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National Income Inequality, Society, and Multinational Enterprises

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Chapter 11
National Income Inequality, Society, and Multinational Enterprises

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ABSTRACT

This chapter calls for understanding the perspective of multinational enterprises (MNEs) on international differences in income inequality. The authors set a research agenda on how national differences in income inequality influence MNE expansion strategies. Applying a transaction cost framework, both negative and positive economic outcomes of income inequality, from the MNE's perspective, are identified. Low levels of income inequality may deter foreign investment, as MNEs prefer countries where they incur lower levels of transaction costs arising from interactions with various market and non-market actors. However, the positive effect of income inequality on location attractiveness will likely diminish at higher levels of inequality when benefits are increasingly offset by additional monitoring, bargaining and security costs owing to instability and conflict. The chapter further explores the implications for level of MNE equity applied in the choice of entry mode under different levels of income inequality.

INTRODUCTION

In this chapter, we begin a discussion, and call for novel research, on how multinational enterprises (MNEs) respond to national income inequality worldwide. Prior research on MNE strategy has detailed how location characteristics, comprised of land, labor, infrastructure and capital endowment, along with institutional quality, impact the 'where' and 'how' of international expansion (Nielsen, Asmus-

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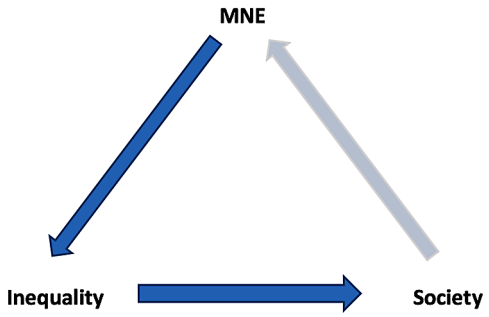
sen & Weatherall, 2017). The role of societal characteristics, however, receives much less attention. One societal characteristics that has received much attention lately is income inequality. Recent studies provide evidence that long-term rise of income inequality leads to slower economic growth (OECD, 2015), implying that there is a more direct relationship between economic investments and inequality. Our goal, therefore, is to motivate a research agenda aimed at understanding the MNEs' preferences for varying levels of income inequality (i.e. location attractiveness), and how it impacts the MNEs' expansion strategies (i.e. cost and benefits of inequality).

Figure 1 depicts a simplified overview of what is known about the interrelations between income inequality, society and the firm. Income inequality impacts social conditions including crime, quality of life, and unrest, and also impacts economic growth and political stability (Neckerman & Torche, 2007). The firm affects inequality as it is the primary mechanism through which incomes are provided (Cobb, 2016). What is so far missing from current research is the effect that the societal impacts of income inequality have on the functioning of business operations. Our chapter thus aims to flesh out this relationship by applying a transaction cost lens to predict how the social outcomes of different degrees of income inequality impact the economic interests of the MNE. By better understanding this relationship, we will be able to predict how income inequality impacts MNE decisions on international expansion, such as location choice and entry mode.

Following this introduction, we briefly define income inequality, its measurement, and its known outcomes. Next, we review literature on MNE expansion strategies to deduce how the social consequences of both low and high income inequality will impact them. In this section, we apply a transaction cost lens (Williamson, 1985) to relate the social and economic consequences of income inequality to economic costs and potential benefits for firms. We follow this with a section outlining our tentative predictions on the extent to which the MNE will exhibit a preference for income inequality, depending on its economic motives for expansion. This section also directs future research on how the MNE may use organizational structure, namely entry modes such as wholly-owned subsidiaries, joint ventures, etc., to buffer the firm from the negative consequences of social conditions induced by income inequality. Finally, we call for research on how MNE experience, including the nature of its home country income inequality and international experience will also shape the MNE's general preferences towards income inequality.

Figure 1. The position of the multinational enterprise between inequality and society



BACKGROUND

National Income Inequality Defined and Measured

National income inequality refers to the distribution of total wage earnings amongst a country's workers, including wages from employment, business income and earnings from investment. The extant inequality research has mainly focused on its negative impacts on individual wellbeing and societal functioning (Neckerman & Torche, 2007; Pickett & Wilkinson, 2015). While the factors that contribute to income inequality are multifaceted, income inequality is an inevitable outcome of wage differentiation based on profession, qualifications and/or productivity levels (Jacoby, 2005). Such differences are to be expected, as wage setting is a key mechanism for increasing employee motivation and skills upgrading (Simpson, 2009).

Measurement of income inequality can be approached in different ways, although most techniques involve use of either point estimates or coefficient of variation (Cobb, 2016). Point estimates compare the proportion of cumulative wealth above and below specific thresholds, for example, the share of cumulative earnings of the top 1% of wage earners compared to the other 99%, or the number individuals whose combined wealth equals that of the bottom half of earners worldwide (Atkinson, 1975). At the time of this writing, the eight wealthiest persons of the world had a combined wealth equal to that of the bottom half of the world's population (Mullany, 2017). Point estimates typically tend to depict inequality in sharp relief while ignoring the characteristics of the middle of the distribution. As such, these estimates tend to depict conditions which do not entirely reflect the experience of the middle class. The OECD (Lopez Gonzalez, Kowalski & Achard, 2015), for example, points out that while globally the gap between middle and bottom earners is widening, the gap between middle and high earners is shrinking.

Coefficients of variation, such as the Gini coefficient, are less sensitive to the extreme points in the distribution and thus better capture the shape of a distribution throughout all ranges. Recent work by Solt (2009) provides the most comprehensive and comparable data on worldwide national income inequality. Nonetheless, all measures of inequality are currently limited in that it is impossible to divide the proportion of income derived from non-labor earnings from labor earnings due to national differences in tax reporting of investment income. Likewise, most income inequality data are currently aggregated to the national level, and therefore do not allow examination of sub-national variation, such as the sharp contrast between rural and urban populations in India, or the population whose economic activity is primarily informal, and hence not observable.

