mentioned above, Lombardy is the richest, most industrialized and most densely populated area of the country. In a research by two leading merchant banks, the region is called one of the four “economic engines” of Europe, together with Baden-Wurtenberg, Rhone-Alpes and Cologna. (Regione Lombardia, 2006). The region accounts for one-fifth of the total Italian Gross Domestic Product, and the unemployment rate is 3,8%, which is much lower than the national figure of 9,5%. The region is also the financial centre of the country and education levels are relatively high; Lombardy is the Italian region with the highest number of expenditures and the highest amount spent on scientific research. (Regione Lombardia, 2006) Being the largest and most important city of this region, there is no doubt about the important role Milan plays in Italy.

*National context*

Italy, with about 58 million inhabitants, is a country that is known for its large regional disparities. There is a sharp divide between the North and the South of the country. The economic superiority of Milan and Lombardy that is described above, is contrasted by the economic problems in the south, the “Mezzogiorno”. The differences between the north and south, when income, employment and education are concerned, are large. Where the north of the country succeeded to connect itself to the economic development in the surrounding countries after Second World War, the Mezzogiorno stayed behind. However, some convergence between the weak and strong regions is noticed by the OECD in the 90’s, there are still large economic disparities. (OECD, 2001)

## §3.2

## Characteristics of multinational companies and foreign direct investment

Multinational Companies (MNC's) are important players in the global economy. For example, they take care of approximately twenty percent of the total employment in production in Europe. Another example of the importance of MNC's is that they earn every fifth dollar in the production sector in the United States of America. (Barba Navaretti & Venables, 2004)

However, there exist some mixed feelings about MNC's around the world, under citizens as well as under economists. On one hand, policy-makers are delighted with foreign investments in their country and they are proud of their nation's large and well-known multinational companies. On the other hand, there is much concern about the closure of facilities in the domestic market because of investment in foreign countries and there is concern whether domestic companies can challenge the effectiveness of foreign countries. However, these feelings are often not based on any economic and scientific arguments. (Barba Navaretti & Venables, 2004) Therefore, it seems to be useful to discuss some empiric and scientific information about the functioning of multinational companies.

*Definition of multinational companies and foreign direct investments*

Let us start to define to define multinational companies. Barba Navaretti and Venables (2004) define multinational companies as "firms that own a significant equity share (typically 50 percent or more) of another company (henceforth subsidiary or affiliate) operating in a foreign country". Therefore, companies that have an over 50 percent share in a foreign country are concerned. Multinationals can be large, globally known companies like Coca-Cola, Nike or General Motors, but multinational companies can also be relatively small companies with not more than one facility in a foreign country. (Barba Navaretti & Venables, 2004) It is important to stress that foreign direct investments are not about outsourcing activities to a foreign country, but about the transfer of activities to a foreign country where this is, activity is performed by a (partially) owned subsidiary. This is an important difference between outsourcing and foreign direct investment. (Barba Navaretti & Venables, 2004)

A striking characteristic of a multinational company is its size. Though there is mentioned that a MNC does not have to be a large company by definition, the mean size of a multinational is larger than the mean size of a single-nation company. (Griffith & Simpson, 2001) When we look at the mean number of employees and the mean turnover of MNC´s, it appears that these are higher than these of national companies are. Productivity of MNC´s is often higher than the production of single-nation firms, too. (Barba Navaretti & Venables, 2004). The reason for this will be discussed later on.

In many cases, there is not enough data available about capital flows between and within MNC's. Therefore, MNC's capital flows are measured by flows of Foreign Direct Investment (FDI). These flows contain the costs of new investments, the profits of foreign subsidiaries, internal loans and border-crossing mergers and acquisitions (M&A's). In other words, to start a foreign establishment, to acquire a foreign company or to expand a foreign subsidiary, a multinational uses FDI. (Barba Navaretti, Checci & Turrini, 2003)

*Development of global FDI flows*

The past decades, there has been a large increase in worldwide flows of foreign direct investment. Especially between 1985 and 2000, these flows have increased extremely. Statistical information by

UNCTAD shows that the largest part of these flows is coming from developed countries. Between 1998 and 2001, 92,9 percent of total FDI was coming from the developed world. However, not only are these flows mainly originated in developed countries, these investments are also mainly flowing to developed countries. (Barba Navaretti & Venables, 2004)

However, in the nineties a strong increase of incoming FDI in developing countries has been mentioned. In 1991, they only received 21 percent of total FDI, in 1997, this has doubled to 42 percent. It was mainly the Latin-American and Asian economies that were responsible for this increase. However, they were also responsible for the sharp decrease after 1997. In the late nineties, the economic crisis in Asia caused uncertainty about the economic stability in Asian countries and developing countries in general. (Barba Navaretti & Venables, 2004) The tables below, table 3.1 and table 3.2, show statistics about worldwide FDI-flows, as well incoming flows as outgoing flows. The high-income regions include the USA, Europe, Japan and parts of Oceania. The developing and transition regions include Latin America, Africa, Asia without Japan, parts of Oceania and Eastern Europe.

| | **1970-1978** | **1979-1988** | **1989-1994** | **1995-2001** |
|---|---|---|---|---|
| High Income Regions | 76% | 73% | 69% | 68% |
| Developing and Transitions Regions | 24% | 27% | 31% | 32% |

*Table 3.1: Incoming FDI, % per area (UNCTAD, 2001)*

The establishment of a foreign subsidiary can take place in two different ways. The first way is to decide to obtain a foreign subsidiary by merger or acquisition. The second way is to start a completely new establishment in a foreign country, a so-called *Greenfield entry*. It appears that mergers and acquisitions (M&A) are responsible for the largest part of flows of FDI. What is striking, is that in developing countries, MNC's often choose a Greenfield entry. (Barba Navaretti & Venables, 2004)In the following table, the shares of Greenfield entry and M&A in global FDI flows are shown.

| **1998-2001** | **M&A** | **Greenfield** |
|---|---|---|
| World | 76,2% | 23,8% |
| Developed countries | 89,0% | 11,0% |
| Developing and transitions countries | 35,7% | 64,3% |

*Table 3.2: Share of M&A and Greenfield entry in total incoming FDI flows, % (UNCTAD, 2001)*

There are some clear differences in the sector distribution of FDI flows. According to statistics from UNCTAD (2001), about 8 percent of the global FDI flow concerns the primary sector, 41,6 percent of total FDI flows belong to the production-sector and a mayor 50,3 percent belongs to the service-sector. The sectors in which presence of FDI is most common are characterised by large investments in research and development, a large share of well-educated personnel and the production of technological complex and differentiated goods. (Barba Navaretti & Venables, 2004)

*The Netherlands: flows of foreign direct investments*

In 1985, the Dutch foreign direct investments accounted approximately €60 billion. Nineteen years later, in 2004, the outgoing flow of Dutch FDI accounted €437 billion. Therefore, the total amount of money spent on FDI in the Netherlands has seven folded the past two decades. A large part of this amount, €300 billion, is spent in Europe and more than half of the total amount, €244 billion, is spent in the European Union. The share of Dutch FDI that flows to the European Union almost doubled the past two decades. In 1985, the share of Dutch FDI flowing to the countries of the European Union was 36 percent, in 2004, this share was 69%. (Dutch National Bank, 2006) Off course, this increase is partly caused by the increase of countries belonging to the EU.

But there is a second cause. For a large part, the increase is caused by increasing horizontal investments. Because of the integration of the European internal market, there has been a sharp decline in "trade costs". These costs involve costs of transport, import barriers, costs caused by communication and differences in legislation. However, as we will see later, an important reason to decide to invest horizontally is to avoid trade costs. So when trade costs fall, a large increase of horizontal investment may not be expected. The reason for the increase of horizontal investment is the fact that the European integration has caused a wave of border-crossing mergers and acquisitions. This wave of mergers and acquisitions is a result of the restructuring of the European economy because of the development of one internal market. (Barba Navaretti & Venables, 2004)

In 2004, the FDI flow from Holland to Italy accounted €12 billion. There are eight countries that receive a larger amount of investment from The Netherlands. An overview of the 10 countries that receive the most FDI from Dutch firms is shown in the following table. This table shows that Dutch outgoing FDI mainly goes to other developed western countries.

| | | |
|---|---|---|
| 1 | USA incl. Puerto Rico | 65.471 |
| 2 | United Kingdom | 60.125 |
| 3 | Belgium | 40.181 |
| 4 | Germany | 33.696 |
| 5 | Switzerland | 31.141 |
| 6 | France | 28.420 |
| 7 | Luxembourg | 23.742 |
| 8 | Spain | 17.888 |
| 9 | Italy | 12.338 |
| 10 | Ireland | 10.861 |

*Table 3.3: Top-10 countries receiving FDI from the Netherlands, x million € (Dutch National Bank, 2006)*

In 1984, the flow of FDI towards Italy was only €832 million. The Italian share in the total Dutch FDI portfolio increased from 1,4 percent to 2,8 percent. (Dutch National Bank, 2006) This increase is according with the increasing importance of investments in Europe that was mentioned above. In the graph below, the growth of Dutch foreign direct investments is shown on a global, continental and single-nation scale

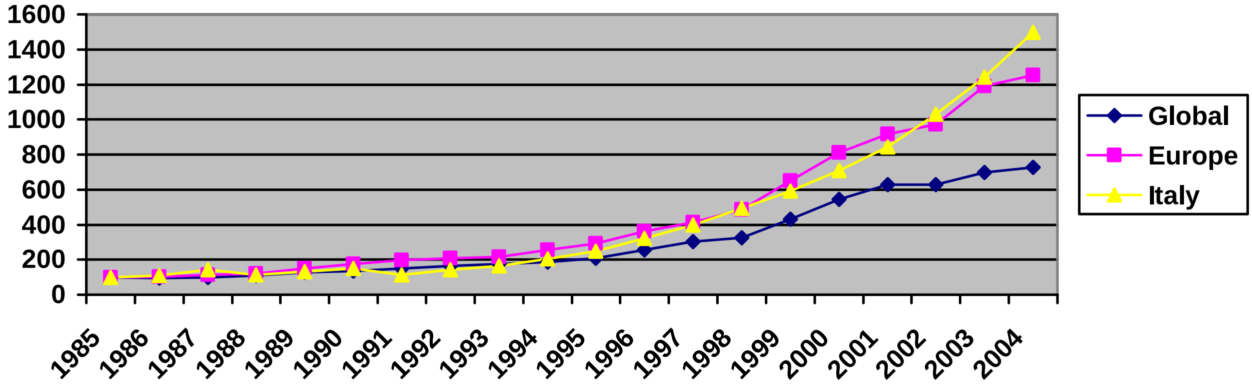


*Figure 3.1: Index growth of foreign direct investments by Dutch firms, 1985-2004 (Dutch National Bank, 2005)*

*Development of Dutch outgoing FDI flows with regard to distribution between sectors*

Not only the size of Dutch outgoing FDI flows has changed dramatically the past decades, the distribution of investment between different sectors also changed. The emphasis has turned more and more towards investments in the service-sector, while the share of industrial investments has decreased. In 1984, almost 70 percent of Dutch outgoing FDI flows were industry-based. In 2004, this share has decreased to 40 percent. In this year, a major share of about 60 percent of the investments was service based. (Dutch National Bank, 2006) Data from the Dutch national bank shows that Dutch FDI flows inside Europe are more often service based than FDI flows that are global. The next figure clearly shows the increasing share of service-based investments in total Dutch outgoing FDI on a national (Italy), continental (Europe) and global scale.

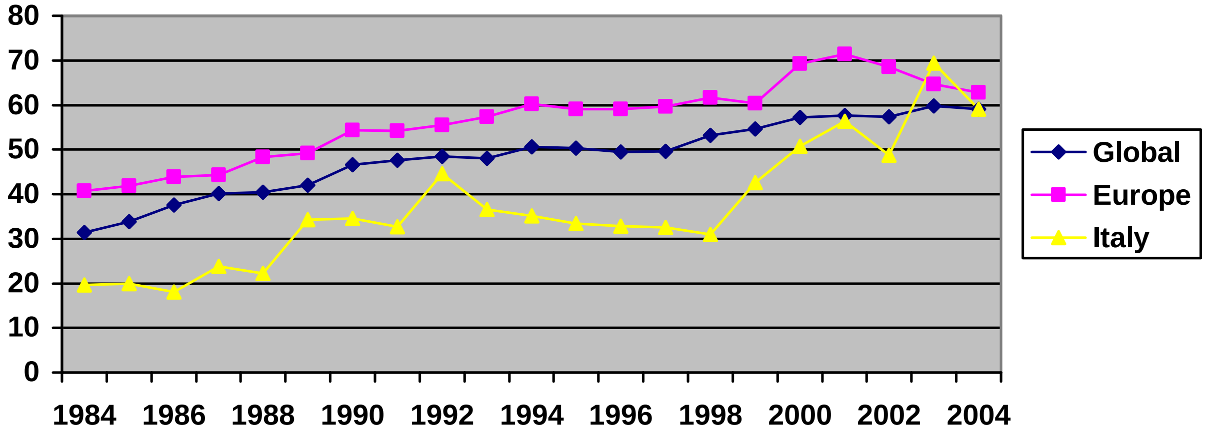


*Figure 3.2: Share of Dutch FDI in service sector, 1984-2004 (Dutch National Bank, 2006)*

**§3.3**

**Why do firms invest in foreign countries and which forms of FDI exist?**

More than ever, firms have the choice to decide where to locate parts of their production process. They can choose between their domestic country and countries abroad. Activities are transferred to countries that are economically less developed than the domestic country, and are transferred to countries that are equal from an economic point of view.

As mentioned above, this move towards a foreign country can take place in two different ways. This can take place by mergers and acquisitions, and by start-ups, the so-called Greenfield entry. However, there are some major differences between these ways of investment, they have one important characteristic in common: they result in the geographic dispersion of company activities. (Barba Navaretti, 2004) Two types of foreign direct investment exist, these are horizontal FDI and vertical FDI. Both types have different causes and characteristics, and will be explained in the following paragraph.

However, we will start this chapter by describing the theoretical background of the process that precedes direct investments in foreign countries. Foreign direct investment is very often a last step in a long pathway. This pathway is described underneath.

*Pathway to internalization / foreign direct investment*

As mentioned above, foreign direct investment is often a last step in a long pathway. This pathway is described in the book of Lowes, Pass and Sanderson. They describe a path of five steps, and by each step, the firm will involve deeper in a foreign market. This approach, the slowly, stepwise entry of a market is called the ‘incrementalist approach’. The five successive steps in the pathway to internationalisation are shown in the next table.

| | |
|---|---|
| 1 | Initially, a firm may avoid the risk of foreign investment by arranging a licensing deal with a local firm. When a firm has a specific advantage in technology, and does not produce a standardized product, it may reject this step. |
| 2 | The next step will be export via an agent or a distributor. |
| 3 | As foreign sales will build up, the firm may export through its own local sales representative or establish a sales subsidiary. |
| 4 | Then, as the firm becomes more familiar with the foreign market, it may begin to move into foreign production, by engaging in local assembly and packaging. |
| 5 | When the firm has generated sufficient knowledge on the host country, it may start to set up its own local production facility. |

*Table 3.4: Stages in the pathway to internationalization (Lowes, Pass and Sanderson, 1994)*

With this pathway, Lowes, Pass and Sanderson focus on market orientated, horizontal FDI. This pathway is specifically applicable to firms that invest in foreign market inspired by market motives. This model shows that the decision to invest directly abroad is often a result of a process that is internationalization and market survey that lasts a long time. Many companies only decide to practice complete market entry when they have gained enough information about a specific market. This results in a decrease of risk for a company. Foreign direct investments can be divided in two categories, horizontal and vertical FDI. These types will now be described..

