'Principled Embeddedness': How Foreign Direct Investment May Contribute To Inclusive And Sustainable Growth In Developing Economies

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Abstract

Foreign direct investment (FDI) plays a crucial role in enabling developing economies to embark on a path of inclusive growth. This applies in particular if local subsidiaries of multinational enterprises (MNEs) are committed to 'principled embeddedness' meaning that they are prepared to integrate parts of the local economy into global value chains by enabling them to comply with the required quality norms and standards. It also results in capacity development and technology transfer that is likely to benefit local entrepreneurs who contribute to the diversity of markets in the domestic economy. The empirically validated contribution of embedded subsidiaries of MNEs to inclusive growth challenge the normative view that FDI in developing economies would merely pose a threat to existing embedded economic systems.

1. Introduction

In his seminal book 'The Great Transformation' Karl Polanyi (1944) calls the expansion of formal global markets a 'satanic mill' that would disembed local communities and their informal economies with fatal consequences for the local people and the environment. His gloomy view is shared by the Nobel Prize-winning economist Joseph Stiglitz, who wrote the foreword to the 2001 edition of Polanyi's masterpiece.

Moreover, even the more pragmatic literature on embedded liberalism (Ruggie 1982, Ruggie 2008, Rodrik 2011) and global corporate social responsibility (CSR) (Scherrer et al. 2006) seem to implicitly endorse Polanyi's claims by focusing their attention on the potential damage caused by multinational enterprises (MNE) as forces of 'disembeddedness' of local economic structures. These forces, so they argue, would ask for public and private initiatives to 're-embed' the affected communities through the expansion of the national welfare state and global CSR initiatives, respectively.

More recent empirical research in economic history (North 1977, Bang 2016), economic sociology (Granovetter 1985, Beckert 2007), and industrial policy (Uzzi 1996, Meyer et l. 2011) largely disqualify Polanyi's assumption that the modern formal economy lacks embeddedness in society. After all, no economy is detached from individuals and their societal networks that are primarily concerned with addressing coordination problems in daily business transactions. Therefore, MNE with long-term interests as foreign direct investors in less developed countries encourage their subsidiaries to strengthen their local economic and social networks. As such, subsidiaries support local business partners in their efforts to become integrated into their respective global value chain (GVC) through the compliance with industrial principles, standards, and norms.

This MNE strategy of 'principled embeddedness' eventually contributes to growth and job creation in the local economy and, simultaneously, enables local business partners to better cope with the sustainability challenges related to climate change, population growth, and increasing affluence. In this context, this paper argues that the UN Guiding Principles on Business and Human Rights (UNGP)[1] should recognize that corporate responsibility cannot be limited to a principle of doing 'no harm'. MNE that benefit the region in which they operate should also be awarded for doing 'good' not because they want to be good corporate citizens but because it is in their long-term interest to also contribute to the flourishing of the local economy in which they invest. The ISO 26000 Standard on Social Responsibility[2] tends to acknowledge the value of corporate embeddedness indirectly through its priority area 'community involvement and development'. But its content remains vague when it comes to capturing its value concretely, and it tends to conceive the priority area as a moral duty rather than being in the long-term strategic interest of the company.

In this paper we illustrate the embeddedness challenge that MNE face when investing in developing economies by referring to the three major coordination problems that every company is confronted with when investing abroad: the coordination problem of value that is not just about the price determined by demand and supply but also the challenge of fair compensation with regard to products that have public good character (life-saving drugs, technologies that boost agricultural productivity, and food quality), the coordination problem of competition that emerges from the reluctance of market participants to be exposed to perfect competition, and the problem of cooperation that emerges from the need for pre-competitive collaboration and the build-up of social trust. These coordination problems, as originally outlined by the sociologist Jens Beckert (2007), can be most effectively addressed by a foreign direct investment through a strategy of principled embeddedness.