Figures 2 and 3 depict trends in inequality in a sample of emerging (i.e. BRIC) and developed (i.e. G7) countries, respectively. The most noticeable difference between the two graphs is average level of inequality. While G7 countries tend to be more vocal about rising inequality, BRIC economies are overall much higher on this dimension. Furthermore, while some G7 countries have experienced increases in inequality (i.e. Canada, the U.S., and Germany), these changes are quite gradual compared to the more volatile shifts in BRIC countries. China, for example, saw a large spike in inequality around 2000, which coincided with its ongoing economic liberalization, perhaps indicating the rise of capitalism. India, also

Figure 2. Income inequality trends in BRIC countries

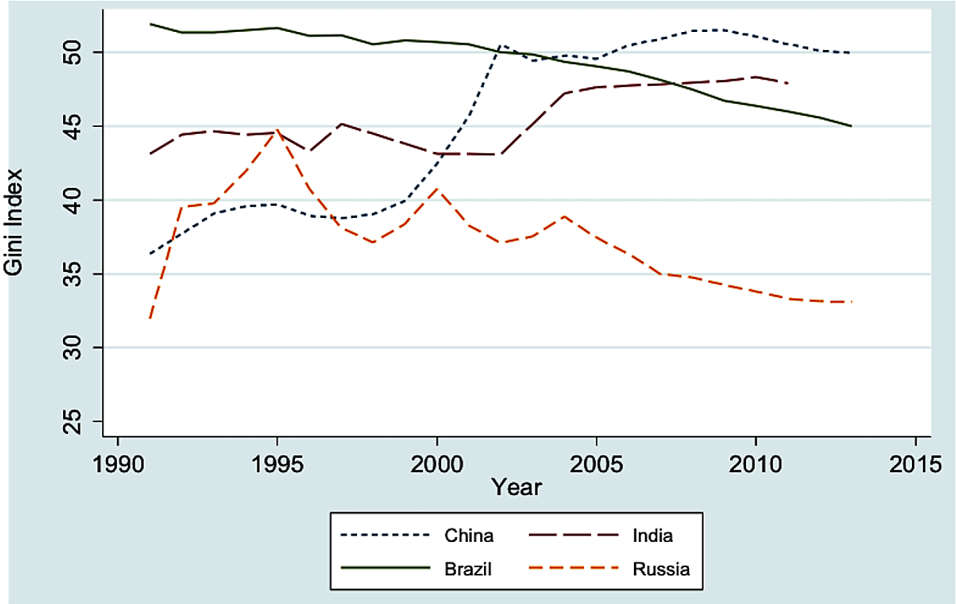
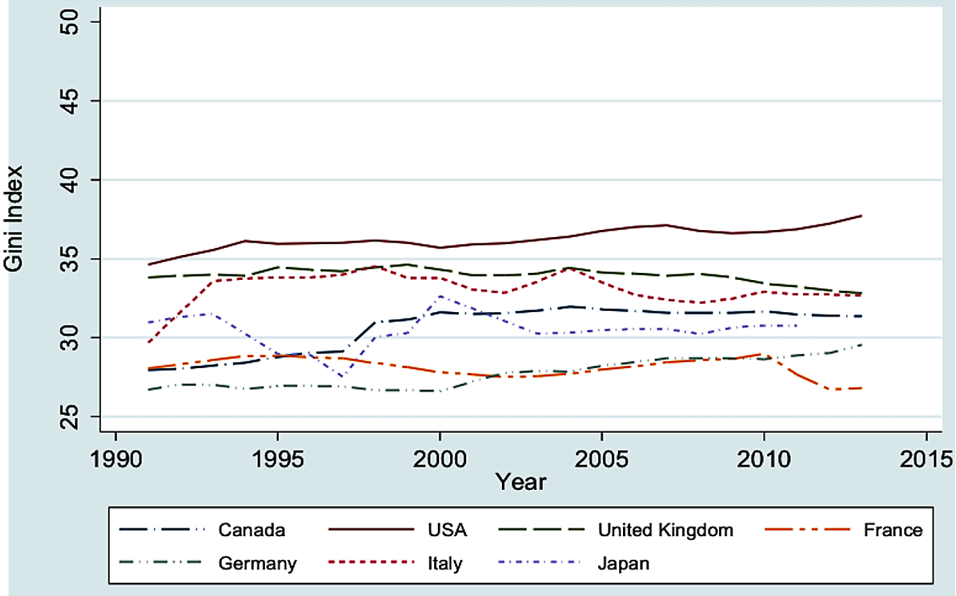


Figure 3. Income inequality trends in G7 countries



possessing high economic growth rates, has similarly experienced an income inequality spike, albeit less pronounced than in China. Although economic growth in Brazil has not met the more optimistic of predictions, its income inequality has declined since late 1990s. This cursory analysis cannot begin to explain national income inequality differences and trends, and indeed a substantial body of literature we review later suggests the causes are complex and highly interrelated. For the purposes of this chapter,

it is important to note that differences in levels and trends in income inequality between countries vary widely, and that economic globalization, comprised of substantial foreign direct investment and liberal economic policies, appears to play a role. We next examine what is known about the outcomes of income inequality for society. The specific role of the MNE is examined later.