*Horizontal foreign direct investment*

Horizontal FDI accounts for the largest share in worldwide FDI-flows. This is illustrated by the fact that approximately 90 percent of worldwide FDI flows take place between developed countries. Horizontal FDI occurs mainly between developed countries. (Barba Navaretti & Venables, 2004) We speak of horizontal FDI when a company decides to duplicate certain parts of the production process abroad. Horizontal investment is driven by the wish to enter a foreign market. When a company decides to start production in a foreign market to supply that market, we speak of horizontal FDI. This causes loss of certain economies of scale, but only at plant level, not at firm level. (CPB, 2005)

Flows of horizontal FDI often take place between similar countries, as mentioned before. According to Shatz (2003), the level of mutual flows of investment depend on factors like the gross domestic product of both countries, the distance between both countries, a mutual border and cultural characteristics like a similar language. For example, almost 90 percent of Dutch outgoing FDI flows go to the EU, North America and Australia. These three area's account for almost 70 percent of the incoming FDI-flows in the Netherlands. (Dutch National Bank, 2005)

*Vertical FDI*

A second way to disperse activities geographically, is by applying vertical FDI. Vertical foreign direct investments are based on the fact that there are differences in production costs between countries. In some countries, costs of production are (much) lower than in other countries. Labour costs per hour are much lower in developing countries than in developed countries. These differences in labour costs can be exploited by international trade and investment. In case of vertical FDI, companies do not duplicate their production processes abroad. Instead, a company decides to disperse the production process geographically by *function.* By splitting the production process in small different parts, and transfer parts of this process abroad, a company can save on production costs. (CPB, 2005)

An important and well-known example of low factor costs is low labour costs in developing countries. Because of these low labour costs, it is very attractive for multinationals to transfer labour-intensive production activities that require low-skilled labour to countries with relatively low wages. Well-known examples are investments by US companies in Mexico and investments by West-European companies in Eastern Europe. Contrasting with horizontal investment is the fact that vertical FDI does not occur mainly between similar countries, but between countries that differ in factor costs. (CPB, 2005)

Some comments must be placed. However low wages are off course very attractive to multinationals, low wages do not necessarily mean low production costs. This is because labour productivity in developing countries is lower than in developed countries. Therefore, the labour productivity has to be taken in account while determining the production costs. Second, there has to be a difference in the sector distribution of different parts of the production process. Otherwise, there is no need to split the production process geographically. (Barba Navaretti & Venables, 2004)

However, there are costs attached to vertical FDI. Splitting the production process geographically means that economies of integration are foregone. For example, there are costs attached to shipping commodities between the different parts of the production process. This *disintegration costs* that are the result of splitting the production process are an incentive to concentrate the production activities geographically. (Barba Navaretti & Venables, 2004)

In the following table, differences between horizontal and vertical FDI are shortly summarized. It is clear that costs and benefits of both forms of FDI have different causes.

| | Horizontal FDI | Vertical FDI |
|---|---|---|
| Costs | -Economies of scale foregone | -Disintegration of costs |
| Benefits | -Market entry<br>-Lower trade costs<br>-Improvement of strategic position | -Lower costs of production |

*Table 3.5: Costs and benefits of horizontal en vertical FDI (Barba Navaretti &Venables, 2004)*

*Motives for FDI*

The motives of a company to duplicate a part of the production process elsewhere can be found in the tension that exists between trade costs and economies of scale. At a certain level of production, the trade costs are higher than the benefits of scale economies, what is an incentive for horizontal investment. Trade costs include transport costs, import costs, trade barriers, communication costs et cetera. (CPB, 2005) Economies of scale imply that marginal costs lower when production increases. These economies of scale occur when fixed costs can be spread over a larger production of a plant. When production is fragmented over different geographical areas, a firm will avoid trade costs, while the benefits of economies of scale will decrease. (Barba Navaretti & Venables, 2004)

When a company decides to produce abroad, near local customers and suppliers, they have to pay less trade costs. This phenomenon is called “tariff jumping”. Therefore, high trade costs are an incentive to produce abroad. However, avoiding trade costs is certainly not the only reason to decide to invest horizontally. When companies act in a local foreign market, they will be capable of easily adapting their products to the demands and circumstances at the local foreign market. This is illustrated in the book of Barba Navaretti and Venables (2004), in which the website of Dutch/English multinational Unilever is quoted:
*“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.”*

A next advantage of acting in a foreign market is the improved competitiveness. Because the multinational is now able to produce with lower costs, it is able to sell its products for lower prices. As a result of this, the multinational can increase its market power. When a company invests by applying the tactic of merger or acquisition, it will increase its market power by directly eliminating a competitor. So, increased competitiveness and increased market power is an important advantage of horizontal foreign direct investment. However, the size of the foreign market is important for the multinational. This is because entering a foreign market by direct investment requires high fixed costs and the larger the market, the better and faster these costs can be regained. (Barba Navaretti & Venables, 2004) Europe is a good example of the last phenomenon. The countries of the European Union saw a large increase of incoming flows of FDI,  because they became more attractive to invest in. This increased attractiveness seems to be a result of the development of an internal market.

Firms decide to relocate activities to countries abroad because this relocation offers benefits. When consumers are geographically spread over different countries, this will be an incentive to spread activities geographically. This is because there are costs involved with supplying these customers abroad. By using local production, transport costs, trade-barriers and import costs can be avoided. The IOO (1999) mentions four different motives for the application of foreign direct investments, some of which are already discussed above.

*Natural resource seeking:* Resource-seekers are companies that invest abroad to obtain specific production goods at lower costs than in their native country. Dunning (1993) incorporates three sorts of firms in his definition of resource seekers. At first, there are companies that want to obtain specific, location tied production goods. Second, there are companies looking for cheap, low-skilled labour. The third kind of resource-seekers are companies looking for technological knowledge and managerial and organisational expertise. The motives of the latter two types are closely connected to the efficiency seeking and the strategic asset-seeking motive.

The first sort of firm, looking for specific location tied production goods are called "natural resource seekers". For these companies, low relative costs are not the major reason for FDI, but it is the quality and availability of production goods that is crucial for undertaking FDI. Additionally, FDI makes sure that these companies have more control over the supply of important inputs. Natural resource seeking acquires a relatively high input of capital and needs high initial investments. This motive is important for firms that use minerals and agricultural products. Additionally, natural resource seekers are acting in the service sector. In this case, the make use of location tied production good, like places that are attractive to tourists. (IOO, 1999)

*Market seeking motive:* The goal of the foreign direct investment is to serve the local market. There are five important advantages connected to serving the local market by local production instead of serving it by exports. The first one is that it is easier to adapt production to the wishes of local consumers. This motive is important to firms that produce goods, which should be precisely fitted to the constantly changing demand of customers. A second advantage of local production is that transport costs are saved. However economies of plant scale can be foregone, this loss can be minimalized by "export platform-seeking", through which several markets are served by one plant. A third reason for local production is the presence of important clients. An example is the presence of the presence of about 300 car-part manufacturers in the USA to attend local Japanese car manufacturers. A fourth reason, which is of increasing importance, is the wish to be presented in countries where other multinationals are also present. This is especially the case in markets dominated by a few global suppliers, like the markets of rubber, car tyres and medicines. The last reason to serve the local market by local production is the presence of trade barriers. When a company undertakes FDI, these costs are foregone, so called *tariff jumping*. (IOO, 1999)

*Efficiency seeking motive:* According to Dunning (1993), efficiency seekers are firms that already have production facilities abroad, because of market seeking of resource seeking motives. These companies organise their international production in such a way that the efficiency of the company as a whole is increased. Efficiency seeking is defined as "undertaking of FDI to lower the costs of one ore more parts of the production process" (IOO, 1999). Efficiency seeking can be accomplished by realisation of economies of scale and risk spreading, as well as through utilize differences in factor costs between countries. The latter type is characterized by vertical FDI. The diminishing of trade barriers between developed countries, like the realization of the European market, increases FDI because of efficiency seeking. (IOO, 1999)

*Strategic asset seeking motive:* This means that firms try to internalise knowledge and strategic advantages of other firms by mergers and takeovers. These advantages can consist of technical knowledge, brand names and market share. This motive became more important in the last years and is an important explanation for the wave of mergers and takeovers in the nineties. The difference with the market-seeking motive is the fact that the primary goal of firms that are looking for strategic assets is not the serving of the local market. The primary goal of these firms is to strengthen or at least maintain their international competitiveness. (IOO, 1999)

*Importance of the different motives*

It is supposed that in the past decades, the motives of efficiency-seeking and strategic asset seeking have gained importance. This is caused by the integration of the markets of developed countries. An important example is the integration of the European market. The value of incoming FDI in the USA, caused by mergers and takers is four times larger than the value of incoming FDI caused by Greenfield entries. (UNCTAD, 1997) A great share of these mergers and takeovers are established because of the strategic asset-seeking motive.

De Groot (1994) has done a research to find out why Dutch policy makers plan foreign direct Investments. It appears that 50% of the planned investments were caused by the motive of market seeking. A research by Bernard (1997) unfolded that there are differences between the motives of companies in different sectors. Market related motives (market-seeking and strategic asset seeking) seem to be more important to service companies than to industrial companies. The importance of the market-seeking motive is also shown by the research of Hatem (1998), which shows that the market-seeking motive is most important to policy makers. This research also makes clear that the strategic-asset motive is more important to large companies as it is to small multinationals.

*Causes of sectoral differences in FDI levels*

It is important to make a distinction between economies of scale at firm level and economies of scale at plant-level. High economies of scale at firm level imply that companies will be large and tend to sell their products in many countries. High economies of scale at plant-level imply that firms will not be eager to split up their production process. This is because a large part of the scale economies at plant-level will be foregone in that case. The result of these tendencies is that multinational companies will be most common in sectors where high economies of scale at firm level and small economies of scale at plant-level exist, what makes it relatively easy to split the production process. Data form the US Bureau of Census indicates that there are relatively many multinational companies in sectors with relatively large economies of scale at firm level. (Barba Navaretti & Venables, 2004)

Horizontal investments can be expected in sectors where finished products have large transport costs, like the car-industry. This results in high trade-costs. Vertical investment can be expected in sectors where trade costs and disintegration costs are low. (Barba Navaretti & Venables, 2004)

*Fragmentation*

Dispersion of the production process, as described above, is also called “fragmentation”. According to Venables (1999), fragmentation is stimulated by disappearing trade barriers and decreasing costs of transport and information. These developments make it easier to disperse an integrated production process. The development of information technology makes it easier to keep control over the business at subsidiaries abroad. Research by Venables points out that that fragmentation leads to the occurrence of vertical as well as horizontal multinationals. When “upstream” production (at the end of the production process) is labour-intensive, companies tend to become vertical MNC’s, while companies tend to become horizontal MNC’s when downstream (in the beginning of the production process) production is labour-intensive. In addition, when there are a high trade costs involved with downstream activities of the company, the company will tend to develop into a horizontal multinational company. Take, for example, the car-assembly plant of Japanese car producers in the United States and Europe. These overseas facilities make sure the Japanese firm will avoid high trade costs. (Barba Navaretti & Venables, 2004)

Venables mentioned trade barriers as one of the incentives that stimulate the start and expenditure of multinational companies. The goal of the European Union is integration of the domestic market, so free movement of commodities, services, capital and people will be possible. Theory says that the creation of a large internal market should increase an increasing flow of inward FDI. As we saw above, this is the case. Integration of the different markets will also radically lower trade costs between countries in Europe. At European scale, a decrease in horizontal investment and increase in vertical investment is expected from theory, because cost differences can be exploited easier. Statistics from UNCTAD (2000 and 2001) indicate that inward and internal FDI flows have increased. However, what appears is that the internal FDI flows are mainly horizontal and not vertical. This is not what was expected. Well, this is a result of the restructuring of the European economy in the nineties. The intensive process of integration has caused a serious economic restructuring and the large flows of mergers and acquisitions are caused by a large amount of border-crossing mergers and acquisitions. (Barba Navaretti & Venables 2004)

*Benefits of foreign direct investments compared with the benefits of outsourcing*

There are more ways to internationalize a company's activity. A company can choose other strategies to enter a foreign market. For example, a company can choose to outsource production or to licence a company abroad to use the brand and the knowledge of the company. The choice between keeping the production in own control by direct investments abroad and the outsourcing of activities is called the "make-or-buy-decision". (CPB, 2005) To make a choice between these two options, a company should compare the high fixed, starting costs of a direct investment with the costs that are attached to the outsourcing of activities.

There are some inefficiency costs that have to do with foreign direct investment. In case the company decides to develop a certain activity abroad, it neglects other, local, companies that are able to produce cheaper. There is a possibility that a local company can produce cheaper because such a company has specific knowledge about the local market, about production, and because there is a chance that the local company benefits from large-scale economies. By choosing for internal production, costs of production can turn out to be relatively high. (Barba Navaretti & Venables, 2004)

The costs that are involved with the outsourcing of activities are trade costs, information costs and costs from incomplete contracts. The last costs have to do with the so-called hold up problem. (Barba Navaretti & Venables 2004) Additionally, some companies are afraid to share their technology (especially hi-tech companies) or are afraid to harm their image, like top-fashion companies. There are three practical problems involved with outsourcing of activities to foreign companies. These problems cause inefficiencies.

The first practical problem is the "hold-up" problem. In case not all uncertainties can be discussed in the contract, both parties may fear that the other partner will ask for renegotiation. Especially when the investment is specific to the relationship, the supplier will have a weak bargaining position. Fearing the uncertainties, the supplier's initial investment tends to be suboptimal. This leads to inefficiencies. A second problem has to do with the fact that a company does not like to transfer her assets, and especially knowledge, to local firms. When a firm's knowledge and production is transferred to a local firm, these assets can be transferred to the local market through learning by doing. In this way, a firm can create its own competition. The efficiency of the outsourcing will not be optimised if a firm chooses not to share its assets. This problem is an incentive to keep production internal and invest directly. The third problem is caused by so-called agency costs. There are costs attached to monitoring the firm to which the business if outsourced. When the outsourced activities become larger, it will become more difficult and more expensive to monitor and control the activities abroad. (Barba Navaretti & Venables, 2004)

*Constraints to Foreign Direct Investments*

Above, the motives for investing abroad have been mentioned, as well as the benefits of investing abroad. However, in literature, some disadvantages of FDI and some constraints to FDI are mentioned. Investing abroad can save costs but it can still be very expensive, particularly in industries that require large investments. The risk of failure is relatively large because a company invests in an unfamiliar market and can meet unexpected problems. This great risk of failure is often caused by cultural differences. This ignorance of local culture can be overcome by forming an alliance with a local partner (Lowes, Pass and Sanderson, 1994). Dutch researcher Westerman (2003) mentions some other constraints to foreign direct investments that are specific to the European Union.

There can be differences in legislation and tax policy that constrain foreign investment. Second, local companies can oppose to foreign investors. For example, they can force local governments to raise trade barriers in order to secure their own position. At last, the general economic climate can make it difficult to invest successfully. This general economic climate consists of economic circumstances, institutional factors (for example, the influence of banks) and cultural differences. (Westerman, 2003)

*Why are performances of multinationals superior to performances of national companies?*

In the previous paragraphs, some advantages of multinational companies are already discussed. For example, horizontal investment makes it possible for a multinational company to benefit from huge economies of scale at firm level. Vertical investments make it possible to benefit from lower production costs abroad. In fact, there is a lot of empirical proof for the hypothesis that MNC's perform better than national companies. Surveys from the USA, the UK and Italy point out that the labour productivity of MNC's is much higher than the productivity of national companies. Ratings vary from a 30 percent to a 70 percent higher labour productivity at MNC's. (Griffith, 1999) The superior performances of MNC's are shown in table 2.4. In this table, employment, turnover and turnover per employee of MNC's and national companies from five different countries are compared.

| | **France** | | **Germany** | | **Japan** | | **Great-Britain** | | **USA** | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Mnc | NonMnc | Mnc | NonMnc | Mnc | NonMnc | Mnc | NonMnc | Mnc | NonMnc |
| Employees | 265 | 131 | 289 | 173 | 314 | 49 | 302 | 25 | 783 | 53 |
| Turnover (x mln$) | 61 | 26 | 106 | 34 | 184 | 12 | 95 | 5 | 235 | 11 |
| Turnover/employee (x mln$) | 0,2 | 0,2 | 0,4 | 0,2 | 0,6 | 0,2 | 0,3 | 0,2 | 0,3 | 0,2 |

*Table 3.7: Performances of multinationals compared to performances of national companies (OECD, 2001)*

As we see in this table, MNC's have higher employment, a higher turnover and a higher turnover per employee than national countries. However, some comments have to be placed to the superior performances of MNC's. The characteristics of MNC's automatically lead to superior performances. They have a larger size, spend more money on research and development, and they have relatively high-educated personnel. When companies choose a company to merge with or to acquire, often they will pick the best performer at a local market. When the data is corrected for these factors, performances of multinational companies are still 1 to 7 percent better than the performances of national companies. (Barba Navaretti & Venables, 2004)

## §3.4

**How do companies decide where to locate foreign direct investments and what are the consequences of foreign direct investments?**

In this paragraph, the influence of location factors will be discussed. There are different location theories, which explain the attractiveness of a region to foreign firms. The role of the government also plays a role in attracting and this role will be discussed. There will be effects in the host economy as well as on the home economy when a firm eventually decides to establish a foreign direct investment. These effects will be discussed in this paragraph.

*Location theories*

There are many different location theories that explain the spatial diffusion of companies. According to Pellenbarg (1985), there is no such thing as the one location theory. There is a large set of separate contributions, written by authors that can be classified in certain groups that all have their own theory. In general, two different sorts of location theories can be distinguished. These are the “classical” location theories and the “modern” or “behavioural” location theories.