We illustrate this commitment to 'principled embeddedness' using concrete brief case studies. They are not meant to praise the selected MNE for all their business practices. After all potential opportunities for opportunism in large companies are widespread despite increasing expenses on compliance issues and due diligence processes. But, these examples of embeddedness of MNEs show their potential to enable local economic empowerment and sustainable change in developing regions that are characterized by a high degree of economic and political uncertainty.

2. New Economic Sociology and re-definition of the term 'embeddedness'

The term 'embeddedness' has been shaped and re-shaped by the research of economic sociologists in the 20th century.

Karl Polanyi initiated the academic debate on embeddedness with the publication of 'The Great Transformation' in 1944. His basic argument was that the institutions of embedded traditional economies are being destroyed by a self-regulating market economy in which the market no longer serves the needs of the people but rather the reverse, that people would have to meet the needs of the market. As a consequence, the expansion of the formal market economy would lead to the disembedding of local economies with 'catastrophic consequences' for local communities.

Polanyi's view is also associated with the term 'substantivisim' in economic anthropology. It distinguishes the substantivist 'embedded' economy that is focused on self-sufficiency, from the formalist 'disembedded' economy that thrives on the rational pursuit of profit but would have no social roots. It presupposes an autonomous formal economy without social content; an assumption commonly found also in the formal theory of neoclassical economics (Gemici 2008).

Polanyi's dualistic and normative view of embeddedness was eventually challenged by a new generation of economic sociologists toward the end of the Cold War period. They criticized his assumption that embeddedness would be mostly limited to economic activities in premarket societies that were firmly embedded in social relations. The assumption that such embeddedness would no longer matter in modern economies since commercial transactions have ceased to be guided by social and kinship obligations seemed increasingly unrealistic given new empirical research on embeddedness in modern economies (Granovetter 1985, Biggart and Beamish 2003, De Bakker et al. 2013). It uncovered the embeddedness in the form of social networks, online and offline, that provide the very basis for formal business relations on the local as well as the global level.

The term 'embeddedness' was no longer applied to distinguish between substantivist (embedded) and formalist (disembedded) economic models. Instead, it was used to define the concrete, ongoing systems of social relations that underpin economic action (Granovetter 1985). Mark Granovetter, the sociologist who played a crucial role in re-defining the term 'embeddedness', started with a general criticism of over- and undersocialized conceptions of human action in sociology and economics. While the oversocialized conception in sociology mainly saw societal norms and values, internalized through socialization, as explanatory factors of human interaction, neoclassical economics started from a undersocialized conception with its homo oeconomicus who has no age, is not embedded in any social structure and completely independent of social relations in economic decision-making. According to Granovetter, actors do not behave or decide as atoms outside a social context, nor do they act exclusively according to prescribed roles that reflect certain moral norms and values. Instead, it is the social relations rather than merely institutional arrangements or a 'generalized morality' that are mainly responsible for a low degree of fraud and malfeasance and the production of trust in economic life. His embeddedness approach concretely follows and analyzes patterns of social relations to explain how societies overcome the problem of trust and disorder in economic life. It makes no predictions of universal order or disorder but rather assumes that the details of social structure will determine it (Granovetter and Swedberg 2001).

2.1 The moral dimension of entrepreneurship

Granovetter is in line with the argument of the economist Albert O. Hirschman who showed that the pursuit of economic self-interest in the formal market economy has hardly ever been based on reckless utility-maximizing attitudes designed to merely realize short-term material preferences. Instead, human behavior in formal markets is characterized by civilized and gentle human interactions based on meta preferences that are also related to cultural upbringing and social relations (Hirschman 1992). In addition, each economic actor faces the risk of reputation loss if she fails to play by the unwritten rules of fair interaction. In this context, Hirschman refers to the so-called 'doux-commerce' hypothesis as suggested by well-known philosophers of the age of enlightenment such as Montesquieu and Condorcet. It basically argues that people involved in supraregional formal markets would develop more civilized manners in dealing with each other and acquire a more pronounced sense of fairness and reciprocity. Something that has recently also been confirmed in empirical and experimental research in the field of behavioral economics. Henrich (2006) showed for example that the more local communities are involved in supraregional trade, the more developed their sense of fairness and reciprocity.