Income Inequality and Society

Growing income inequality in societies around the world, and its relationship with social ills such as damaged trust, lack of social mobility, negative health consequences, high crime rate and stagnating wages, is garnering substantial attention in mainstream (e.g. Irwin, 2014; Piketty, 2014) and academic discourse alike (e.g. Alvaredo et al, 2013). Even long-time stalwarts of competitive business strategy have raised alarm over the potential for a downward economic spiral with business at the helm (e.g. Porter & Kramer, 2011). The causes of income inequality are many, and these vary by country, and between countries, as discussed earlier. Some of the more widely cited influences on increasing income inequality are the increasing reliance on mechanization and automation, the decline of unionization and collective bargaining, and globalization (Van Reenen, 2011; Wolff, 2015).

Technological change influences wage distribution through increasing the marginal productivity of skilled workers, who are paid more, while the wages of less-skilled labor remain stagnant. The often-cited Kuznets curve (Kuznets, 1955) assumes that demand for skilled workers exceeds supply and thus, in the short term, technological change widens the earnings gap. Inequality is then the unintended consequence of technological developments.

While technological progress can increase inequality by displacing less-skilled workers from higher paying jobs, unions are largely credited with raising the wages of lower income earners at a faster rate than upper wage earners, thereby narrowing income gaps in the middle of the wage spectrum (Alderson & Nielsen, 2002). Countries like Spain, Ireland, Mexico and Chile have experienced an increase in union memberships. Chile, for example, has doubled the number of workers unionized since 1981 (Economist, 2015). The traditional economic view suggests that an increase in union membership would lead to higher bargaining power of the members, which in return allows them to secure higher wages (Lommerud, Meland & Sorgard, 2003). For rich countries, however, labor union memberships are at historic lows. In the United States for example, membership dropped by almost 30% from 1979 to 2013 (Economist, 2015). Declining unionization is largely cited as a source of widening income gaps in the United States over the latter half of the twentieth century.

Finally, globalization is often targeted as the primary driver of wage stagnation, as manufacturing jobs are transferred overseas to lower wage countries, thereby placing downward pressure on the lower end of the wage spectrum while the upper end continues to rise (Hellier & Chusseau, 2010; Smeeding, 2005). However, while jobs have been displaced in developed economies, these losses have been found to pale in comparison to those caused by mechanization and automation of production (Lehmacher, 2016). As MNEs move parts of their operations around the globe in order to obtain greater efficiency, higher productivity, higher revenues and tax advantages, they impact income inequality not only at home, but also between and within countries abroad. In the next section, we summarize the findings on research that examines the link between the MNE's investment activity and its impact on national income inequality.

Income Inequality and the MNE

Business is one of the primary mechanisms affecting social inequality given its proximal relationship with value creation (Davis & Cobb, 2010). Most research has focused on the impact of foreign direct investment (FDI) on national income inequality. In addition, prior studies on the relationship between income inequality and FDI typically rely on aggregate investment data (Basu & Guariglia, 2007; Deng & Lin, 2013; Jensen & Rosas, 2007; Lin, Kim & Wu, 2013; Wu & Hsu, 2012) and thus do not provide direct answers to the question of how an individual firm's expansion strategy may either benefit from or be constrained by income inequality.

Research on the impact of FDI on income inequality has produced mixed and sometimes contradictory results (Jensen & Rosas, 2007; Mah, 2012; Mahler, Jesuit & Roscoe, 1999; Peluffo, 2015; Tomohara & Yokota, 2011). These inconsistencies have been attributed to national differences in human capital endowment, the technological capability of local industries, and a variety of other institutional and economic conditions in the host country (Lin et al., 2013; Tsai, 1995; Wu & Hsu, 2012). The lack of consensus within this literature implies that both the portion of economic gains from FDI captured by the MNE and the portion distributed to different income segments and stakeholders varies between countries (Tsai, 1995). This means that as an MNE considers a foreign investment the attractiveness of a target location depends on how much of the economic gains the MNE expects to capture. This MNE perspective on the societal conditions produced by income inequality is necessary to better understand the role of the MNE in shaping national and cross-national income inequality. We next introduce transaction cost economics (TCE) to better understand location attractiveness; and then use this framework to understand the implications of income inequality on the MNE's expansion strategy.

CLOSING THE LOOP: SOCIETAL QUALITY AND BUSINESS FUNCTIONING

Transaction Cost Economics (TCE) and International Expansion

Transaction cost theory is useful for understanding business decisions in general, and the impact of inequality on the MNE as it internationalizes, in particular. TCE has long played a crucial role in the research on strategic management and international business (Coase, 1937; Macher & Richman, 2008; Williamson, 1979; Williamson, 1985). TCE holds that markets, firms, and intermediate organizational forms (e.g. strategic alliance) are discrete, efficient governance structures that match different types of economic transactions. Based on the two key assumptions of bounded rationality and opportunism, the theory focuses on three transaction attributes, namely asset specificity, uncertainty, and frequency. TCE predicts that various governance forms have different impacts on minimizing the costs associated with bargaining, governing and monitoring transactions (Williamson, 1985). The theory is at the core of several lines of research on strategic management in the global economy.

The theory of the MNE, especially the internalization framework, draws directly on transaction cost theory (Buckley & Casson, 1976; Hennart, 1982; Rugman, 1981). According to TCE, the MNE and the market are alternative governance structures for organizing interdependent economic activities across countries. The internalization framework argues that, due to market imperfections (especially for intermediate products), the firm is inclined to undertake economic activities internally (e.g. the transfer of proprietary technology) than through markets, as the latter is subject to higher transaction cost.

Internalization allows the MNE to retain competitive advantage derived from its tangible and intangible capabilities that cannot be readily transferred internationally using market mechanisms such as in the cases of exporting and licensing (Rugman & Verbeke, 1992). Thus, MNEs exist mainly as a governance solution to exploit opportunities arising from the integration of ownership advantages (e.g. proprietary technology) and location advantages (e.g. resource endowments and favorable state regulations) (Dunning, 1988; Hennart, 1982).