The development of the classical location theories is initiated by German scholars like Von Thunen, Launhardt and especially Weber. According to Von Thunen and Launhardt, transport costs are an important influence on location choosing. The location theory of Weber is more extensive. He included more factors in his theory than transport costs alone. Weber assumed that the most attractive location was the place were total production costs were minimalized. Later, there emerged location theorists that took sale maximalization as starting point. They saw the market size and sale possibilities as important location factors. Losch is an important representative of this group of scholars. (IOO, 1999)

As time went by, many scholars considered the classical location theories to be imperfect. Modern location theories tried to enhance the classical theories. In the book of the IOO, special attention is given to the contribution of the economic geographer Porter to modern location theory. Porter (1990) added an important contribution to modern location theory. He looked at the influence of location factors on the competitiveness of countries in international trade. Porter was looking for the location factors that were critical for the international competitiveness of countries. This competitiveness is decisive for the amount of incoming and outgoing FDI. According to Porter, there are four main factors that are important to the development of competitiveness. They will be discussed underneath.

Factor conditions: the appearance of commodities, capital and labour; geographic position; quality of infrastructure etc.

Demand conditions: this condition involves the distribution, the size and growth of domestic demand, as well as the internationalization of domestic demand, through which domestic preferences will be implemented on foreign markets.

Networks between sectors: this condition involves the existence of extensive clusters of interdependent sectors, which are internationally competitive

Economic system: the organization type of the economy

Besides these four location factors, Porter mentions two additional factors, these are *chance* and *government*, whose role will be discussed later on. A distinction must be made between original and advanced factor advantages. Original factors are factors like geographic position, climate, appearance of commodities and a certain degree of education. These factors are kind of inherited from generation to generation. On the other hand, advanced factors are factors like telecommunication-infrastructure, existence of high tech institutions, the quality level of universities and the share of high-educated employees in the total workforce. These factors are not, or nearly not, inherited. There should be constant attention to these factors to keep them on a good level. Here is an important role for the government. (IOO, 1999)

Porter makes a second distinction. This is the distinction between general and specific factor advantages. Specific location factors are of increasing importance, according to Porter. An example is a high education level of the workforce, which is as such a general location factor. However, these high qualifications have to meet the specific needs of the business sector. Here we see the importance of specific location factors. The more an economic system is developing, the more the importance of specific factors is increasing. (IOO, 1999)

In paragraph 3.2, we discussed the motives of companies to invest abroad. Research by Dunning (1993) makes clear that there is a relationship between the existing locations factors in a country and the motives to invest in that country. Natural-resource seekers, market-seekers, efficiency seekers and strategic asset seekers have different interests in different location factors. The important location factor for the different kind of firm will be discussed underneath.

Natural resource-seekers: Off course, the appearance of commodities like oil or pre for example is essential for these firms. These specific commodities have to be available at relatively low costs. Additionally, there have to be convenient production facilities to work with these commodities. For some natural-resource seekers, the domestic market size and the quality of infrastructure can be important.

Market-seekers: For these firms, the size of the domestic market and the growth perspectives of the domestic market are the most important factor locations. Other location factors that are important to these firms are the level of competition on the local market, the differences in production costs between different countries and the level of trade barriers. The liberation of world trade causes a decreasing importance of trade barriers as a location factor. Another important location factor for these firms is the costs of local labour, and the quality and availability of the local labour-supply.

Efficiency-seekers: Regarding efficiency seeking companies, the most important production factor for these firms is the costs of production factors. If vertical FDI is involved, differences in labour costs between countries are important. Investment incentives, developed by local governments are of important concern to vertical FDI efficiency seekers, too. In case horizontal FDI is concerned, these location factors are less important. In this case, companies attach more value to costs and availability of skilled labour and transport and communication costs, as well as to the quality of the local infrastructure.

Strategic asset-seekers: For strategic-asset seeking companies, the local location factors are often of a minor concern. They are primarily interested in the assets of the company they will take over or merge with. The important location factors for these firms are connected to the specific business sector. However, political and economical stability has to be guaranteed on a certain level.

*Role of the government*

Multinational firms possess production facilities in several countries and these production facilities have a relatively high degree of mobility. This high degree of mobility affects the effectiveness of domestic tax- and trade policies. This fall in effectiveness is caused by *transfer pricing*, for example. In this case, a multinational firm transfers profits to low-tax countries. On the other hand, governments can decide to create tax advantages for MNC´s to seduce them to transfer facilities to this specific country. Some aspects of government policy towards multinational firms will now be discussed.

*Taxation*

Taxation is an important aspect of government policy towards MNC´s. The general theory of optimal taxation says there should be an inverse relationship between tax rates and the elasticity of supply of the tax base, as this would minimize the distortions caused by the taxes. (Barba Navaretti & Venables 2004). Therefore, the tax rate increases as the production factor becomes more inelastic. Translated to international trade, this means that the highest taxes are put on immobile factors. Since capital is the production factor with the highest mobility, the highest tax burden will be moved from capital to production factors that are less mobile, like labour and land.

Two important aspects are connected with the rise of multinationals. These two aspects are the *choice of tax principle* and the *problems related to transfer pricing*. Let us start with the first issue, the choice of tax principle. This is an important choice, it involves the question between residence-based taxation, and source based taxation. In case of source-based taxation, profits are taxed by the country in which the investments take place. Under the residence principle, taxes are levied on the ultimate recipients of profits, so where the capital owner lives. (Barba Navaretti & Venables, 2004) Literature shows that the residence-based principle has the most advantages, but still most countries use a tax policy that is based on the source-based principle. This is partly caused by the fact that it is very difficult to oppress a system based on the residence-based principle, because this brings many practical difficulties. For example, it can be very difficult to obtain exact information about profits that are made abroad. Therefore, mutual tax agreements are signed between countries, in order to improve international investments and trade.  Barba Navaretti & Venables, 2004)

The second specific problem connected with taxing multinationals is called “transfer pricing”. This means that MNC´s are able to spread profits between different parts of the firm in order to minimize their tax burden. Transfer pricing is caused by the fact that income is taxed differently in many countries, what makes it possible for MNC´s to minimize its tax burden by spreading their income between different countries. There are two ways for governments to stop this form of tax avoidance. The first solution is to require that transactions within MNC´s should take place at market prices - so called arm-length transactions. (Barba Navaretti & Venables, 2004). However, the problem is that there are no market prices available for many transactions. Additionally, it is undoable to track down all internal transactions of a multinational company. A second solution could be a change of the international tax system that involves a system in which the total income of a MNC is taxed, no matter where income is earned. (Barba Navaretti & Venables 2004)

It is clear that the rise of multinational firms and the ongoing process of globalisation of world economy lead to new demands on existing tax systems. Governments have to develop effective measures to come to a fair and stimulating tax system that satisfies the needs of the globalised world economy. Governments have to put many efforts in mutual consideration to come to develop the right tax policies and treaties.

*Trade policies*

Government's trade policies play an important role in the decision making process of firms that involves foreign direct investment. In this case, it is very important which sort of FDI is involved. In case of horizontal investments trade barriers lead to an increase of FDI, while in case of vertical FDI trade liberalisation leads to an increase of FDI flows. Normally spoken, the goal of trade policies is to secure domestic rents or employment. (Barba Navaretti & Venables, 2004) Think of the saving of income of particular population groups. However, FDI can affect the effects caused by trade barriers. This is shown by the fact that a part of the profits made through trade barriers can leak away, because a part of a production facility is owned by a foreign party. On the other hand, trade barriers can force a company to obtain foreign direct investments, instead of exporting goods. This may cause heavy competition on the domestic market that will harm domestic firms instead of protecting them. (Barba Navaretti & Venables, 2004)

Outgoing FDI-flows affect trade policies, too. Because of trade barriers, business of domestic multinationals abroad can be harmed, what is clearly not the desired effect. The fact that worldwide trade has liberalised, and trade barriers have decreased, caused a better condition for international fragmentation of production. Therefore, the liberalization of the world economy is partly connected to the strong increase of vertical FDI in the nineties. The liberalization of world trade also caused better conditions for export-platform FDI is some cases. A nice example is the establishment of American or Asian firms that serve the complete European market from one point in Europe. For these firms, export platform-FDI has gained attractiveness because of the combination of high external and low internal trade costs.

As mentioned above, there have been great changes in the attitude of governments towards foreign direct investments. The UNCTAD (2001) notices a shift towards a more liberal and stimulating policy towards FDI, and a decrease of protection policies. The policy measures of governments towards FDI can be divided in two categories. This are so called welfare improving measures and so called political-economy policies. Welfare improving policies are applied to compensate for market imperfections and thus increase national welfare. Political economy policies, on the other hand, are meant to keep certain population groups satisfied and to compensate them for effects of FDI that may turn out to be negative. Therefore, this form of policy measures exists to keep certain groups, farmers for example, satisfied. (Barba Navaretti & Venables, 2004)

Many countries and regions apply a stimulating and positive policy towards FDI. Regional and national governments try to seduce MNC´s to invest in their region by using certain incentives. The UNCTAD (1996) mentions three kinds of government policy that is meant to stimulate MNC´s to invest in a certain area. These three categories are fiscal incentives, financial incentives and other incentives. Fiscal incentives consist of direct or indirect subsidies or tax reliefs. Financial incentives consist of a number of measures that are there to ease the financing of new foreign direct investments. Most common examples of this kind of incentive are cheap loans for foreign investors and financial participation of the government in certain FDI projects. The third category, other incentives, consists of a large range of different measures that are profitable to foreign companies. Some examples are building of specific infrastructure and preferential treatment of certain foreign investors. The goal of all these measures is to decrease the investment costs for potential investors and to raise the attractiveness of the specific region. (Barba Navaretti & Venables, 2004)

*Effects of FDI on the host economy*

In this part, we will focus on the consequences of incoming flows of FDI. Theory and empirics show both negative and positive effects. Let us start with the negative effects of FDI for the host country. It is possible that the state will experience a loss of income. This is caused by the so called “tariff jumping”. This involves the implementing of horizontal investment, to avoid, for example, import tariffs. These tariffs are a source of income for the host country that will decline when horizontal investment substitutes import.

However, the effects of FDI on host economies are, for the greatest part, positive. For instance, there is a discussion going on whether multinational companies are good or bad employers. Well, according to Griffith and Simpson (2001), FDI has a positive influence on wage level. The research by Conyon (2002) says that wages in a company will increase with 3,4 percent after the national company is acquired by an MNC. In contrast, wages will drop by 2,1 percent when a subsidiary of a MNC is acquired by a national company. One of the other positive influences of FDI, especially vertical FDI, is that the knowledge level of the receiving country will rise. This is especially the case when the receiving country is a developing country. MNC’s generally transfer labour-intensive production, requiring low-skilled labour, to developing countries. The knowledge intensity of these activities is often much higher than the knowledge intensity of local firms, what results in increasing knowledge intensity of production in the host economy. (Barba Navaretti & Venables, 2004)

As we have seen in the previous paragraph, MNC’s perform better than national companies do. Therefore, when a national company is taken over by a multinational company, you can expect that this company will perform better after the take-over. This results in a positive effect on the host economy. Some people think that jobs at multinational companies are vulnerable, because MNC’s are supposed to change their location of production rapidly when they have the opportunity to produce cheaper somewhere else. Additionally, it is less difficult for a MNC to move production than it is for national companies. However, empirics do not indicate that jobs at MNC’s are vulnerable, according to a research by Barba Navaretti and Turini (2003). The opposite is the case, employees of MNC have less chance to lose their jobs than employees of national companies have. However, MNC’s react faster on changes in the economic environment, less people will lose their job than is the case at national firms. (Barba Navaretti & Venables, 2004)

The outcome of many surveys is that MNC’s have a spill over-effect. Spillovers are, for example, transfer of technological knowledge, transfer of market knowledge and transfer of knowledge about training and education. The degree in which a country will benefit from such spillovers has to do with the “absorptive capacity” of the country. The closer the level of technological development of the host economy is to the level of development of the sending country, the higher is the “absorptive capacity”. Therefore, spillovers in developed countries are higher than spillovers in developing countries. Haskel, Pereira and Slaughter (2003) have done a research on spillover effects in a developed country, the United Kingdom. They found out that when the share of MNC’s in a certain sector increases by 10 percent, production of national companies in that sector will increase by 0,5 percent. So here we have a positive effect of FDI on host economies. (Barba Navaretti & Venables, 2004)

Besides these effects, FDI also has an effect on the local market. When MNC’s are more efficient than national companies are, their performances will be better. This forces the other companies in the market to increase their efficiency. The least efficient companies will leave the market. This will increase the performance of the sector. However, there is a danger that multinationals obtain to much market power. In that case, inefficiencies caused by oligopoly or monopoly can occur. The last effect of FDI on host economies we mention is the creation of *backward-linkages*. The presence of a multinational company creates demand for local suppliers. These local suppliers will also raise their knowledge level by doing business with the multinational company. (Barba Navaretti & Venables, 2004)

*Effects of FDI on  the home economy*

The county that sends the outgoing flows of FDI experiences results, too. Considering the fact that multinational companies perform better than national firms, you can expect that firms that start investing abroad will achieve better performances. This has positive effects on the home economy. It is a widespread idea that vertical investments abroad lead to declining employment in the home country. Nevertheless, studies by Brainard and Rikert (1997) and Blonigen (2001) point out that the opposite is true. According to these studies, vertical direct investments complement home activities, while horizontal investment sometimes appears to substitute home activities for activities abroad. There is an explanation for this. Vertical investments cause lower production costs for the whole company. Production costs lower, and production might increase. This results in an increase, or no decrease at least, of employment in the domestic country. The situation is different when horizontal investment is concerned. Products that were first produced at the home market and were exported, are now being produced in the host economy. In this situation lies the cause of the substitution effect that leads to employment decrease at the home market. (Barba Navaretti & Venables, 2004)

Foreign direct investment, especially the vertical type, leads to improvement of the knowledge intensity of production in the economy. This is caused by the fact that low-skilled labour is transferred to a country abroad. When low-skilled labour leaks away from the home market, the share of high skilled labour will automatically increase, and knowledge intensity will rise. (Slaughter, 2000, Head and Ries, 2002)

## §3.5

## What is the meaning of the concept "embeddedness" and what is the relation with FDI?

*Embeddedness*

In the last decade, there has been an institutional turn in economic geography. A recognition developed among economic geographers that the form and evolution of the economic landscape cannot be fully understood without giving due attention to the various social institutions on which economic activity depends and through which it is shaped. (Martin, 2003) The institutionalist approach is a reaction to the behavioral approaches that became prominent in the 1960s and 1970s. The institutionalist approach says that economic activity has to be understood in wider structures of social, economic, and political rules, procedures and conventions. Institutionalism is focused on the role of these systems of rules, procedures and conventions, both of formal and informal nature. An important aspect of the institutionalist economic geography focuses on the social regulation and governance of regional and local economies. (Martin, 2003) In this aspect, the role of the European Union is very interesting. This is because through Europe, social regulation and governance of regional and local economies appears to be very different. However, as I mentioned earlier, the EU is putting much efforts in integrating the internal European market. The question is whether these efforts result in smaller institutional differences between regions and countries. The role of the Italian government is also interesting in this aspect.

So called 'rational choice institutionalists' argue that institutions function to reduce transaction costs and thereby they help to develop successful local and regional economies. (Martin, 2003) This argument to invest abroad is also used in the CPB publication I mentioned above. This argument says that investing abroad lowers transaction costs and thereby increases the firm's competitiveness. Another alternative approach in institutional economic geography is the sociological institutionalism. Granovetter is a leading exponent of this approach and of the concept of 'embeddedness'. This concept means that economic activity is said to be 'embedded' is social institutions and networks to the extent that it depends on interaction with other agents in those networks. The 'embeddedness hypothesis' argues that trust, reciprocity, cooperation and convention play a key role in successful regional development. (Martin, 2003). It is interesting to find out about the network structures of Dutch firms in Italy. The question is whether more integrated (embedded) companies are more successful than less embedded companies. The embeddedness hypothesis says that, at least, more embedded firms have more opportunities to be successful.

*Network structures in the host economies*

In the book of Castellani and Zanfei, "Multinational Firms, Innovation and Productivity", a lot of attention is given to the network structure of multinational firms. The authors use the concept of embeddedness in their analysis of networks structures. Castellani and Zanfei describe embeddedness as a process of integration in the local economic network. The degree in which a company integrates in a local context is influenced by two important factors: the nature and intensity of the relations between the MNC and local firms, and the degree in which these companies adapt to each other. (Lane and Lubatkin, 1998). By adapting to the local situation, multinational companies can recognize the conventions and values of local employees, and learn from them. By forming close relationships with local firms, or by forming alliances with local firms, MNC's can obtain themselves entry to specific, local knowledge and skills. (Castellani and Zanfei, 2005) When MNC's offer a greater degree of sovereignty to foreign subsidiaries, these companies are likely to develop a higher degree of embeddedness. Several studies point out that there is a positive relationship between the degree of sovereignty and the degree of embeddedness. (Almeida and Kogut, 1999, Andersson and Fersgron, 2000)

Multinationals are more and more forming so-called “double network structures”. This implies that multinational firms are more and more characterized by links between large numbers of internal components. But on the other hand, these components tend to develop external networks with actors outside the boundaries of the multinational company. The increasing sizes of internal and external networks do not substitute each other, but are complementary. (Castellani and Zanfei, 2005)

The external actors that form relationships with components of the MNC are part of wider networks of other companies and institutions. Therefore, multinationals become embedded in different local networks in which different companies and institutions are presented. In this way, they form “bridging institutions” that connect different geographical and economic dispersed regions and countries. In this way, multinational companies contribute to the economic development of the regions in which they are active. The higher the degree of embeddedness of a multinational, the more this MNC will act as a “bridging institution”. (Castellani and Zanfei, 2005)

## §3.6

## Concluding paragraph

Milan is an attractive location to invest in for Dutch multinational firms. It is located in Lombardia, the most prosperous and developed province of Italy. Milan is leading in the trade, fashion, high-tech manufacturing and finance. Italy has an internal market of 58 million consumers. This is quite large for European standards and it increases the attractiveness of Milan for Dutch multinational companies.

These multinational companies (MNC´s) play an important role in the world economy. These companies are defined as “firms that own a significant equity share of another company (henceforth subsidiary or affiliate) operating in a foreign country”. MNC´s capital flows are measured by flows of foreign direct investment (FDI). These flows contain the the cost of new investments, the profits of foreign subsidiaries, internal loans and border-crossing mergers and acquisitions. The last 2 decades flows of FDI have grown dramatically. Dutch outgoing FDI-flows also saw a strong growth. Since 1985, Dutch outgoing FDI have sevenfolded.

A distinction can be made between two types of FDI. We speak of *horizontal* FDI when a company decideds to duplicate certain parts of the production process abroad. Horizontal investment is driven by the desire to enter a foreign market. This kind of FDI often takes place between developed countries. In case of *vertical FDI*, companies don´t duplicate their production process abroad. Instead, a company decides to disperse the production process geographically by function, and exploit differences in production costs between countries. Flows of vertical FDI typically occur between developed countries and less developed countries.

Dutch FDI in Milan are mainly horizontal. The motives of *market-seeking*, *efficiency-seeking* and *strategic asset-seeking* might be applicable on Dutch firms investing in Milan, the *natural resource-seeking* motive does not seem to be applicable on these firms. Different studies show that MNC´s perform better dan domestic firms, what might be caused by their high efficiency.

Multination firms have many options where to invest. Their choice where to invest in influences by *location factors*. There are a lot of different location theories that explain the spatial diffusion of Companies. In this report, I will use the location theory of Porter. He made an important contribution to modern location theory. According to Porter, there are four factors that are important to the development of competitiveness of a place. These factors are *factor conditions, demand conditions, networks between sectors* and the *economic system.* Barba Navaretti and Venables also pay much attention to the role of the government. The government may have strong influence of the competitiveness of a place. Important tools for the government are *taxation* and *trade policies*.

FDI has different impacts on the economy that receives investments, the *host economy*, and the economy that sends investments, the *home economy*. The impact on the host economy is mainly positive, is shown by Barba Navaretti and Venables. The impacts on the home economy depend on which type of FDI is involved. Surprisingly, the effects of vertical FDI are more positve than the effects of horizontal FDI. Horizontal FDI might lead to employment decrease in the home economy.

An important theoretical concept that is connected to the functioning of firms in a strange economic environment is the concept of *embeddedness*. This concept stems from institutional economic geography. This kind of economic geography has grown in importance the last decade. Institutionalists recognize that the form and evolution of the economic landscape cannot be fully understood without giving due attention to the various social institutions on which economic activity depends and through which it is shaped. This recognition leads to the concept of embeddedness. This concept means that economic activity is said to be embedded in social institutions and networks to the extent that it depends on interaction with other agents in those networks. In case a Dutch firms decides to invest in Milan, it has to deal with the local social institutions and networks.

A second theoretical concept that has to do with FDI is that of *network structures in host economies*. Castellani and Zanfei describe embeddedness as a process of integration in the local economic network structure. MNC´s are more and more forming “double network structures”. This implies that multinational firms are more and more charactrized by links between a large number of internal components. On the other hand, these components tend to develop relations with actors outside the MNC. The development of internal and external networks is complementary. These double network structure can contribute to the economic development of a region, because a MNC can inject a place with specific knowledge. If a MNC has internal and external networks, it can act as a “bridging institution”, transferring knowledge from one place to another.

Now I will move on with the analysis of the data. Chapter four contains an analysis of quantitative data, chapter five contains an analysis of the qualitative data. In chapter six I will answer the questions mentioned in the first chapter. The exploration of literature in this chapter will help to understand the outcomes of the data analysis. In chapter six, I will integrate the theoretical concepts mentioned above with the data, in order to give (hypotethical) answers on my research questions.

# Chapter 4

## Quantitative Data Analysis

In this chapter, the information in the database supplied by Politecnico di Milano will be explored and analyzed. In the first paragraph, the nature of activities transferred from the Netherlands to Milan will be discussed. In the second paragraph, the characteristics of Dutch subsidiaries in Milan will be discussed. The analyzed characteristics are yearly turnover, number of employees and the number of Dutch establishments in the city. These characteristics will be compared to the same characteristics of Dutch subsidiaries in Italy as a whole. The third paragraph contains the concluding remarks.

The *difference in proportions test* is used to test for a statistically significant difference between two proportions drawn from independent samples. (Answers Research inc., 2006) By using this test, the differences in characteristics between Dutch subsidiaries in Milan and subsidiaries in the rest of Italy can be tested statistically.

## §4.1

## The nature of Dutch FDI flows to Milan

In order to analyze the nature of Dutch FDI flows in Milan, Dutch activities are divided in three different sectors. These are the industrial sector, the distribution sector and the service sector. The database of 95 Dutch establishments in Milan shows that 23 establishments are industrial, 46 establishments belong to the distribution sector and 26 subsidiaries are service-based. So, 24,2 percent of Dutch establishments in Milan is industrial, 48,4 percent is distribution based and 27,4 percent is service-based.

Nevertheless, the number of establishments does not show the importance of the different sectors properly. The industrial subsidiaries take care of 61 percent of the total yearly turnover of Dutch establishments in Milan, while the service and wholesale sector both take care of approximately 20 percent of total yearly turnover. Additionally, 41 percent of the employees of Dutch firms in the industrial sector are working in the industrial sector, 36 percent is working in the service sector and only 22 percent is working in the distribution sector. The importance of the different kind of Dutch activities in Milan is shown in the following graphs. This graph shows that the industrial sector has the highest number of employees and the highest turnover and in this perspective, industrial production is the most important activity of Dutch firms in Milan.

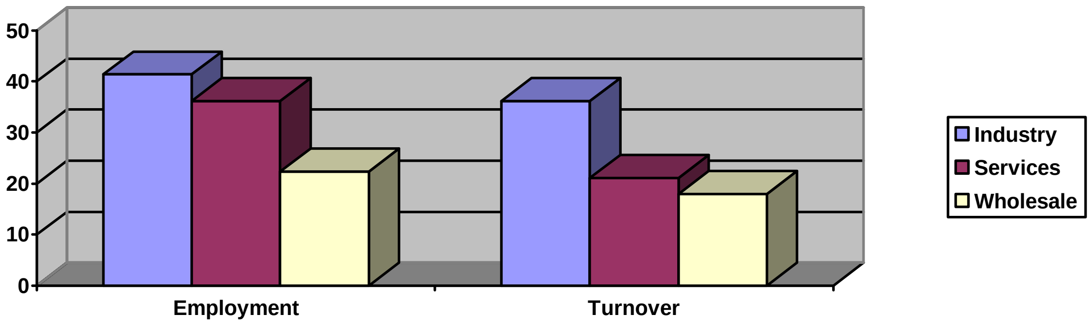


*Figure 4.1: Share in total employment and turnover of Dutch establishments in Milan, per sector (%)*

*Shift in sector distribution*

However, the industrial sector takes care of the main part of turnover and workforce of Dutch subsidiaries, there are signs that the importance of other sectors is increasing. The past few decades, a shift in sector distribution seems to have occurred. This is shown by the next figure. The three time-periods are compiled by percentiles. The companies are divided by year of entrance. The 33,3% that were established first form group one (1923-1981) and the 33,3% that were established form the last group (1988-2005).So there is a clear shift in sector distribution: the first group that established in Milan consisted mainly of industry and distribution firms. Between 1923 and 1998, we see a slight increase of the service sector and declining importance of the industrial firms. The last years, the most establishments appeared to be in the service sector. This shift is in accordance with the general shift in sector-distribution in industrialized countries. It is also in accordance with the decreasing importance of industrial firms and increasing importance of service companies that is recognized by the European Union. (EU, 2006) It is important to notice that this distribution is based on the number of establishments, so it does not say anything about the turnover or number of employees per sector.

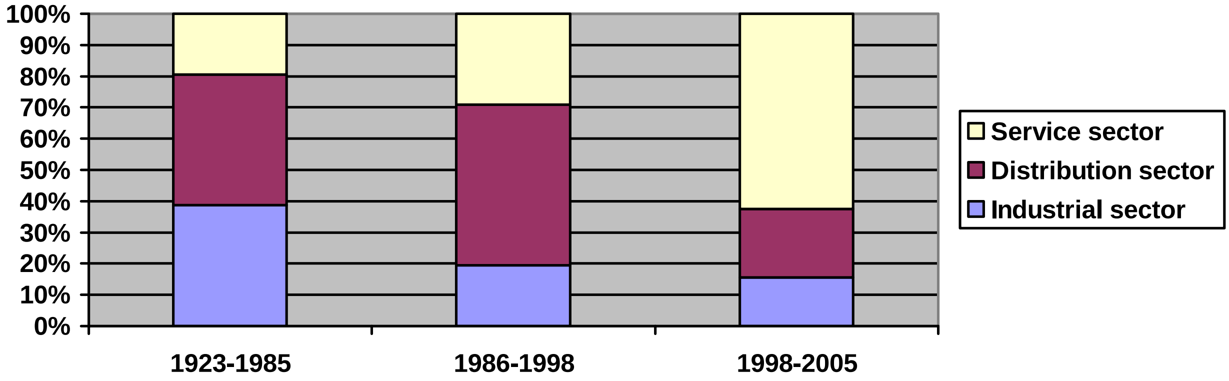


*Figure 4.2: Sectoral distribution of Dutch subsidiaries in Milan, by number of establishments*

## §4.2

## Characteristics of Dutch subsidiaries in Milan compared to the characteristics of Dutch subsidiaries in the rest of Italy

In this chapter, I will discuss the characteristics of Dutch subsidiaries in Milan and compare them to the characteristics of Dutch subsidiaries in the rest of Italy. The difference of proportions test will be used to find out if there is a statistically significant difference between the characteristics of Dutch establishments in Milan and the characteristics of Dutch establishments in the rest of Italy. The characteristics that will be discussed are the firm's year of establishment, the yearly turnover per firm and the yearly turnover per firm. The population size of Dutch establishments in Milan is 94, the population size of the rest of Italy is 206. Therefore, 31 percent of Dutch establishments are located in Milan. Apparently, this share is quite large for a single city.

*Year of establishment*

The information from the database shows that Dutch firms have invested in Milan relatively early, compared to the rest of Italy. For example, one third of the contemporary Dutch establishments in Milan were founded before 1985. In the rest of the country, only 15,5 percent of Dutch establishments were founded before 1985. In the graph below it is shown that Dutch firms were established relatively early in Milan. The largest share of contemporary Dutch establishments is founded in the last decade, as shown by the graph.

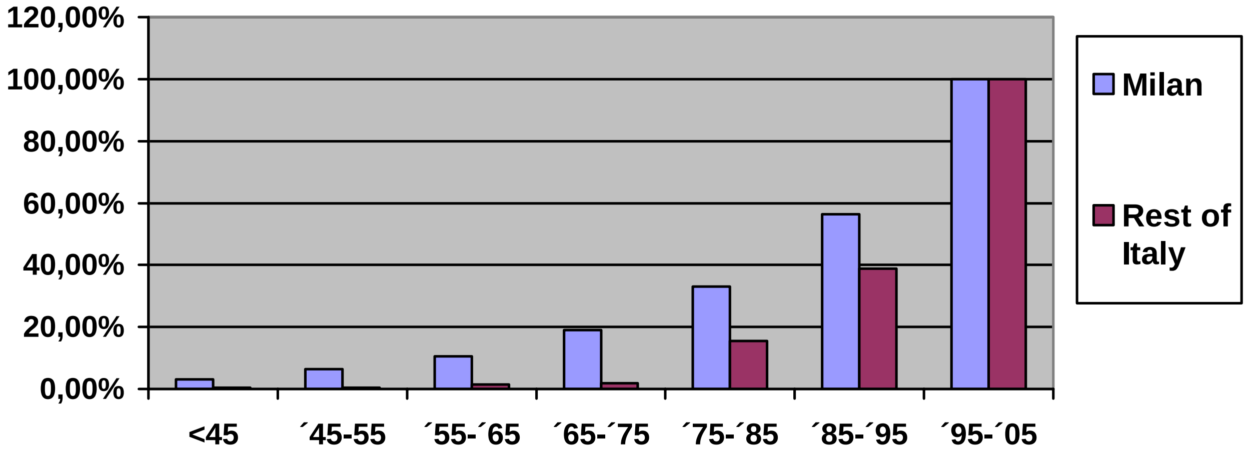


*Figure 4.3: Decade of establishment of contemporary Dutch subsidiaries in Milan and Italy (cumulative %)*

It is clear that the graph above indicates that Dutch subsidiaries were established in Milan much earlier than in the rest of Italy. By using the difference of proportions test, we will examine if there is a statistical difference between Dutch subsidiaries in Milan and in the rest of Italy, regarding period of establishment. The tested hypothesis is: *The share of subsidiaries founded before 1985 is the same for both populations.* The difference of proportions test result in a z-score of 3,33, what makes p (possibility) 0,0004. This is smaller than 0,05, what means that the 0-hypothesis is rejected. Therefore, there is a significant difference in share of subsidiaries founded before 1985 between both populations.

*Number of employees*

Now we have seen that Dutch firms have established relatively early in Milan, the next question is whether these establishments have a relatively large number of employees. This can be expected, because Dutch subsidiaries in Milan have had a relatively long time to develop themselves. This idea is supported by the fact that Dutch subsidiaries founded before 1985 have an average workforce of 217 people, while Dutch subsidiaries established after 1985 have an average workforce of only 140 people. The total number of employees of Dutch establishments in Milan again shows the important role this city plays in Dutch FDI in Italy. The total employment of al Dutch subsidiaries in Italy accounted 40.495 jobs in 2005. In Milan, the total number of jobs known was 15.611. (Mutinelli, 2005) Therefore, 39 percent of the employment of Dutch subsidiaries in Italy is settled in the province of Milan.

The number of employees of the Dutch affiliates is high compared to the number of employees of domestic Dutch firms. To classify the number of employees we use the same classification as the European Union and the Dutch government.  Companies with less than 50 employees are classified as small businesses firms, companies with more than 50 and less than 250 employees belong to the group of medium-sized companies, and companies with more than 250 employees belong to the group of large companies. (MKB Nederland, 2006) More than 50 percent (54,3%) of Dutch subsidiaries in Milan belong to the group of small companies. About one third (29,8%) is medium-sized and 16 percent of the companies is large, so they have more than 250 employees. This distribution is very different from the distribution in Holland, where only 1 percent of all the companies belong to the group of large companies. This supports the idea mentioned in chapter 3, that MNC´s are larger than domestic firms are.

The average number of employees of a Dutch subsidiary in Milan is 166 people. In the rest of Italy, the average workforce of a Dutch establishment is 123. The fact that Dutch firms in the rest of Italy are more often founded after 1985 may be an explanation for this difference in workforce. These findings raise the question if there is a statistically significant difference in workforce size between Dutch establishments in Milan and the rest of Italy. To answer these questions, the difference of proportions test will be used again.

The average number of employees of all Dutch firms in Italy is 136 people. To run the test properly, all cases with 136 or more employees are labelled “true”, while all cases with 135 or less employees are labelled “not true”. The hypothesis I will verify says: *there is no difference in size of workforce between Dutch establishments in Milan and Dutch establishments in the rest of Italy.* After running the difference of proportions test, the z-score turns out to be 2.54. This results in a $p$ of 0,0055. This figure is smaller than 0,05 so the mentioned hypothesis has to be rejected, what means that there is a statistically significant difference between Milan and the rest of Italy, when it comes to the number of employees per Dutch establishment. Dutch subsidiaries in Milan have more employees.