While host countries may offer economic advantages, such as access to low-cost natural resources or subsidy to set up operations, the countries' socio-political and institutional environment can potentially increase the cost of doing business. Political hazards such as seizure of assets and adverse changes in taxes and regulations can diminish the economic gains captured by the MNE. From a TCE's point of view, the socio-political environment of a country market determines how costly it is for MNEs to engage in economic investment and political activities (Henisz & Zelner, 2004; North, 1990). Uncertain environment implies higher transaction costs because frequent shifts in government policies or in agreements with other stakeholders such as organized labor mean frequent re-negotiation of new arrangements (Anderson & Gatignon, 1986) and this will present the social and political actors with many occasions to behave opportunistically to shift rents from the foreign investor to local stakeholders (Henisz & Williamson, 1999).

Transaction costs, comprised of contract negotiation, monitoring and enforcement costs, are incurred to mitigate ex-post opportunistic behaviors by transacting parties (Hennart, 1991). MNEs are particularly subject to hold-up by external actors such as the state (e.g. changing royalty regime for a refinery) due to the lengthy investment horizon and the fact that the assets invested are not easily redeployed (Henisz, 2000; Hennart, 1982; Jensen, 2006; Rugman & Verbeke, 2005; Williamson, 1981). MNEs thus incur substantial transaction costs to mitigate threats, and sometimes forgo investing in a potential host country in favor of locations that offer lower transaction costs. The extent to which the MNE leverages ownership and location advantages through internalization thus depends on the economic and institutional conditions of the host country, which directly influence transaction costs. For instance, more stable institutional environments characterized by firm rule of law, reliable property rights protection and political stability tend to reduce these transaction costs (Henisz, 2000). All else being equal, locations in which MNEs incur lower transaction costs are more attractive. We next examine how societal outcomes of income inequality can impact these costs, and therefore contribute to the investment attractiveness of a country.

The Costs and Benefits of Income Inequality From the MNE Perspective

Drawing upon income inequality research in the fields of labor economics, sociology and organization theory, we highlight the costs of both high and low inequality, which may detract indirectly from the MNEs overall cost efficiency. These costs, amongst others, impact the extent to which the expected gains from international expansion are realized. Employees are a primary group of stakeholders impacting the MNEs' decisions, but given the impact of income inequality on social functioning, the role of secondary stakeholders including government, civil society organizations (CSO) and local citizenry in general are also considered. We therefore examine the impact of income inequality on location attractiveness by exploring the transaction cost implications of labor market rigidity, political engagement of market and non-market actors, and labor supply characteristics in host countries. We later argue that the costs and benefits of inequality and their effect on transaction costs impact the MNE's expansion decisions regarding where to invest (i.e. location choice) and how to invest (i.e. through direct investment or non-

equity alliances). To these discussions we further add the contingent effects of MNE investment motives, and the roles of international and home country experience, which may alter the MNE's responses to income inequality.

Direct and Indirect Labor Costs

The cost of labor comprises a substantial portion of the MNE's overall operating costs. While reducing labor cost is not the only motive for international expansion and offshoring, it is a key MNE consideration in moving production operations to a new country. Indeed, moving jobs offshore is highly objected to by those holding an anti-globalization perspective. All else equal, income inequality indicates a wide distribution of wages levels, i.e. fat tails (Spilimbergo, Londono & Szekely, 1999). Here, income inequality is often a direct manifestation of a large and underemployed workforce. The rapid economic expansion in China, for example, was fueled both by an increased focus on industrialization and enticing the vast potential workforce from rural areas into the manufacturing sector. Due to persistent downward pressure on wages at the lower end of the earnings spectrum, income inequality tends to remain persistent (Hellier & Chusseau, 2010). In a less abundant labor market, conversely, the lower wages would rise more rapidly as local firms and MNEs competed for labor resources. High rates of unemployment thus work in conjunction with already low wages to further stifle wage growth, especially in the absence of more stringent labor regulations. This presence of abundant low-cost labor creates an attractive condition for MNEs seeking to maintain bargaining power over labor, which not only reduces wages but also the costs involved in locating and retaining a more cooperative workforce.

While it is generally assumed that the MNE seeks to lower labor costs simply by moving to lower-wage countries, that perspective overlooks the fact that these costs also depend on the efficiency of bargaining, monitoring and enforcing employment contracts. In addition to lower wages, the MNE can increase the efficiency of its operations by capitalizing on a more flexible labor market (i.e. less rigid markets). The term labor market *rigidity* refers to the extent that constraints imposed by labor institutions on the firm's ability to alter wages and staffing levels in response to changing business conditions, such as fluctuations in global demand (Cuñat & Melitz, 2012). Stringent policies at the national level regarding job protection and the use of collective bargaining, are the main factor leading to increased labor market rigidity, and consequently lower income inequality (Siebert, 1997). Research has also shown that rigid labor markets formed through high levels of unionization, centralized collective bargaining, government regulations restricting layoffs and contract extension policies create higher direct and indirect costs for firms (Belderbos & Zou, 2009; Gross & Ryan, 2008; Lafontaine & Sivadasan, 2009). In the case of collective bargaining, for example, firms must invest time and resources into negotiations with labor organizations. In 2016, for example, workers at the former appliance division of General Electric rejected a new contract, spurning an attempt by the new owner, China's Haier Group, to cut labor costs at a factory in Kentucky (Mann, 2016). Need for approval from these organizations before making staffing changes that impact either staffing levels, wages or both limits the firm's responsiveness to market conditions. Government policies on layoffs also create compliance costs, and limit the firms' flexibility in staffing decisions. Higher inequality arising from less rigid labor markets should thus be more attractive to MNEs because they create more conducive environments for labor cost economizing.