*Yearly turnover*

The last characteristic of Dutch firms in Italy and especially Milan that we will discuss in this chapter is the yearly turnover. We have seen that Dutch establishments in Milan take care of a large share of the total workforce of Dutch firms in Italy. It is expectable that the same is true for the yearly turnover. An analysis of the geographic distribution of turnover of Dutch subsidiaries underlines the important role Milan plays for Dutch firms in Italy. Total known turnover of all Dutch subsidiaries was €15,4 billion in 2005. The province of Milan accounted for €8,5 billion in 2005. So, 55 percent of the total turnover of Dutch subsidiaries in Italy is made in Milan. The average turnover of a Dutch subsidiary in Milan in 2005 is €90,7 million. In the rest of Italy, the average yearly turnover was €33,3 million. Again, we see that Dutch subsidiaries in Milan are larger-sized than other Dutch firms in Italy.

But to be sure, this idea will be tested statistically again. Average turnover of a Dutch firm in Italy is €51 million. Cases with a turnover of €51 million or more are labelled as "true". Cases with a yearly turnover of €50 million or less are labelled as "not true". The hypothesis I will verify is: *There is no difference in yearly turnover between Dutch subsidiaries in Milan and Dutch subsidiaries in the rest of Italy.* Running the difference of proportions test results in a z-score of 2.70, what gives a p of 0,0035. This figure is smaller than 0,05, what means that the hypothesis mentioned above can be rejected. There is a statistically significant difference between the yearly turnover of Dutch subsidiaries in Milan and Dutch subsidiaries in the rest of Italy.

## §4.3

## Quantitative data analysis: conclusion

Milan plays a very important role for Dutch direct investors in Italy. Almost one third of all Dutch subsidiaries in Italy is located in Milan. More than half of the yearly turnover made by Dutch firms in Italy is made in Milan, and 39 percent of all people working for Dutch firms in Italy are employed in Milan. This figures show that the province of Milan is a very important location for Dutch investors in Italy.

Dutch firms invest in service-based, wholesale and industrial companies in Milan. The industrial sector seems to be the most important sector for Dutch firms in Milan. More than 60 percent of the yearly turnover made by Dutch subsidiaries is made by Dutch industrial firms. The industrial firms employ 41 percent of all employees of Dutch subsidiaries. This makes the industrial sector the main employer. However, a shift in sector distribution is visible. The importance of the service-sector in Dutch FDI flows to Milan seems to be increasing, while the share of the industrial sector seems to be declining. This is in line with the increasing importance of the service-based sector in developed economies.

There are some striking differences between Dutch subsidiaries in Milan and Dutch subsidiaries in the rest of Italy. Differences in year of establishment, yearly turnover and number of employees turn out to be statistically significant. Dutch firms invested much earlier in Milan than in the rest of Italy. It seems that Dutch multinationals established themselves initially in Milan, before they spread their wings over the rest of Italy in the last two decades of the twentieth century. In this respect, Milan has acted as a first place of establishment for many Dutch companies. This is caused for a large part by the fact that Milan is the economic centre of Italy and that it is less different from North-European countries in culture than other parts of Italy.

As a result these subsidiaries have had more time to become embedded in the local economic context. Additionally, these firms are located in the most prosperous region of the country. These two factors may explain the fact that Dutch subsidiaries are large in turnover and workforce, compared to subsidiaries in the rest of Italy. The difference of proportions test shows that the turnover and workforce in Milan are significantly higher than in the rest of Italy.

# Chapter 5

## Qualitative data analysis

To support my research on the functioning of Dutch subsidiaries in Milan I have had a number of interviews with employees of firms owned by a Dutch multinational in Milan. This interview were held by face-to-face contact or by e-mail contact. In this chapter I will shortly summarize the interviews that were held in Milan.

Seven Dutch companies in Milan reacted positively on my (repeated) request to cooperate in my survey by means of answering my questionnaire. There has been a interview at one more company, Global Crossings, but this company turned out not to be in Dutch, but in American hands, what is not according with the information in the database.

In the questionnaire many aspects of the functioning of the companies were paid attention to. Now a summary of the interviews held follows.

## §5.1

## Summary of the interviews

### *TNT Post Italia Spa*

This company is originally founded in 1919 as “Rinaldi l’Espresso” and is acquired by TNT in January 2006, renamed as TNT Post Italia. In this case, we speak of a takeover (brownfield entry), because TNT now owns 100 percent of the shares. TNT Post Italia focuses on the distribution of mail, with Italy as its market. The main market for the company is northern Italy. All suppliers of the firm are from Italy. The mother company, TNT, is an important player in the international market of mail distribution.

TNT decided to invest in Italy because the company want to expand its market. So in this case, we speak of a market seeking motive, and the investment in Italy is a horizontal, market seeking investment. This idea is supported by the fact the takeover of Rinaldi did not lead to the closure of production facilities elsewhere. In case of vertical investment, closure of production facilities may be expected. This is caused by the geographical dispersion of the production process. But in the case of TNT Post Italia, this does not happen.

TNT Italia does not employ any Dutch workers. This company has contact on a daily basis with its mother company in Holland. The affiliate in Milan has a certain influence on the strategic decisions that involve the business of the affiliate. Strategic decisions are made on a fifty-fifty basis. It is clear that local managers have an outstanding knowledge of local circumstances, what improves the effectiveness of decision-making. Managers working at the mother company in Holland act on a long distance from this specific market, what makes it harder to find the right argumentations decisions. TNT Italia, owned by a Dutch firm, functions by using local suppliers and only serves the domestic market. However, there is contact on a daily basis to evaluate the planned strategy.

### *Unilever Italia*

Unilever was first established in Italy in 1928, when “Van den Bergh Italia” was founded. Unilever is a firm that operates all over the world, focused on food and consumer goods. The main goal of Unilever is to play a dominant role in the sectors in which it is active. This results in the desire to be present all on markets all over the world. The Italian affiliate of Unilever is an important establishment for Unilever, because Unilever Italia makes five percent of the total annual turnover of the firm.

Unilever in Italy, and more specifically in Italy, always consisted of a mixture separate start-ups and takeovers. But a few years ago, Unilever reorganized its internal structure in order to centralize the structure of the firm. As a result, all seven Unilever companies in Milan are now part of one holding. The administration, financial administration and training of employees for example are now centralised. There are two Unilever head offices in Italy. One in Rome, that serves the southern part of the country, and one in Milan, that serves the northern part of the country.

The yearly turnover of Unilever in Italy is 2,8 billion dollar. At the head office in Milan 400 people are employed, and in Italy as a whole 5000 people are employed. Exept the supplier and customers relations, Unilever does not have much contact with other companies. However, the company is member of the oranization of of industrial firms in Lombardia, that serves to defend collective interests. About ten percent of the goods produced in Italy are sold abroad. The other ninety percent is set for the domestic market. The export is mainly sold at Unilever firms abroad. Abroad means

Europe in this case, because Unilever works on a continental scale, not on a global scale. It would be too costly to transfer production goods on an intercontinental basis, the manager declared. There is one exception on this rule. Italian brand Bertolli, that produces olive oil and olive oil-based products, exports its products worldwide. This is because there is specific knowledge demanded for its production process which is only available in Italy.

The strategy of the firm has clearly changed the past few years. In the seventies, multinational firms desired to become large conglomerates, with businesses in all sorts of sectors. Unilever followed this trend. It had a transport-branch, a chemical-branch and more branches that were not active in the firm's core business: food and consumer goods. In the nineties Unilever decided to focus on its core business and pushed off some parts of the firm.

The Unilever investments in Italy mainly have the goal to serve the domestic market. So here we have horizontal investment, that do not involve closure of activities elsewhere. The office in Milan employs some Dutch expatriates. However, there are many expatriates working at the office and the Dutch group of expatriates is only a small share of the total number of expatriates. They are working in middle and higher management. In most cases they are employed in higher functions, because they are more expensive than domestic employees. They have to be accomodated, for expample.

The long-term strategical decisions are made at the headquarters in Amsterdam and London. The responsibility for the short-term policy lies at the office in Milan. There is much communication between the affiliate in Milan and the mother company. However the responsibility for strategic decision-making is located at the headquarters, a lot of attention is paid to the opinion of local managers, because they have a lot of knowledge about the local market. The managers at the head-office are supplied with specific information by the local managers. Based on this information, the general managers define a world-wide strategy. In this way, a process of constant information transfer is established, what makes it possible to optimalize the effectiveness of strategy-making. A strong example is the planned withdrawal from the frozen-food sector all across Europe. It was thought at the headquarters that this sector did not have enough potential. Managers in Milan succeeded to convince the the managers at the head quarters that this activity had enough potential in Italy, and it was decided that Unilever remained in business in this sector.

The survival of the office in Milan is in jeopardy a little bit. Unilever has made a large reorganization the past few years. A central aspect of this reorganization was centralisation of its offices and factories, partial to obtain more economies on scale. In this view, a merger of the Milanese and Roman head office could be expected, but there are concrete plans made public yet.

***Disky Communications SRL***

Disky Communications is started in 1994 as a branch of Dutch mother company "Hermans Holding BV". The business of Disky Communications is distributing Home Entertainment carriers, like DVD´s and CD´s. The company has a yearly turnover 0,8 million euros and has a small workforce of 2 employees. The firm is serving the Italian market and especially the northern market. Ninety percent of the company's sales are located in northern Italy. The same for the location of the suppliers. The large part of suppliers is located in the area of Milan and northern Italy. So for this company, suppliers and customers are mainly located in northern Italy.

The past decade the nature of the business of the firm has changed since the start in 1994. The firm started working the stocks of the major music companies. Later on they started dealing with DVD, games for PC´s and Playstations, toys and now they are dealing in the entirely entertainment business. The firm in Milan is only a commercial affiliate of Hermans, to avoid trade costs caused by exporting to Italy. Financial, logistic and transport departments are based in the Netherlands.

Since the investment by Hermans holding was aimed to infiltrate on the Italian market, it was a horizontal investment that did not involve closure of operations elsewhere. Hermans decided not to send Dutch employees to Milan. In fact, the branch in Milan has a high degree of sovereignty. However the company has a daily contact with their mother company, the firm is responsible for serving their own local market. Hermans has no concrete plans to enlarge their investments in the future.

***AcNielsen Customized Research SRL***

The firm AcNielsen was founded in Milan in 1963 and was taken over by VNU in 1975. AcNielsen is now owned by VNU for 100 percent. So we speak of a brownfield entry. The investment was made before the great wave of FDI started in the eighties. AcNielsen business is consultancy, so it is a service company. The firm has a relatively large workforce of 520 employees. As we saw with the previous interviewed firms, the suppliers as well as the customers of the firm are located in Italy.

VNU did not move employees from the mother company to AcNielsen. So the business at AcNielsen is done by local, Italian, employees. The investment by VNU in Italy did not involve closure of other facilities abroad. The managers at AcNielsen have a high degree of autonomy. However the strategic long-term decisions are taken by the managers at VNU, AcNielsen has a high degree of autonomy practising their business in Italy. This is illustrated by the fact that AcNielsen does not have contact on a regular basis with the mother company. This maybe caused by the fact that the investment by VNU dates back to 1975, and AcNielsen may have gained in autonomy the past thirty years.

***EcoAppraisal SRL***

The firm EcoAppraisal SRL was established in Milan in 1991. In 2000, the Tauw Group from the Netherlands decided to take over the company for 100%. The entry of Tauw Group in Italy has been a Brownfield entry. After Greenfield entries in Belgium, Germany and France Tauw Group felt that a merger or acquisition could show better results. Acquisitions in Spain and Italy approved this idea. The fact that the acquired companies have local knowledge and local contact improve the results of these brownfield companies, compared to Greenfield companies. EcoAppraisal is a company that is involved in soil-cleaning. The firm is doing research, gives advice and is able to take care of the accomplishment of the cleaning. Further, the company is involved in calculation of the costs of a potential cleaning. There are 18 employees working for the firm.

Italy is not the only market where Tauw Group has established facilities. Tauw group has facilities in Belgium, Germany, France, Italy and Spain. They started their process of internationalization in Belgium, then followed second Germany, third France, then Italy and eventually a facility in Spain was established. The investment in Italy is part of an international strategy of the Tauw group. The company serves governmental institutions and local companies, but they serve multinational firms as well. The nature of these firms asks for a company that is represented is several countries in the European Union.

There has been a clear change in business of the company in Milan the past years. When Tauw Group took over EcoAppraisal the company was only involved in research and advice on soil cleaning. 2005, EcoAppraisal, in deliberation with representatives of Tauw Group decided to add a new branch to the firm. This is the branch that is involved in really cleaning the soil. In approximately fifty percent of the cases, customers make an appeal to this service.

Again, as is the case with the other interviewed firms, the move into Milan did not involve closure of operations elsewhere. According to the manager at EcoAppraisal, the opposite is the case. The internationalisation policy of Tauw Group improves the performance of the company and the attraction to multinational firms. So the internationalisation of the policy improves the general performance of the firm.

In the case of EcoAppraisal, two employees went from the Netherlands to Milan on a fulltime-basis. One employee works at EcoAppraisal as an engineer, he develops soil cleaning-strategies. Another Employee from Tauw Group has served EcoAppraisal from 2003 until 2005. He worked as an account manager. The function of managing director is still performed by Mister Carlo Bossi, who established the firm in 1991. The fact that Tauw Group sends two employees on a fulltime-basis, shows they want to keep control on the business in Milan.

The main market that EcoAppraisal serves is Northern Italy. Approximately 75 percent of her activities are performed in this part of the country. The remaining 25 percent of the activities are performed in the remaining part of Italy. No activities abroad are accomplished. EcoAppraisal keeps contact on a regular basis with other companies across Europe. In the soil- cleaning sector of the company, there is a lot of contact with companies abroad, not companies from The Netherlands, but across Europe. This is because the firm has the view that the quality of the knowledge is most important, and not the origin of the knowledge. When the advice-part is concerned, the company has more contact with local firms. This is because in this sector, there is a lot of local knowledge in the region. When finance is concerned, the company used to outsource this activity, but since 2004, EcoAppraisal takes control of its own financial administration. The manager finds it somewhat difficult to tell about the location of the suppliers of the firm. But when you look at energy delivery and supply of work capital, like cranes and trucks, then the suppliers are Northern-Italian.

It is not the case that strategic decisions of the company are either taken in or Milan or at the headquarters in Deventer. Decisions that involve the strategic course of the company are taken in close deliberation between Milan and Deventer and the mutual relationship is very good. So there is much contact between the mother company and EcoAppraisal. This contact occurs in particular by e-mail and by phone. The contact is on a weekly basis. Two or three times a year, a meeting is organised where representatives of all European firms meet.

### *Bayards Italia SRL*

Bayards Italia is an affiliate of Dutch company Bayards Aluminium Constructions BV. The firm is a Greenfield entry (start-up) and was founded in 2002. The business of the firm is the sale of aluminium constructions delivered by the mother company. The turnover of the company is 0,2 million euro. The firm is a one man company. The company serves an international market. So you could call Bayards Italia an export-platform facility, because more than one country is served. About ninety percent of the sales go to countries outside Italy. About ten percent is sold in Italy it self. The suppliers of the company are from all over the world.

Bayards Italy is not the only foreign sales office of the firm, there is also a sales office in Singapore, which started in 2005. This office should serve the Asian market. Both these sales offices are part of the internationalisation strategy of the firm. With these sales offices they try to improve sales abroad. The fact that the sales office in Milan is a one man firm implies that it did not imply the closure of facilities elsewhere. In fact, the policy of internationalisation improves the competitiveness of the firm.

Bayards Italia keeps regular contact with other companies in Milan and Italy. For example to share knowledge and to outsource financial administration. Logistic activities are also outsourced to local, Italian companies. So the firm has close connections to other, local companies. This is caused by the fact that the firm is a one man firm, so many activities should be outsourced.

The company in Milan has little sovereignty. All the strategic decisions are taken in Holland and communicated to Milan. There is a daily contact between the affiliate in Milan and the mother company  in Holland. Bayards have no concrete plans to enlarge investments in Italy. However, according to the pathway to internationalization, the establishment of a foreign sales office is only one of the first steps in internationalization. So it could be possible that in the future Bayards decides to enlarge their investments in Italy.

***Kappa Graphic Board SRL***

Kappa Graphic Board was founded in 1985 in Milan as a start-up. Is it fully owned by Dutch mother company Kappa Packaging NV. The Italian branch of the firm is doing distribution and sales of graphic boards. The yearly turnover of the firm is about ten million euro, and the workforce consists of ten people. Kappa Packaging has many other facilities around the world. They have been established since 1983 in USA, Spain, France, Germany, United Kingdom and Singapore. So the Italian branch seems to be part of an internationalisation strategy of the firm. Since the move to Milan is part of an internationalisation strategy to enlarge the sales market of Kappa, the move to Milan involves no closure of other Kappa facilities abroad.