Political Engagement of CSOs

Other stakeholders, such as consumer and environmental advocacy groups, also exert demands to which the MNE may ultimately need to respond. When the MNE seeks to expand its operations abroad, there are costs and benefits which are unevenly distributed amongst various stakeholders (Jensen, 2006). For instance, foreign acquisition brings with it the possibility of job losses, which have both direct and indirect effects on the local economy, including lower wages and downward pressure on overall wage levels (Mann, 2016). Firms must also meet local product quality and labelling requirements, environmental performance standards, expectations to invest in the local community, and other issues that add to the cost of investment. Hence, MNEs consider regulations imposed by the state, such as local content requirements, quality and quantity of employment and overall economic development as detracting from overall firm profitability (Saka-Helmhout, Deeg & Greenwood, 2016).

Similarly, local governments are faced with conflicting demands from different segments of society. For example, investment by foreign firms can bring new jobs, injects capital, and hopefully stimulates the overall economy, yet their constituents may raise numerous concerns which cannot be ignored such as adverse effects of production on the natural environment. Policymakers are thus pressured by various groups to mitigate potential job losses, protect domestic industry, reduce resource exploitation, and limit profit repatriation, while encouraging investment in local communities. The more politically engaged these interest groups are, the more constraints the MNE will face in pursuing its economic goals (Jensen, 2006; Solt, 2008).

While it is apparent that these policy requirements will produce friction in firms' abilities to achieve economic objectives, income inequality is also likely to have an effect on the vigilance of CSOs. Relative bargaining power theory demonstrates that both individual and organizational constituents of a society are less likely to voice their concerns, seek concessions and so forth when they are simply not accustomed to having their demands met (Goodin & Dryzek, 1980; Solt, 2008). High levels of income inequality are likely to lead to a reduction in these sort of societal pressures, as large numbers of individuals increasingly interpret the social system as being 'rigged' against them, thereby inducing them to disengage, politically (Uslaner & Brown, 2005).

As income inequality increases, engagement with the political process for many stakeholders declines, due to the positive connection between wealth and political power (Solt, 2008). Simply put, the higher the income inequality of a country, the lower the level of interest amongst the non-elite to improve their standing through political processes. As a result, the political process becomes less competitive and the relative political bargaining power of the MNE consequently increases. Hence, it will be easier for the firm to create alignment between its interests and those of local policymakers (Bonardi, Holburn & Bergh, 2006). The MNE can focus on a smaller subset of requirements such as job creation and technology provision, and sometimes political contributions (Boddewyn, 1994). A lower level of political engagement amongst CSOs thus allows the firm to reap greater benefits from its economic activities, as it faces a more muted policy response for environmental protection, setting labor standards, increasing domestic content, supporting local industry and so forth. Conversely, under conditions of low income inequality, the firm faces arduous negotiations and lengthy bargaining sessions with the state and CSOs, thus incurring higher transaction costs. As the MNE seeks to expand, it will thus likely seek out locations with less politically engaged constituents, which ultimately means that countries exhibiting higher income inequality will appear more attractive.

The Costs of Social Unrest

To this point, we have argued that income inequality, as socially unpopular as it may be, may be perceived favorably by foreign investors. However, the positive effects we have argued for are likely characteristic of more economically developed countries, where income inequality is low to moderate. The negative societal conditions noted by sociologists, including increased crime, negative health outcomes, lack of trust, and general social unrest, are more likely to manifest as income inequality increases. As general society becomes less cooperative, more suspicious of business interests, and generally more violent, there are real costs borne by firms. In this section, we therefore argue that although higher inequality countries may be more attractive for conducting business, the benefits associated with income inequality diminishes as increasing inequality can become a socially intolerable and economically unattractive location attribute.

There is a growing sentiment that rising inequality is a form of economic injustice brought about by global capitalism, and MNEs are often seen as central actors in fostering this process (Alvaredo, Atkinson, Piketty & Saez, 2013). Higher levels of inequality are often considered the cause of social unrest, (Alesina, 1996; Uslaner, 2008) resulting in increased societal conflict and political dysfunction (Alesina & Rodrik, 1994; Uslaner, 2008). This socio-political unrest tends to stifle economic growth (Alesina & Perotti, 1996), produce a less healthy population (Kawachi, Kennedy & Wilkinson, 1999; Pickett & Wilkinson, 2015), and entrenches income inequality across generations by restricting economic mobility (Pickett & Wilkinson, 2007). These poor-functioning societies, brought about by rising income inequality, are characterized by constituents exhibiting mistrust of authority figures such as, police and government, and diminished inclination towards cooperation. Aside from making life less pleasant for their members of these societies, this dysfunction is likely to make conducting business transactions more arduous. The efficiency of collecting payments, negotiating and reinforcing contracts, monitoring employees and business partners, will all be reduced, leading to higher transaction costs for firms (Flores & Aguilera, 2007; Knack & Keefer, 1997). As well, there is likely to be an increased need to protect against crime, thus increasing security costs incurred in guarding the firm's assets (Kawachi et al., 1999).

Increasing Risk of Political Violence

Political risks involve the degree of instability of policies concerning taxation and expropriation, but also the risk that a government may lose power through the use of force. The political tension fuelled by higher income inequality produces greater uncertainty for business investors regarding future costs (Alesina & Perotti, 1996; Alesina & Rodrik, 1994). For example, taxation may increase in high income inequality countries as those controlling the state seek to increase their benefits at the expense of the general public, or in more extreme cases, by seizing the assets of the firm (Habib & Zurawicki, 2002). This increases the uncertainty faced by firms, increasing the costs they incur in monitoring their local environment, in particular the emerging desires of the state. While aligning with the states' interests is often beneficial for foreign firms, it can become a liability as governments become less stable. Since the policy decisions of a destabilizing government tend to become more erratic, alignment with the state threatens the firm's assets and even survival when the government changes hands (Siegel, 2007).

The instability of high income inequality societies may further manifest itself in overt political activity including, in the extreme, political violence (Fowles & Merva, 1996; Keefer & Knack, 2002). In essence, while increasing inequality tends to reduce political engagement, further increasing inequality may result

in *actively* disengaged constituents, more prone to political upheaval. As these threats increase to the point of manifestation, the functioning of the state is greatly impeded and may ultimately fail. Without the ability to use its authority, the state is less able to enforce laws, thus leading to increased crime, violence and corruption. These fractious societies experience a higher frequency and severity of vandalism and violent crimes (Kawachi et al., 1999). MNE employees and other assets may be specifically targeted because they are increasingly viewed as perpetrators of inequality through their use of offshoring and their political alignment with the state. The firm thus finds its indirect costs of production on the rise, as expenditures are increasingly needed on safeguards and security such as police protection (Hakkala, Norback & Svaleryd, 2008). These violent conditions need not be manifest for the MNE to be induced to make additional security investments. Even in countries where conflict is actively suppressed by the state or military, the increasing threat of violence is likely to induce the firm into making larger investments to secure its assets.

FUTURE RESEARCH DIRECTIONS

Investment Location Attractiveness

We have argued that income inequality would be generally viewed as positive, given that firms enjoy the benefits of more flexible labor markets and operate more efficiently in environments that do not place too many additional, sometimes conflicting demands on their resources. However, reduced levels of trust, declining cooperation, socio-political instability, and the dysfunctional nature of high inequality societies are unattractive from both a social and business perspective.

Of course, the more serious breakdown of society resulting from these effects is, in recent times, more of an exception than the norm. We thus believe that, given current cross-country differences in levels of income inequality, MNEs would generally maintain an overall positive perspective on income inequality, all else equal. This perspective would manifest itself in, for example, choosing locations with higher income inequality in which to establish more efficient operations. The more unfortunate effects of income inequality on society are likely to manifest only in countries with the highest levels of income inequality. In these countries, the increasing costs incurred to mitigate against crime, violence and general lack of cooperation will begin to outweigh the benefits, directly reducing the MNE's ability to capitalize on efficiency gains. Thus, while income inequality will be viewed as generally positive by firms, we expect that this effect will diminish at higher levels. The following are initial predictions on how inequality impacts MNE expansion strategy based on available evidence to date. Future research needs to test these empirically, and provide a more nuanced understanding of how income inequality impacts the location decisions of MNEs. Such research will help not only MNE investors, but also policymakers interested in reducing inequality while encouraging foreign direct investment.

While we think that MNEs in general will favor higher inequality countries (i.e. the benefits of inequality outweigh its cost), we believe the impact of inequality on location attractiveness will depend on its economic motives. Dunning (2000) classifies motives for investment into resource-, efficiency-, market- and strategic asset-seeking. Each of these motives may alter the relationship between income inequality and location attractiveness, thus contributing to cross-country imbalances in the types of foreign investment. The reasons for these expected differences lie in the fact that different motives create economic value through different mechanisms. For example, efficiency-seeking investments are focused

on achieving cost reductions, often through accessing lower cost labor, while market-seeking investments seek to expand revenues and achieve market penetration in the local market.

Efficiency-seeking investment can achieve cost reductions through enhanced access to larger labor pools and/or increased labor productivity. MNEs seeking to improve their efficiency through international investment will experience the most friction from low inequality countries, due to increased labor rigidity and the increased bargaining power of lobbyists and CSOs. This is because labor market rigidity limits the MNE's ability to adjust employment levels and conditions in response to fluctuating demand levels, and changing global market conditions. In general, MNEs seeking to create new value through increased cost efficiency will benefit the most from cost advantages realized through investing in higher income inequality locations. Nonetheless, relative efficiency is an important consideration for nearly any type of investment, and so we do not expect that different motives will change the MNE's overall preference for higher inequality, at least within the current context of liberal market capitalism.

MNEs can also improve their performance by more fully leveraging the MNE's tangible and intangible assets to achieve economies of scale, which in turn enhances its market power (Dunning, 1993). Research establishes that market-seeking investments are most attracted not only to the availability of sufficiently large and affluent market segments, but also levels of economic growth, which in turn signal increasing consumer demand (Lei & Chen, 2011). Higher inequality countries often experience more stagnant growth. This is because socio-political conflict, pressures for redistribution through taxation, tend to lead governments to favor policies that do not encourage economic growth but redistribution of wealth (Alesina & Perotti, 1996; Rodrik, 1999). Thus, when MNEs consider the growth potential of a market, gains from the reduced labor market rigidity are at least partially offset by the reduced market potential.

The benefits of higher inequality for market seeking investments are further eroded through adverse reputational effects. These investments typically require the firm to work more closely with market and non-market actors in the host country such as consumers, wholesalers, retailers, advocacy groups, and non-governmental organizations. This increases the number of situations in which bargaining situations arise (Hakkala et al., 2008), thus exposing the MNE to more threats of opportunism and consequently higher operating cost. In essence, the MNE becomes more exposed, on more fronts, to the negative aspects of high inequality countries, in which mistrust and political instability more readily prevail (Adger, 2000; Dai, Eden & Beamish, 2013). The MNE in turn is compelled to invest more resources in building political coalitions and securing property and persons (Boddewyn, 1994). At the extreme, MNEs may choose to avoid the market altogether, in favor of a commercially less promising but safer locale for market expansion.

Another motive for investment is to develop the strategic, intangible assets of the firm, most notably through hiring skilled workers and conducting R&D. This type of investment is focused on enhancing the MNE's competencies, rather than exploiting them (Cantwell & Mudambi, 2005). Through these investments, the MNE seeks to augment its capabilities by tapping into geographically dispersed sources of strategically valuable knowledge and knowledge workers (Le Bas & Sierra, 2002; Tallman & Chacar, 2011).