There did move one Dutch employee to the facility in Milan. The job of general manager is done by a Dutch, high skilled employee. The Italian branch of Kappa serves the Italian market. About ninety percent of their sales occur in Italy. Their suppliers are located in northern Italy and the Netherlands. The strategic decisions of the firm are taken in the Netherlands. However, Kappa Italy does not have contact with  the mother company on such a frequent base as we saw before, The contact between Kappa Italy and the mother company occurs on a monthly basis. On the other hand, Kappa keeps regular contact with other firms in the Milan area. The mother company is not planning to enlarge investment in Italy in the near future.

## §5.2

### Critique on the economic environment in Milan

The employees of the firms were asked to give their opinion on the quality of economic factors in Milan. They were asked about the quality of the following factors: workforce, infrastructure, sites and premises, the government, taxation and local suppliers. The factors above can be judged as weak, neutral or strong, compared to the western-European standards.

Workforce: The skilfulness of local employees is judged as average by six of the seven companies. Kappa is the only firm that entitles the skills of local employees as a weakness. Some companies comment that abilities of employees are relatively good in the north of the country, compared to the south. The availability of suitable workers is judged as neutral by five firms. TNT and Unilever find that this availability of the region. Three out of the seven firms entitle the labour costs in the region as a weakness, the other four consider the labour costs as a neutral location factor. It was commented that labour in Milan is more expensive than in other parts of the country.

Transport / Infrastructure: The transportation and infrastructure facilities is judged as weak by three of the seven firms. The other four firms consider these facilities as normal. The regional government of the state of Lombardy seems to realize that something has to be done about the local infrastructure. The website of the local government reports that the local infrastructure will be reorganized and improved, to properly accommodate economic growth in the area.

Sites and premises: Three out of seven companies consider the price of sites and premises in the area as a weak location factor. So, in their opinion, the relation between price and quality is not very attractive. The availability of sites and premises does not seem to be considered as a problem, only Bayard finds that the availability of sites and premises is weak. Te other companies consider the availability as normal or they do not have an opinion on this topic.

Role of the government: The role of the government is judged as negative by a majority of the companies. It is commented that the Italian government is not cooperative at all. The government is not properly stimulating regional economic development, according to the persons interviewed. Five out of seven companies consider the bureaucracy within the government as a large weakness, too. There are complaints about a slow treatment of procedures by the government and about poor service by the government. AcNielsen seems to be an exception, they consider the government to be a positive location factor.

Taxation: Not only the role of the government is seen as a weakness. The taxation climate in Milan is seen as a weakness, too. This in spite of the tax reform that was introduced in 2003 in order to make Italy a more interesting country for foreign investors. (Italian organization for investment promotion, 2006) Four of the seven firms consider the taxation policy to be a negative location. Only AcNielsen is positive about the taxation.

Quality of local suppliers: At last, the firms is asked to give their opinion on local suppliers. This is an important factor for firms that decide to invest in a certain region. The seven companies unanimously consider the quality of local suppliers to be normal.

**§5.3**

**Qualitative data analysis: conclusion**

The interviews held with seven Dutch firms in Milan, by e-mail or face-to-face, show some similar results. The assumption that Dutch investments in Milan are horizontal, seems to be affirmed. This is assumed because vertical FDI exploits mutual differences in factor costs. The differences in factor costs between the Netherlands and Italy are not that large. Instead, Dutch firms invest in Milan to acquire entrance to the Italian. There seems to be a rather equal distribution between Greenfield entries and Brownfield entries. It is striking that the small establishments are Greenfield entries. The firms that were interviewed are all owned by their mother company for one hundred percent.

What strikes, is that the firms mainly serve the local, Italian market. At least ninety percent of the production of the firms involved is sold on the domestic market. This indicates that the most important motive to invest on the Italian market is infiltration on the local market. The strategic asset motive also plays an important role for a large multinational firm like Unilever. The manager at this company declared that the firm wants to be present on as much markets as possible, world wide. Not only the customers are mainly located in Italy, the suppliers of the firms are also mainly located in (northern-)Italy. TNT, Disky, AcNielsen and EcoAppraissal state that their suppliers are only located in Italy. Kappa has some Dutch suppliers, together with northern Italian suppliers. Unilever, that has centralised its business on continental level, has suppliers all over Europe. The majority of the company says that they do not employ expatriates (employees from abroad). Unilever, EcoAppraisal and Kappa Graphic Board do employ expatriates. These expatriates are often Dutch. They are employed in higher management, because these employees are more expensive than domestic employees. They must be accommodated, for example.

The interviewed companies often declare that they have a lot of contact with their mother company. Five companies state that they have contact with their mother company in Holland very frequently. Eventually, the mother company is responsible for the long-term strategic decisions. But however, most companies indicate that there is a fine cooperation between the mother company and the affiliate, and these two parties are both involved in decision-making. This is because the local managers have good knowledge about the local market. This knowledge is used by managers at the mother company to come to optimal short and mid-term strategic decisions, in accordance with the managers at the affiliate. The phenomenon that local managers are not really involved in long-term strategic decisions is showed by the fact that the local managers do not have any, or very little, insight in plans to enlarge the investments of the mother company in Italy.

When the managers are asked about the quality of the local environment, they do not react very positive. Compared to Dutch or Western-European standards, the circumstances in Milan are considered to be of the same quality in the best case, but are often considered to be inferior. An important disadvantage of Italy seems to be its government. The firms are disappointed in the uncooperative, uncompromising role of the government. In many cases, the government opposes economic development, instead of stimulating it. But the government is not the only disadvantage. The price and quality of sites and premises, the education level of the workforce, the infrastructure and taxation, they are all not satisfactory. The quote of the communication manager at Unilever accurately translates the attitude of foreign companies that invest in Italy: *"Many circumstances are not of North-European standards, but if you want to be present in this country, you have to accept this and pay the costs"*. This quote really shows the motive that impel market seeking companies.

# Chapter 6

## Integration of theory and empirics

In chapter 3, the theoretical background of Dutch direct investments in Italy has been described. Chapters 4 and 5 contained information about the empirical findings, as well quantitative as qualitative. In this chapter, I will try to integrate the empiric data and theoretical knowledge in order to formulate answers on my research questions that are supported by theory. I will formulate a hypothesis based on the theory for question 1 and 2. These 2 hypotheses will be verified by using the information from the quantitative data analysis. For the other 5 questions, I have formulated an answer based on the theory and the qualitative data analysis. In paragraph 6.2 I will evaluate the functioning of Dutch affiliates in the local context of Milan.

## §6.1

### Which activities are transferred to Milan and for what reason?

Milan is located in Italy, a modern and developed European country. This situation has several consequences for the type of firms that will invest here. As mentioned in the second chapter of this paper, mutual flows of FDI increase as countries become more similar when it comes to GDP, geographic location and cultural characteristics. Milan is located in the Italian region Lombardy, what is the most developed and prosperous region of the country. Theoretically, considerable flows of FDI can be expected between these two developed, European countries. This is shown by the fact that there are only eight countries in which Dutch firms invest more than in Italy.

Between developed countries mainly horizontal FDI takes place. FDI is called horizontal when a company decides to duplicate its production facilities abroad. In case of vertical foreign direct investments, mutual costs differences are exploited. This results in fragmentation of the production process, where simple and labour-intensive production parts are moved to countries with low wages. (CPB, 2005) Obviously, this is not the case for Dutch investments in Milan.

As discussed in chapter two, there are four categories of motives for companies to apply FDI. These motives are the *natural resource seeking-motive,* the *market seeking motive*, the *efficiency seeking motive*, and the *strategic-asset seeking motive*. (IOO, 1999) Natural resource seekers are looking for available commodities for low prices. However Italy possesses a large number of natural resources, this does not seem an important motive to invest in Milan. This motive is mainly applicable to companies that want to invest in developing countries, for example oil companies. The other three motives do seem to be applicable on mutual investments between developed countries. So, as a consequence, they also seem to be applicable on the investments of Dutch companies in the region of Milan. Multinational firms have to keep growing and keep internationalising to remain competitive on the international market. By investing in several countries, the economies of scale increase and the efficiency of production can increase. Here we see the efficiency-seeking motive. The fact that labour productivity in Northern Italy in higher than in Southern Italy (OECD, 2001) increases the attractiveness of the first region. The strategic-asset seeking motive also has to do with the need for increasing efficiency, this time as an effect of foreign mergers and acquisitions.

Now we have left the most important motive. This is the market-seeking motive. As mentioned above, Italy possesses a large domestic market. The domestic consumer power is 24900 PPS (unit used by Eurostat to remove the effect of price differences) and is slightly lower than the average consumer power in the Euro zone, which is 25400 PPS, and lower than Dutch purchasing power, which is 28400 PPS. (Eurostat, 2005). The relatively low Italian purchasing power is mainly caused by the economic problems in the "Mezzogiorno", the southern part of the country. However, purchasing power in Italy is still higher than the purchasing power in other Mediterranean countries like Portugal, Spain and Greece, and much higher than in East-European countries. Add the large number of inhabitants, almost sixty million, and the fact that Italy possesses the fourth total domestic product in Europe, and we see that the domestic Italian market is an interesting market to invest in.

The previous information shows there is more than one motive to invest in Milan. For large multinational companies, the efficiency seeking motive and the strategic asset motive can be decisive to invest on the Italian market. This may help to increase economies of scale and strengthen market power on the international market. The market-seeking motive is also very important, because of the large, thus attractive domestic market, whose consumers have an acceptable purchasing power. So it may be expected that a large range of Dutch firms are interested to invest in Italy, and in Milan specifically. Large multinationals (banks, insurance companies, chemical companies) will be attracted as result of the efficiency seeking motive and the strategic asset motive. There will also be many Dutch companies that see possibilities to infiltrate in the large Italian domestic market by using direct investment. This is becoming less complicated as a result of the integration of the European domestic market.

To conclude, it may be expected that the Dutch direct investments in the area of Milan consist of horizontal investments. The reasons for this investments lie in efficiency seeking, strategic asset seeking, and, very important, market seeking. Most companies will invest in Milan to infiltrate the domestic market. This findings lead to the following hypothesis:

***"Dutch direct investments in Milan occur in a large number of sectors, by large business, medium business and small business firms, often with the goal to infiltrate the domestic market"***

By analysing the database, we see that firms in Dutch subsidiaries in Milan are present in a large number of sectors. The sectors differ from consultancy, to chemicals and from food-industry to mechanical industry. All the sectors in which Dutch subsidiaries are active are divided into three sectors. These sectors are production, service and distribution. 24 Percent of all Dutch establishments in Italy belong to the industrial sector, 48 percent belongs to the distribution sector and 27 percent belongs to the service and IT sector. It appears that the subsidiaries in Milan are pretty evenly distributed among the three different sectors. But these figures only represent the number of establishments. By looking at turnover and number of employees, the industrial sector appears to be the largest and most important. 61 percent of the turnover of Dutch subsidiaries in Milan is made by industrial firms, and 41 percent of the people working for Dutch subsidiaries are employed by industrial firms. So however Dutch firms are represented in a large number of sectors, the main sector for Dutch subsidiaries in Milan is the industrial sector.

Dutch multinationals in Milan are present in small business firms, medium sized business firms and large business firms. 54 percent is active in the small business sector, 30 percent is active in the medium sized business and 16 percent is active in the large sized business. The share of large size businesses in the Dutch economy is only 1 percent. According to Barba Navaretti, multinationals are larger firms than single-nation firms. This idea is supported by the finding that almost every sixth Dutch subsidiary in Milan is a large business firm.

The fact that all the companies that were interviewed almost sell their entire production on the (northern)Italian market supports the presumption that Dutch firms have moved towards Milan to infiltrate the domestic market. In case of vertical investments, these companies would have sold their production on foreign, developed markets. But the empiric finding that Dutch subsidiaries in Milan sell their production on the domestic market supports the hypothesis that their mother companies have invested with a market-seeking motive.

## §6.2

## Characteristics of Dutch subsidiaries in Milan

The question I will try to answer in this paragraph is: what are the characteristics of the firms (partially) controlled by Dutch firms in Milan? Do these attributes differ by sector, period of establishment and geographic location?

As mentioned in the theoretical background, global FDI-flows have exploded since the early eighties. This is also the case for the FDI-flow from the Netherlands to Italy. It is expectable that the number of Dutch subsidiaries in Milan has increased with the increased flow of investments. Since Lombardy, the federal state in which Milan is located, is the most developed and prosperous region of the country, Dutch firms may have established here relatively early. This idea is strengthened by the fact that northern Italy's culture is more similar to the Dutch culture than southern Italy's culture is. (EVD, 2005) This makes it relatively easier for Dutch companies to invest in the north. These findings imply that Milan has functioned as a sort of "platform" for Dutch companies. In other words, Dutch companies may have invested first in prosperous and cultural similar Milan, before they spread their wings over the rest of Italy. So it may be supposed that Dutch companies have invested relatively early and in relatively large numbers in Milan.

In the past decades, there has been a large change in the distribution of capital and labour between the different sectors. The share of agriculture and industry decreased, while on the other hand the share of the service-sector increased. It may be expected that this pattern is also visible in Dutch FDI-flows. So the share of the service-sector in the outgoing FDI-flow will increase at cost of the share of the industrial sector.

It is assumed that Dutch companies have established in Milan relatively early in comparison to the rest of Italy. This implies that these local subsidiaries have had a longer period to develop themselves. So it may be expected that Dutch subsidiaries in Milan have a relatively high turnover and a relatively large workforce in comparison to other Dutch subsidiaries in Italy.

These presumptions lead to the following hypothesis:

***"In the past decades the flow of FDI from the Netherlands to Milan has increased. The share of the service sector has increased, while the share of the industrial sector in the total investment flow has decreased. Dutch companies have invested in Milan relatively early. The turnover and employment of establishment in Milan will be large compared to Dutch subsidiaries in the rest of Italy. It may be assumed that Milan has acted as a "platform" for Dutch companies willing to invest in Italy."***

The hypothesis seems to be supported by the empirical findings. The Dutch investments have grown spectacularly the past few decades. The flow of FDI from Holland to Italy, €825 million in 1984, has increased to €12 billion in 2004. The Italian share in the total Dutch FDI portfolio doubled from 1,4 percent in 1984 to 2,8 percent in 2004. (Dutch National Bank, 2005) Analysis of the database containing information on Dutch affiliates in Milan show that the share of the service sector has grown the past decades. Almost forty percent of the Dutch companies established in Milan before 1985 are industrial. Only 15 percent of the companies established between 1998 and 2005 are industrial. On the contrary, not even twenty percent of the affiliates established before 1985 are service-based. About 50 percent of the affiliates established between 1998 and 2005 are service-based.

The hypothesis that the turnover and number of employees of Dutch firms in Milan are relatively high are supported by the quantitative data analysis. There are statistically significant differences between the number of employees and the turnover of Dutch firms in Milan and Dutch firms in the rest of Italy. The turnover and number of employees of Dutch subsidiaries in Milan are higher.

The quantitative data-analysis also supports the assumption that Dutch companies have invested relatively early in Milan. This is shown, for example, by the fact that 31 percent of all the Dutch affiliates were established before 1985. Only 15,5 percent of the Dutch affiliates in Italy as a whole were established before 1985. So affiliates in Milan are established relatively early. This may have to do with the cultural resemblance with the Netherlands, and the fact that Milan is the ‘economic capital’ of Italy. The fact that Dutch affiliates in Milan are relatively long established, results in a relatively high number of employees and a relatively high turnover.

## §6.3

### Customer and supplier relationships of subsidiaries of Dutch multinationals in Milan

Literature about FDI shows that relationships with customers and suppliers strongly depend on the nature of the investment. This makes it important to find out which kind of investment is involved when we talk about investments in Italy. So let us start to find out which kind of investments are concerned, based on the theory described in chapter 3. Foreign direct investments are divided in vertical and horizontal investments. Vertical investments imply move of facilities to exploit differences in factor costs. (CPB, 2005) In this case, one or several production parts are moved abroad to diminish costs of production.

Which consequences does this type of investments have for the customer and supplier relationships? Well, it is possible that facilities abroad are (partly) supplied by local supplier. Take commodities, for examples. When it comes to customer relations, not many relations are expected. The production facility is moved to minimize production costs, not to produce for the supply of the local market. Since the production facility is part of the internal production process of the MNC, the production of the facility abroad will be exported to the developed world, where the product will be sold. So, vertical investments do involve possible relationships between the local market and the subsidiary by means of demand for local supply. The fact that a subsidiary of a MNC creates extra demand for the local market is also known as a backward linkage.(Barba Navaretti & Venables. 2004) On the other hand, there are almost no customer relationships with the domestic market.