In order to gain a strategic advantage in more knowledge-intensive functions, the MNE needs to access skilled workers and keep them motivated to share their knowledge and collaborate. These two objectives are difficult to achieve in higher inequality countries. First, these countries are more often characterized by reduced access to education, making them less attractive to firms seeking knowledge workers. In addition, higher inequality can lead to fewer incentives for knowledge sharing amongst individuals because they tend to closely guard any source of advantage they possess (Dyer & Nobeoka, 2000). Therefore,

the reduced trust and the lack of norms for collaboration limit employees' ability and motivation to integrate knowledge (Minbaeva et al., 2003). Moreover, MNEs will find it difficult to become more socially embedded in these fractious socio-political environments, which in turn complicates knowledge absorption and assimilation (Heidenreich, 2012). Hence, the competence-enhancing potential for learning and capability development is limited, ultimately reducing opportunities for innovation (Dodgson, 1993).

In addition to building new capabilities, MNEs are also more cautious about sharing their existing proprietary knowledge through subsidiaries, as this tends to increase contract monitoring and enforcement costs (Oxley, 1999). Faced with greater risk of political unrest, policy uncertainty, and most pertinently, concerns about property rights protection (Easterly, Ritze & Woolcock, 2006), MNEs seeking to enhance their competencies may be less inclined to invest in higher income inequality countries.

In summary, the costs and benefits of income inequality are borne unequally by MNEs motivated by different investment objectives. Cost reduction is most significant to efficiency-seeking investments, and thus the positive relationship between income inequality and location attractiveness is likely to be more pronounced. In the case of market-seeking and more so in competency-enhancing mandates, the costs of inequality begin to weigh heavily on the benefits, thus eroding the attractiveness of higher inequality locations for these purposes.

Entry Mode Choice

Firms may use strategies and organizational structure to buffer the costs of income inequality, for example by choosing to enter via equity joint venture or alliance rather than wholly owned subsidiary. MNEs face an array of entry modes including wholly-owned subsidiary, joint venture, or non-equity investments such as licensing. As a general rule, an entry mode is preferable when it offers long-term efficiency in managing and controlling economic activities overseas. A large body of research investigating the choice of entry mode into a foreign market from a transaction cost perspective generally agrees that different modes of entry entail different levels of control (Brouthers, 2002; Brouthers & Brouthers, 2001; Madhok, 1997). For instance, Anderson and Gatignon's (1986) seminal paper proposed that firms possessing highly specific assets and stronger brand names will be better served by choosing entry modes offering higher degrees of control, such as wholly-owned subsidiary, and that the benefits will be greater when external environment is uncertain. Recent meta-analysis has largely confirmed this predictive strength of TCE in explaining entry mode choices (Zhao, Luo & Suh, 2004).

A related body of research extends the transaction cost framework to examine inter-firm relationship and governance arrangements, especially within a strategic alliance or a joint venture (Pisano, 1989; Sampson, 2004). These studies show that the importance of protecting transaction-specific assets such as intellectual property determines the structure of alliance relationship and that misaligned governance choices such as excessive bureaucracy can lead to higher transaction costs between alliance partners and inferior economic performance. However, research that draws on relational exchange theory and institutional theory, has shown that trust between transacting parties can lower transaction costs, facilitate investment in transaction-specific assets, increase the use of joint action agreements, and hence improve firms' economic performance (Dyer, 1996a, 1996b; Gulati, 1998; Zaheer, McEvily & Perrone, 1998). Therefore, the interplay of transaction attributes and social and environment conditions is important to the understanding of firms' strategies and performance.

According to relational exchange and institutional theories, it appears likely that in low income inequality countries, where firms face more arduous relationships with labor organizations and more

politically active CSOs, a higher equity stake would be preferable. Wholly-owned subsidiaries offer the highest degree of control and hence lowest transaction costs, but cooperating with a local partner also has benefits. Working with local partner can be beneficial for building trust and legitimacy, and learning how to successfully manage external stakeholders. Hence, MNEs seeking to work with a more locally experienced partner may choose majority-owned joint ventures. At the opposite end of the inequality spectrum, since MNEs face heightened uncertainty surrounding political risk and socio-political unrest in the highest income inequality countries, it would appear that these environments too would predict use of higher equity stakes. Since wholly-owned subsidiaries offer the most control, this may be the preferred method for entry, although such an approach also creates the greatest risk in terms of loss of investments, or expropriation.

Finally, it would seem that equity entries would be most efficient in a moderate inequality location, where labor markets are more flexible, other stakeholders are less politically engaged, and society is generally more trusting. That said, there are numerous other considerations, especially the MNEs preferences towards certain modes and its economic reasons for international expansion that will bear upon the entry mode decision. Hence, we would predict that in moderate income inequality countries, the probability of choosing a particular entry mode is less affected by differences in inequality. Indeed as we argued previously, these are likely the most desirable FDI locations, all else equal, from a strategic perspective.

MNE Experience, Home and Abroad

Learning from experience changes a firm's strategic behavior (Nelson & Winter, 1982). As a firm repeatedly engages in an activity, its ability to efficiently manage the activity improves because the firm can infer from previous outcomes and adjust its actions accordingly (Cyert & March, 1963). MNE experience alters its perception of location attractiveness and consequently affects its foreign investment strategy (Delios & Henisz, 2003; Jiang, Holburn & Beamish, 2014). Learning based on direct experience has been found to be an important source of competitive advantage and superior performance for MNEs (Barkema, Bell & Pennings, 1996; Vermeulen & Barkema, 2001). We highlight two types of firm experience, namely international experience and home country experience, which may both influence MNEs' strategic responses to national income inequality.