This situation changes when horizontal investments are involved. In case of horizontal investments, a MNC decides to invest in a foreign country to lower trade costs, like transport costs and costs of communication, for example. (CPB, 2005) So a company decides to produce on the local market instead of exporting to this market. Instead of spreading the production process geographically, a company decides to duplicate its production process on another geographic location. This causes another, more intense, pattern of customer and supplier relations than is the case with vertical investments. Suppliers on the local market will meet less trade costs, so they may be cheaper than foreign suppliers. The foreign subsidiary of an MNC serves the local market, so the companies will start relationships with local retailers and customers.

Now we take a look at the investments the way they occur in Italy, so the customer and supplier relations of Dutch subsidiaries in Milan can be predicted. Following the literature survey in chapter 2, we know that horizontal investments most often take place between similar countries. Similar with respect to cultural and economic characteristics. Italy and The Netherlands are both developed countries, and off course there are differences in culture, both countries do have the same sort of western culture. The GDP per capita are higher than the average of the EU-25. And however the labour costs in Italy (21,39 euro/hour) are somewhat lower than in The Netherlands (27,44 euro/hour), these differences are not of a size that vertical investments are stimulated. For example, the average hourly cost of a Polish employee is 4,74 euro. (Eurostat, 2006)

Besides the fact that The Netherlands and Italy are both developed, western countries, Italy is a very interesting market for Dutch investors. The domestic market is relatively large with its 58 million consumers. These consumers have an acceptable income, somewhat lower than the income of Dutch consumers. (Eurostat, 2006) Based on this information it may be assumed that Dutch investments in Italy are horizontal. These findings lead to the following hypothesis about customer and supplier relationships of Dutch establishments in Milan:

***"Dutch affiliates will mainly serve the Italian market, often supplied by local firms"***

The information above supports the assumption that Dutch affiliates are established in Milan as part of a market seeking strategy. Therefore, these firms will focus themselves on the domestic market. It is presumable that the suppliers of Dutch affiliates are Italian in many cases. This is because local suppliers meet the advantage of low trade costs, in comparison to foreign suppliers. The consumers of the firms will be Italian in most cases because, since we presume that these firms have a market seeking strategy, these firms focus on the domestic market.

This assumption is supported by the information from the qualitative data analysis. The firms interviewed, all indicate that they mainly serve the domestic market. All firms sell at least ninety percent of their production on the domestic market. Not only the customers are mainly located in Italy, the suppliers of the firms are also mainly located in (northern-)Italy. TNT, Disky, AcNielsen and EcoAppraissal state that their suppliers are only located in Italy. Kappa has some Dutch suppliers, together with northern Italian suppliers. Unilever, that has centralised its business on continental level, has suppliers all over Europe. So the assumption based on theory, that Dutch affiliates will mainly serve the Italian market, often with domestic suppliers, is supported by the empiric findings.

## §6.4

### Degree of embeddedness of Dutch subsidiaries in Milan

The question I will try to answer in this paragraph is: in which degree are these companies embedded in the regional context, and which factors influence the degree of embeddedness?

To determine in which degree companies are integrated in the local economic context, it is important to find out which type of investments takes place by these companies. We have formulated before that investments in Italy are expected to be horizontal and not vertical. This finding has an impact on the embeddedness of the firms located in Milan. Vertical companies are part of the internal production process of the multinational (Barba Navaretti & Venables, 2004) and therefore they have less interaction with their surroundings than horizontal firms do. This is because horizontal firms are more autonomous entities that serve the local market and therefore they have more interaction with the local context.

Italian scholars Castellani and Zanfei make a distinction between two types of networks that multinational firms possess. These are internal networks, so relationships inside the company itself, and external networks, which are relationships with other firms and institutions. The more relationships a company develops with external actors, the more "embedded" a firm will be in the local context. These external networks increase the ability to adapt to the environment and the ability to make use of the opportunities a region offers. (Castellani and Zanfei, 2005) Since Dutch direct investments in Milan are mainly horizontal, these companies are expected to have a lot of interaction with their environment, so they will have a relatively high degree of embeddedness. Internal and external networks are complementary and there is a positive relationship between them. For example, internal networks can offer technological opportunities to foreign subsidiaries, and stimulate these subsidiaries to develop external relationships in order to exploit this new technology. The other way around, these external relationships may offer opportunities that can be exploited by other parts of the multinational by means of internal networks. (Castellani and Zanfei, 2006)

Castellani and Zanfei mention two important incentives for multinational firms to develop internal networks. They will be discussed shortly and the question will be raised whether these incentives are applicable on Dutch subsidiaries in Milan. The first factor that stimulates internal networks in an MNC is *external uncertainty*. This uncertainty is caused by geographic and cultural distance. By expanding the internal networks, a multinational firm increases its ability to judge and evaluate the local context on a foreign market. In case of Milan, the geographic distance is relatively small. Milan is only a ninety minutes flight away from Amsterdam. Additionally, especially Northern Italy is culturally comparable with the Netherlands (EVD, 2006), so the cultural distance is relatively small either. So, this external uncertainty does not seem to be a really big incentive for companies that invest in Milan, to expand their internal networks.

The second factor mentioned by Castellani and Zanfei is *behavioral (internal) uncertainty*. Behavioral uncertainty concerns the difficulty of observing and measuring the adherence of contracting parties to the contractual arrangements and the difficulty of measuring the performance of these parties. (Robertson and Gatignon, 1998) The inexperienced firm might not be in a position to accurately assess the performance (outputs) of economic agents active in foreign markets, thus it might resort to monitor their efforts (inputs) by extending hierarchical control (Erramili, 1991). In case the duration of the stay of a firm on a certain market increases, the importance of this factor decreases, because the mutual trust between the MNC and the firms in the environment increases. (Zucker, 1986, Lyons and Metha, 1997) Therefore, this factor plays an important role for companies that have a short history of investment on a certain market, that have little knowledge of the local market and that have not yet developed relations of trust with local firms. For this reason, these companies have close relationships with other parts of the multinational firm. If the duration of a firm's stay on a certain market increases, the behavioural uncertainty decreases and the subsidiary will develop more external relationships.

The information above gives enough information to formulate an assumption about the expected embeddedness of Dutch affiliates in Milan. The fact that Dutch direct investments in Milan are mainly horizontal, results in many relations with local suppliers, retailers and customers, what causes a relatively high degree of integration. The two incentives to focus on internal networks mentioned by Castellani and Zanfei are only partly applicable on Dutch affiliates in Milan. The external uncertainty caused by geographic and cultural distance will not be large. Milan is relatively close to the Netherlands and shows relatively many resemblances to Dutch culture. The other incentive, behavioural uncertainty, plays an important role for companies that have a short history of investment on a certain market, that have little knowledge of the local market and that have not yet developed relations of trust with local firms. Therefore, affiliates established in Milan for a short time, will have an important reason to focus on internal networks. Companies that are established longer, will gain more knowledge of the local market and will develop more relations of trust with local firms. Firms that have invested in Milan by merger or acquisition are able to use the knowledge and relations of its partner, to integrate in external networks. Behavioural uncertainty causes a focus on internal networks by young establishments, especially Greenfield entries. This information leads to the following hypothesis on the embeddedness of Dutch firms in Milan:

***"The longer affiliates are established, the easier it will become for them to integrate in external networks, and as a result, these long established firms will be more embedded in the local context than affiliates that are established for a short period"***

**§6.5**

## Sovereignty of Dutch subsidiaries in Milan

The question I will try to answer in this paragraph is: what is the degree of sovereignty of the firms involved? Which factors influence the competitiveness of a firm, and what is the influence of sovereignty on the competitiveness of a firm?

In the book *"multinational firms, innovation and productivity"* by Castellani and Zanfei, attention is given to the autonomy of foreign subsidiaries from multinationals. In this discussion, it is assumed that the Dutch direct investments in Milan are horizontal.

In chapter two it is mentioned that there exists a positive relationship between the degree of sovereignty and the degree of embeddedness. But before we can say something about the expected degree of autonomy of Dutch subsidiaries, we have to answer the following question: which factors affect the autonomy of subsidiaries? And the question that follows is: what are the effects of increasing autonomy of a subsidiary?

Survey of the book of Castelli and Zanfei shows that the local context is a source of opportunities and competitive assets for MNC's. In case a subsidiary is located in a dynamic and challenging context that offers many opportunities, the need for autonomy increases. (Castellani and Zanfei, 2005). If the mother company does not provide this desired autonomy, diseconomies occur. This is caused by the fact that it is ineffective to centralize the gathering of information and the decision-making. There are three main reasons that cause the inefficiency of centralization.

The first reason is caused by the fact that the subsidiary is located in the middle of the local context. The fact that the mother company is acting on a geographic distance causes a so called *information asymmetry*. This makes it difficult for the mother company to fully control the business of the subsidiary abroad. Information asymmetry causes a shift from direct to output control. (Castellani and Zanfei, 2005) This causes an increase of autonomy of the subsidiary.

Second, it is difficult for a firm with little autonomy to develop relationships with local companies. The more a firm gets integrated in the local context and gets in touch with local companies, the more such a firm requires autonomy. The third and a very import disadvantage is that centralizing decision making will reduce the firm's ability to understand local business environment and hence to develop close relationships with local counterparts, hence further diminishing its innovation potential. (Andersson, Bjorkman and Forgsgren, 2005) Allowing greater autonomy to subsidiaries would instead create greater incentives for the subsidiary to take profitable initiatives at the local and global levels. (Birkinshaw, 1997)

The local context also has its influence on the autonomy of the subsidiary. The more opportunities an environment offers, the more a subsidiary wants autonomy to have the ability to fully exploit these opportunities. So, there is a positive relationship between integration in external networks and the degree of autonomy. (Castellani and Zanfei, 2005)

Castellani and Zanfei do mention some disadvantages caused by decentralization of decision-making within multinational firms. A high degree of autonomy for subsidiaries can harm the internal knowledge transfer within MNC's, because the intensity of internal cooperation decreases. Actually, there is one important condition that is decisive for the possible positive effects of decentralization of decision-making. An increase in autonomy should be connected with integration on the local economic context. In case this does not happen, short term success can be achieved, but on the long term this will not lead to an advantageous development, because the subsidiary will be isolated within the local context. (Castellani and Zanfei, 2005)

Based on the theory described above, it is clear that the advantages of decentralizing decision-making outweigh the disadvantages of it. Especially in an economic strong developed, dynamic and prosperous region like Lombardy, a certain degree of autonomy is very important for the subsidiaries of Dutch firms. This autonomy gives them the ability to constantly adapt themselves to the changing circumstances in the area. This is on condition that the subsidiary does develop some external relationships. This information leads to the following hypothesis:

***"Dutch multinationals should supply their subsidiaries in Milan with a certain degree of autonomy, to make sure these subsidiaries are able to stay competitive in the challenging environment of Milan"***

Now let us look at the sovereignty of the Dutch affiliates in Milan. The interviewed companies often declare that they have a lot of contact with their mother company. Five companies state that they have contact with their mother company in Holland very frequently, almost daily. Eventually, the mother company is responsible for the long-term strategic decisions. However, most companies indicate that there is a fine cooperation between the mother company and the affiliate, and these two parties are both involved in decision-making. This is because the local managers have good knowledge about the local market. This knowledge is used by managers at the mother company to come to optimal short and mid-term strategic decisions, in accordance with the managers at the affiliate. Therefore, the mother companies of these affiliates make good use of the knowledge of local managers, but they must keep in mind that it is profitable to give the affiliates their required sovereignty, in order to avoid the occurrence of diseconomies.

## §6.6

## The attractiveness of Milan to Dutch investors

The question whether the business environment in Milan is attractive, will be answered by using the location theory of Porter (1990) and the constraints to direct investment in Europe that were mentioned by Dutch scholar Westerman (2003).

In chapter 3, some location factors are described which could stimulate or object the competitiveness of a certain area. I will shortly describe these factors. Then, these location factors will be applied on the situation in Milan.

Investing abroad can save costs, but there also some high initial costs connected to direct investments in foreign countries. These initial costs can be difficult to afford. For example, the establishment of a new factory abroad asks for high investments. The risk of failure is quite high, because a firm invests on a rather unfamiliar market on which unexpected problems can occur. These problems are often caused by cultural differences. This ignorance of local culture can be overcome by forming an alliance with a local partner (Lowes, Pass and Sanderson, 1994).

Westerman (2003) mentions some constraints that are connected with foreign direct investments. This Dutch scholar has focused his research on foreign direct investments on the specific situation in Europe, so the constraints he mentions are applicable on the investment relations between the Netherlands and Italy. However the European Union puts much effort in the integration of legislation and taxation of the different countries, there still exist some clear differences between European countries. This difference in legislation and taxation is the first constraint he mentions. The second constraint he is the fact that domestic entrepreneurs may have a negative attitude towards foreign investors. They might be seen as a threat, and domestic entrepreneurs may use their power to make it hard for foreign investors to be successful. Eventually, Westerman mentions the general economic climate as a constraint to foreign investment. The concept “general economic climate” contains the economic circumstances, institutions and cultural characteristics of a certain area. These cultural characteristics were already mentioned by Lowes, Pass and Sanderson as a possible constrain.

Economic geographer Porter has added an important contribution to modern location theory. He looked at the influence of location factors on the competitiveness of countries in international trade. Porter was looking for the location factors that were critical for the international competitiveness of countries. This competitiveness is decisive for the amount of incoming FDI. According to Porter (1990), there are four main factors that are important to the development of competitiveness. The first factor we will discuss is factor conditions*:* the appearance of commodities, capital and labour; geographic position; quality of infrastructure etc. The second factor discussed is called demand conditions: this condition involves the distribution, the size and growth of domestic demand, as well as the internationalization of domestic demand, through which domestic preferences will be implemented on foreign markets. The third factor is the network between sectors: this condition involves the existence of extensive clusters of interdependent sectors that are internationally competitive. The last factor mentioned by Porter is the economic system. Therefore, Porter focuses on economic characteristics to determine the competitiveness of a certain area.

Let us apply the location factors mentioned by Westerman (2003) and Porter (1990) and Lowes, Pass and Sanderson (2004) on the province of Milan. Westerman and Lowes consider the cultural differences as an important possible constraint to foreign direct investments. Well, according to the EVD (2005) there are some cultural differences between Italy and the Netherlands. Doing business on the Italian market is seen as a difficult activity by many Dutch investors; the language, the culture and the fractioned distribution structure show large differences with the Netherlands and its surrounding countries. The complicated business structure in Italy makes it difficult for foreign investors to determine a right strategy for the infiltration of the Italian market. (EVD, 2005)

These cultural differences are also clearly shown in the practice of doing business in Italy. This practice is much more indirect in Italy than it is in the Netherlands. The hierarchy within the firms is more stringent than it is the Netherlands. Employees are not expected to judge the decisions of a higher-placed colleague. However, it must be mentioned that business practise in northern Italy is more efficient than it is in southern Italy. The practice in northern Italy has more resemblances with the business practice in the Netherlands. (EVD, 2005) Still, these cultural differences can be a constraint to successful investments in Italy.

Westerman also mentioned taxation as a possible constraint to foreign direct investment in Italy. In 2003, the Italian government introduced a major tax reform. This reform is aimed at individuals and the business sector and its goal is to simplify the Italian tax structure and to make Italy more attractive to foreign investors. The reform included harmonisation with other countries in the European Union and a lower income tax rate for companies. (Italian organization for investment promotion, 2006) This reform should be a positive influence on the Italian investment climate.

Let us apply the factor conditions mentioned by Porter on the province of Milan. The first location factor he mentions is the factor conditions. These conditions involve the appearance of commodities, capital and labour, the geographic position and the quality of the infrastructure. The skills of the domestic labour force are one of the factors that cause Italy's slow economic growth. The costs of labour have rapidly increased the past years, but the growth of labour productivity has been poor. Italy has a disadvantageously, low-tech export. This is caused by the fractioned business structure and poorly educated workforce. There is a large share of small companies, which invest very little in research and development. In 2002, only 44 percent of the workforce has had secondary education; in the EU-15, the average share of the workforce that had secondary education is 62 percent. Moreover, Italy has a deficit on its yearly account of over three percent. (CPB, 2006) These factor conditions do not have a positive influence on the competitiveness of the country.

On the other hand, the geographic position of Milan is very advantageous. It is located in the most prosperous part of Italy, and much closer to Western Europe than other parts of Italy. Milan is even located in the economic core of Europe. This core is entitled as the *blue banana* and is located between London and northern Italy, via Holland and Germany. In Italy itself, Milan is located in a region called the *golden triangle,* together with Genoa and Turin. Therefore, the geographical location of Milan seems to be a positive factor. The infrastructure, at last, does not seem to be of a very high quality. According to three of the seven interviewed firms, the infrastructure and transport facilities in Milan are weak.