The prevalent Uppsala internationalization process model suggests that MNEs gradually increase their commitment to foreign markets as their experience of international operation accumulates (Johanson & Vahlne, 1977). International experience helps resolve uncertainties about stakeholders, institutions, and market conditions in unfamiliar countries, which reduces perceived risks and associated operating cost in prospective projects, thereby increasing the probability of subsequent investment overseas (Eriksson, Johanson, Majkgard & Sharma, 1997). MNEs acquire and refine their competencies for operating overseas with every new foreign investment. As these competencies are redeploy in new locations the MNE incur lower transaction cost because they become more knowledgeable in engaging with various local stakeholders. A stylized finding from the internationalization process literature is that experience gained through prior foreign investments positively influences the MNE's propensity and pace of subsequent investment (Barkema & Drogendijk, 2007; Chang, 1995; Davidson, 1980). In general, MNEs more globally diffused and with more years of international operation, are typically more experienced with the challenges of operating in more hostile environments (Barkema et al., 1996; Nielsen et al., 2017).

However, prior studies have paid limited attention to the firm's home country experience. Yet, the firm's structure and strategy are history dependent (Nelson & Winter, 1982; Stinchcombe, 1965). The

firm evolve to function effectively in its home country's market and institutional environments. Therefore, social, technical, and economic conditions of the home country to a large degree determine the MNE's competencies and its preferences for location attributes of foreign countries. For instance, Cuervo-Cazurra (2006) finds that foreign investors that have been exposed to bribery at home may not be deterred by corruption in potential host countries, but instead seek countries where corruption is prevalent. Similarly, Holburn and Zelner (2010) find that MNEs from home countries with higher policy certainties, or more intense policy competition among interest socio-economic and ethnic groups are less sensitive to host-country policy risk.

In the case of income inequality, we expect that both international experience and home country experience will influence how MNEs respond to and cope with income inequality in foreign countries. We expect that international experience will overall lower transaction costs associated with income equality, especially in host countries with higher level of socio-political instability attributed to income inequality. Yet, the extent of this impact will likely depend on the level of inequality in the MNE's home country. Since countries at both ends of the inequality spectrum presents higher level of transaction costs to MNEs, we expect that firms from home countries with moderate level of income inequality will particularly benefit from international experience because they likely lack sufficient home country experience in dealing with transaction costs arising from inequality.

CONCLUSION

In this chapter, we have proposed that national income inequality influences MNEs' foreign expansion strategies, due to the various economic and social consequences of inequality which can be translated to transaction costs for the firm. In doing so, we address calls to embed studies of inequality in the context of institutions and organizations (Morris & Western, 1999; Neckerman & Torche, 2007).

If our predictions are at least partially correct, then the costs and benefits of income inequality for MNEs will have consequences on overall firm profitability. By the same token, the preferences of the MNE will be at least partially manifested in their choice of locations for expansion. Future empirical research therefore needs to establish the existence of a link between income inequality and location attractiveness. Research on the contingent role of investment motives will also help to demonstrate how transaction cost considerations come to bear on these issues. A closer examination of investment motives will directly respond to recent calls for in-depth analysis of the role of managerial intentionality in the internationalization process (Buckley, Devinney & Louviere, 2007; Hutzschenreuter, Pedersen & Volberda, 2007)

That said, transaction costs arising from income inequality are only one of many considerations for the MNE. Thus, to the extent to which firms can use organizational structure as a buffer against transaction costs, income inequality may be a partial influence on entry mode considerations. In some cases, the control afforded by higher equity stakes may be the key to achieving these buffers, in others it may be the experience and relational capital of a local partner. Finally, more internationally experienced firms may shun locations with exceptionally low or high income inequality because they appreciate the economic costs of these locations, while less experienced firms may not be able to assess or cope with the risks, thus also choosing to shun these locations. However, more internationally experienced firms may already have developed stronger political and relational capabilities in foreign markets that would

help them counter the costs of income inequality. Likewise, experience dealing with income inequality in the home country should help in similar fashion.

By shining a spotlight on the MNE's potentially differential preferences towards income inequality, we hope this chapter begins a discussion which has the potential to help researchers better understand how firms impact national income inequality. Prior research has helped us to better understand how location characteristics, typically cast as macroeconomic factors such as level of economic development, technological sophistication, etc., moderate the effect which aggregate FDI has on income inequality. This chapter brings MNE investors' economic motivations into the discussion. By better understanding how these motivations impact investment decisions, investment policy makers are better equipped to prioritize amongst investment types, and set objectives for attracting them.

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KEY TERMS AND DEFINITIONS

Entry Modes: Mechanism through which firms internationalize. They can be classified as non-equity (e.g. direct export, licensing, franchising, strategic alliance) and equity modes of entry (e.g. joint ventures and wholly-owned subsidiaries). Non-equity entry modes entail less commitment and control from the parent company than equity modes.

Foreign Direct Investment (FDI): The investment of financial capital, made by a firm, into business operations or assets located in another country.

Income Inequality: The extent to which the distribution of total income amongst a country's employees deviates from perfect equality.

Location Attractiveness: Extent to which a location attracts foreign direct investment due to its endowment of natural resources, skilled or unskilled labor, and/or sizeable markets.

Location Choice: It refers to the decision that MNE managers face when deciding which location is best for a foreign investment. One of the most used theoretical frameworks, to evaluate different locations, among international business scholars is transaction costs economics.

Multinational Enterprise (MNE): A business organization which owns or controls assets in more than one country.

Transaction Costs: Costs incurred by a firm for engaging in an economic transaction. These typically include, identifying potential suppliers, bargaining for price, negotiating contracts, monitoring the quality of the service or product provided by the supplier, and enforcing contracts.