Let us go on with the demand conditions. These conditions involve the distribution, size and growth of domestic demand, as well as the internationalization of domestic demand, through which domestic preferences will be implemented on foreign markets. The Italian market is large for European standards, with almost sixty million inhabitants and the fourth large domestic product in Europe. Twenty percent is earned in the federal state of Lombardy. (Regione Lombardia, 2006) The purchasing power is distributed very uneven. In Lombardy the GDP per capita is 29500 euro, this is 35 percent above the EU-average. In the south, GDP per capita is much lower, 16000 euro. This is 27 percent below the EU-average. (Eurostat, 2005)

Increasing demand is very important to firms that are planning to invest in Milan to infiltrate the domestic market. This is because increasing demand offers opportunities to grow for newly established firms. Nevertheless, this growth is really low in Italy, compared to the European average. Since 1999, GDP has increased with 1,9% in the EU and with 1,2% in Italy. This makes Italy the country with the lowest growth in the EU. The situation in Lombardy, with main city Milan, is even worse. GDP in Italy grew with 0,3%, but the GDP in Lombardy reduced, with 0,6%. (Eurostat, 2006) This decline of regional GDP is considered a negative location factor by foreign investors. It is not attractive to invest in a shrinking market. In the following figure, the growth of GDP in the EU-25 between 2001 and 2006 is compared to the Italian growth rate.

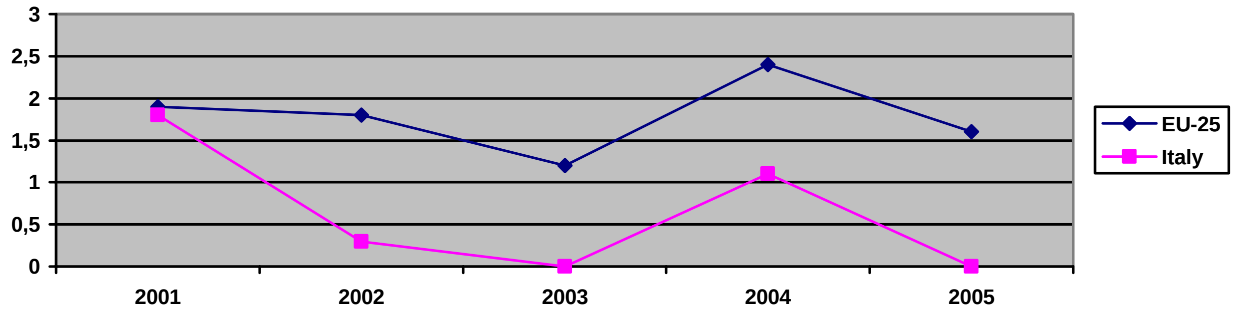


*Figure 6.1.: Growth rate of GDP in Italy and EU-25, in % (Eurostat, 2006)*

The third location factor mentioned by Porter is the existence of interdependent sectors that are internationally competitive. These sectors are clearly apparent in Milan. The city is leading and famous for its textile and fashion accessories. There exists a strong cluster of high-tech manufacturing firms and Milan is Italy's capital of the new economy, with about 8,000 internet-based enterprises, representing twelve percent of the country's total. (Milan Chamber of Commerce, 2006) The economic system, mentioned as the fourth location factor by Porter is capitalism, as it is in the Netherlands.

Asked to their opinion about the local circumstances compared tbo the circumstances in Western Europe, the managers of the requested firms all indicate that the location factors in Milan are comparable, or weaker than they are in Western Europe. Especially the role of the government is criticised. According to the managers, the government is uncooperative, uncompromising and not stimulating regional development. This idea is supported by the EVD (2005), that indicates that the Italian government is regarded as "bureaucratic and uncompromising" by the local population. The managers state that the education level of employees in Milan is higher than in the rest of the country. This leads to the following hypothesis on the attractiveness of Milan to Dutch investors:

***"There are a number of important constraints to foreign investors in Milan. However, characteristics like the geographic position, the large domestic market and the high regional income, still make Milan an interesting city to invest in for market-seeking firms"***

The information above, both empirical as theoretical, gives information on the quality of location factors in Milan, and on the perception of local managers on the local environment. A short summary of strengths and weaknesses of the Milanese economic environment will follow.

There are some cultural differences between the Mediterranean country Italy and the Netherlands. These differences sometimes frighten Dutch managers to invest in Italy. However, Milan has an efficient business practice that shows many resemblances with North-European business practices. The government has recently introduced a tax reform, which resulted in a simplified tax system and lower tax rates for firms, in order to stimulate foreign investment. A great strength of Milan is its geographic position. Located in the north of Italy, it forms the southern border of Europe's southern border. Italy has a large domestic market with the fourth large GDP in Europe. Additionally, Milan is located in Lombardy, Italy's most prosperous area. The GDP per capita here is 35 % higher than the average of the EU. Milan owns some internationally competitive clusters. A well-known example is its fashion industry.

A weakness of the Milanese business environment is the scarce knowledge of the English language in Italy. Because the English language is the international business language, this causes communication problems with foreign (Dutch) investors. The juridical business structure is very complicated, what makes it difficult for foreign companies to infiltrate the domestic market. (EVD, 2005) Another weakness is the sharp increase of labour costs in recent years, in combination with a tiny growth of labour productivity. Compared to other countries in the European Union, the education level of Italy's workforce is poor. The Italian GDP showed the smallest growth rate in the entire EU the last seven years, and the GDP growth rate in Lombardy even showed a negative growth rate in 2003. Add the role of the government, which is seriously criticised, and it appears that the Milanese investment climate has many weaknesses.

It appears that the location factors in Milan are not of West-European standards. There are a number of important constraints to foreign investors in Milan. The geographic position of Milan, in the most prosperous part of Italy, is a large advantage. The large domestic market, combined with a high regional income, still makes Milan an interesting  city to invest in for market-seeking firms.

## §6.7

### Is regional economic development in Milan stimulated by increased embeddedness of foreign multinational firms?

The last question is connected with the institutionalist approach. The economic geographer Martin (2003) has described the embeddedness hypothesis. This hypothesis argues that trust, reciprocity, cooperation and convention play a key role in successful regional development.
Let's start to find out why it is thought that embedded companies are more successful than less embedded firms. Economic institutions are constructed through the mobilization of resources through social networks, conducted against a background of constraints given by the previous historical development of society, policy and technology. In fact, institutions are *congealed* social networks. Economic activity is said to be embedded in these ongoing social institutions or networks to the extent that it depends on interaction with other agents in those networks. I will illustrate this rather abstract description with an example. Product and credit markets can exist because they are based on trust in the fulfilment of future transactions. Here, the capitalist economy is embedded in social relationships. There is considerable evidence that demonstrates that many organizations, as well public as private, operate effectively, precisely because they are embedded in, and incorporate, these social networks. (Martin, 2003)

These social networks require community-like structures, associations, and networks for their existence. Suitably institutionalized, that is subsumed within local business and work cultures and routines, these social relationships offer many benefits to embedded local firms. These institutions reduce uncertainty amongst local economic actors by providing tacit or collective knowledge, by disseminating strategic information, by sharing risks, and by establishing acceptable norms of competition. (Martin, 2003)

The idea that these social networks play a hidden key role in regional development results in the embeddedness hypothesis. This hypothesis argues that trust, reciprocity, cooperation and convention play a key role in successful regional development. (Martin, 2003) This concept of embeddedness, brought forward by institutionalist economics, has several implications for foreign companies that are planning to infiltrate on a foreign market, or who are already acting on a foreign market.

This concept of embeddedness implies that foreign companies that enter a certain market have disadvantages towards domestic, embedded companies. This is because the domestic companies are already embedded in the local social networks and therefore they receive the benefits that are mentioned above. Foreign companies that infiltrate on a market are not embedded and therefore they do not receive those benefits. From this point of view, a foreign company is less competitive than a company that has a longer history on its domestic market.

However, the embeddedness hypothesis is not about the successful development of a company, but about the successful development of a region. The social networks make sure that the competitiveness of embedded firms is increased. Moreover, the fact that foreign companies are not involved in the creation of regional social institutions, does not mean that such a company cannot relate to the social networks. For instance, as written by Lowes, Pass and Sanderson (1994), a company can decide to merge with a domestic company or it can acquire a domestic company. In this way, the knowledge of local culture and institutions can be adapted. And in case a foreign company merges with a local company, it can benefit from the trust and reciprocity the local firm was offered by local firms.

A concept that is related to the concept of embeddedness is the concept of the *double network structure* of Castellani and Zanfei that is already described. In short, it means that a multinational has two kinds of relations, internal relationships, with units inside the multinational and external relationships, with units outside of the multinational. By acquiring local knowledge of the market, a local subsidiary can get access to the social networks in which the regional companies are embedded. And since the internal and external networks of relationships are complementary (Castellani and Zanfei, 2005), the subsidiary can use its internal relations to benefit from being a part of a multinational. For example, a MNC spends a lot of money on research and development. This knowledge is transferred to the subsidiary by using the internal networks. Nevertheless, in case the subsidiary has a high degree of embeddedness in the local context, firms embedded in the external network can use this knowledge in advance of other firms. Therefore, in this way, the embeddedness of a MNC can lead to a sort of spillover-effect, as is mentioned by Barba Navaretti and Venables (2004). There is one condition for this to happen. The internal relationship of the subsidiary with other units of the multinational company has to be sufficient. Otherwise, the flow of knowledge from the headquarters to the subsidiary will be reduced. (Castellani en Zanfei, 2005) Assuming that these internal relationships are sufficient, this information leads to the following conclusion. The appearance of an MNC in an economic region, can lead to strengthen regional economic development, because external knowledge leaks into the regional social network.

However, there is an effect the other way round. If a multinational succeeds to acquire a high degree of embeddedness in a local context, and it is familiar with the social networks, it can benefit of the trust, reciprocity, cooperation and convention that is shared with the local firms. Therefore, the multinational, as well as the economic environment, takes benefits from a high degree of embeddedness of a multinational company. This leads to the following hypothesis:

***"A high degree of embeddedness of a multinational company has a positive influence on the local context, as well as on the company itself. There is an important condition: the subsidiary of the multinational must have sufficient internal relationships with other units inside the MNC."***

As we have seen in paragraph 6.1.4, Dutch firms have a relatively high degree of embeddedness in Milan. This is caused by the fact that Dutch direct investments in Milan are mainly horizontal what results in many relations with local suppliers, retailers and customers. Additionally, the two incentives to focus on internal networks are only partly applicable on Dutch subsidiaries in Milan, as discussed in paragraph 6.1.4. This high degree of embeddedness might have a positive influence on the local economic environment and on the subsidiary itself. As mentioned above, one important condition has to be fulfilled in order to achieve this positive influence: the subsidiary of the multinational must have sufficient internal relationships with other units inside the MNC. The qualitative data analysis (chapter 5) shows that the subsidiaries involved in the interview program have contact with their mother company frequently. Most companies indicate that there is a fine cooperation between the mother company and the affiliate, and these two parties are both involved in decision-making. This finding shows that there are still rather close internal relationships between the subsidiary and the headquarters, what enables a proper flow of knowledge from the mother company to its local subsidiary. Now this condition is fulfilled, there is reason to believe that the relatively high degree of embeddedness of subsidiaries might have a positive influence of the local economic environment and on the subsidiary itself.

# Chapter 7

## Conclusion and recommendations

In this final chapter, I will discuss the outcomes of my research. In the second part of this chapter, I will give recommendations for Dutch MNC’s planning to invest in Italy and for further research on this subject.

*Conclusions*

The goal of chapter six was to define the functioning of Dutch subsidiaries in Milan and to understand this functioning from a theoretical point of view. Therefore attention is given to the characteristics of these firms and to their integration in the local context. What does this research learn us about the functioning of Dutch firms in Milan? The Dutch subsidiaries in Milan are established earlier than other Dutch subsidiaries in Italy and they are larger than other Dutch subsidiaries in Italy. Dutch multinationals might have invested in Milan first, before they spread their wings over the rest of Italy. These companies mainly invest here to infiltrate the large internal market. The Dutch firms have a rather negative opinion about the local business environment, but they argue that if you want to be present on such a market, you have to accept that market conditions are not of Northern European condition. The idea that the business environment in Milan is not of northern European standards is confirmed when Porter’s location theory is used to judge the city’s location factors.

The fact that Dutch subsidiaries in Milan are mainly market seeking, results in many contacts with local suppliers, retailers and customers. These contacts result in a relatively high degree of integration. This high degree of embeddedness might have positive influence on the local economy and on the subsidiary itself. The main condition for this to happen is that the subsidiaries have sufficient internal networks with their mother companies. This condition seems to be fulfilled. As a result, Dutch multinationals in Milan may cause a positive spillover effect on the local economy. It is important to make sure the internal relations stay sufficient in the future, because these relations are decisive for successful transfer of knowledge from the mother company to the subsidiary and indirectly, to the local environment.

*Recommendations for Dutch MNC´s planning to invest in Milan*

This study provides information that makes it possible to formulate some recommendations for Dutch firms that are planning to invest in Milan. These firms have to keep in mind that the local business circumstances may be inferior compared to North-European, or Dutch, standards. Especially the role of the government is regarded as opposing, instead of stimulating foreign multinationals. On the other hand, these firms should realize that Milan might be a very interesting location to invest. Italy possesses a large domestic market of sixty million consumers. Their income is lower than the Dutch income, but still relatively high. Additionally, Milan is located in the most developed and most prosperous region of the country. However, Dutch firms planning to invest in Milan to serve the local market should realize that economic growth in Northern-Italy has been very poor last few years.

In case a multinational has decided to really invest in Milan, this study provides some useful recommendations based on an analysis of relevant literature. It is important for the subsidiaries of MNC´s to integrate in the local economic context. This integration can be achieved by developing relationships with local actors. It may be very helpful to become member of a local organization in which local firms are represented. This integration, or embeddedness, offers many benefits that increase the competitiveness of the subsidiary. A multinational firm can accommodate the integration of its subsidiaries in the local context, by offering a certain degree of autonomy. This makes it possible for a subsidiary to develop external relationships. Additionally, a high degree of autonomy makes it easier for a subsidiary to react on local developments. Since these subsidiaries are really acting on this local market, in this case Milan, they possess specific knowledge of the market that enables them to recognize these developments and to react on them.

Providing a subsidiary abroad with a high degree of autonomy does not mean that, the relationship between the subsidiary and other parts of the MNC´s should be neglected. These internal relationships provide the MNC-headquarters with inside-information of the market abroad, what enables them to develop an efficient long-term strategy. On the other hand, close internal relationships make sure that important knowledge is transferred to the establishment in Milan. In this way, the subsidiary really benefits from the fact that is part of a multinational company. The conclusion of this discussion is the following: Dutch firms that invest in Milan are recommended to offer their subsidiary a high degree of autonomy, what does not mean that they have to neglect internal relationships.

*Recommendations for further research*

This research is built on three sources of information. These sources are literature, quantitative data and qualitative data. A lot of literature is available about the subject of foreign direct investments. In this respect, I want to mention the book of Barba Navaretti and Venables *Multinational firms in the world economy* (2005) in particular. This book contains a lot of state-of-the-art knowledge about foreign direct investments and multinational firms.

The database supplied by the Technical University of Milan contained a lot of information about Dutch subsidiaries in Milan. This database offered the possibility to compare Dutch subsidiaries in Milan with Dutch subsidiaries in the rest of Italy. I had enough quantitative information do a research on Dutch establishments in Milan.

The third source of information is qualitative data. It was difficult to gain enough qualitative information. The plan was to have a 2-month interview program with managers of Dutch subsidiaries in Milan. The reactions on my repeated interview requests were quite disappointing. Only seven Dutch firms in Milan were willing to have a short interview, face-to-face or by e-mail. There might be several causes for this failure. One cause might be a lack of effort on my side. However, I do not think this is the case. One month before I went to Milan, I have sent all the Dutch establishments letters with a request for a short interview. In Milan, I spend many days phoning and e-mailing these firms. I think there are other reasons for the small number of reactions. At first, there is a language barrier with Italian people. In many cases, they lack knowledge of English, what makes it hard to communicate, especially by phone. Second, Dutch subsidiaries in Milan are often large firms, what causes that my requests were sent from one person to another, while no one felt the personal responsibility to react. Third, some companies were not willing to share sensitive information. Nevertheless, the fourth reason is the most important in my opinion: arranging an interview with a Dutch student has absolutely no priority for busy managers. A solution might be to start contacting the firms much earlier. It might be easier to make appointments on a long-term than on short-term.

What the reasons may be, the small number of reactions threatens the validity of my outcomes. Therefore, I have only used the qualitative data to illustrate my findings that were based on quantitative data and literature. Conclusions are based on these two sources of information. The most important recommendation to a student willing to do qualitative research abroad is: make sure that the appointments are made before you travel abroad.

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