By focusing on micro- rather than the macro-foundations of the concept of embeddedness, Granovetter leaves Polanyi's normative macro-narrative unchallenged. In this context, Beckert (2007) proposes to revisit Polanyi's work and starts instead from its basic insight that, ultimately, it is the embeddedness of economic exchange that makes economic and social integration possible. The challenge is then to identify the socioeconomic preconditions that allow economic prosperity to be combined with the realization of a humane social and political order.

2.2 Embeddedness as a way to address three major coordination problems in the economy

The reduction of uncertainty is an indispensable precondition for the emergence and operation of market economies; and embeddedness of economic exchange in a web of social relations helps to reduce this uncertainty and provides stability to market interactions.

Reducing uncertainty through enhanced embeddedness can be addressed by managing three coordination problems effectively, according to Beckert (1996): the problem of value, the problem of competition, and the problem of cooperation. The problem of value is that the price of a product may reflect more than merely its current demand and supply because there is also the social context in which it is introduced for sale. The valuation of the particular product is primarily social in character and as such generates preferences that are endogenous, not exogenous. This problem is most obvious when comparing the uncontroversial price-setting strategies of companies that operate in the market for consumer electronics or luxury goods and the highly controversial one in the field of life-saving drugs or effective inputs in agriculture. Whereas no one bothers if the company 'Apple' asks for a higher price for its new smartphone, society may disapprove of companies that generate profits with the sale of products that should be accessible to the poor to save lives or prevent starvation. If such products are not accessible to those in desperate need because they cannot afford to pay its price, it becomes a moral issue for society. At the same time, such products would not exist in the first place if companies would not have developed them in the hope of creating a profit that is at least able to reimburse the fixed costs invested in R&D and the regulatory approval process. So whereas the price of a smartphone is mainly based on quality markers influenced not just by advertising but also institutions and platforms that discuss the merit and thus the value of the product, the social process of valuation of products that are generally associated with public goods, such as life-saving medicine (no one should be excluded, its consumption should be non-rival), show that the embeddedness of economic action makes it necessary to negotiate prices in ways that make them socially acceptable. Often corporations do so on their own through a strategy of price differentiation (Ridley 2006), but they are also confronted with many more government interventions than in markets for personal accessories due to public concerns about accessibility to public health and food security (Aerni 2015a, 2015b).

The coordination problem of competition relates to the fact that 'perfect competition' may be neither in the interest of business nor the interest of society as a whole. While companies do not like to enter markets of perfect competition in which they can only expect decreasing returns, society as a whole disapproves of cutthroat competition where survival in the market depends primarily on cost-saving measures, often at the expense of the quality of the product, worker safety, and environmental protection. Simultaneously, markets of perfect competition do not generate innovation. Investing in innovation requires a company to have assets generated from previous rent- or profit-seeking activities. Moreover, a company would only invest in innovation if there is a prospect to generate a profit through a temporary monopoly in which the company has price-setting power (Romer 1994). This explains why markets of perfect competition are mostly a temporary phenomenon that is eventually undermined by three forces: lobbying by market incumbents for regulation that prevents market entry of new competitors; labor, environmental, and consumer pressure groups that advocate for regulations that make it more difficult to save costs at the expense of society and the environment; and, finally, start-up companies that want to grow through innovation. The latter ask governments to create an institutional setting that rewards them for the risk of investing in something new. The protection of intellectual property rights (IPR) is one, but by far not the only way to enable innovative companies to have a temporary monopoly that allows them to generate profits that cover the prior R&D costs and to further invest in the continuous improvement of the product. In other words, regulation of perfect competition is primarily designed to discourage cutthroat competition. But the resulting creation of isolating mechanisms that shield incumbents from more competition can also harm long-term societal interests, especially in the case of monopolies that are likely to be permanent thanks to government protection and thus also unrelated to innovation. As a consequence, the economy becomes less capable of renewing itself because the established monopolies become professional rent-seeking insiders that benefit from collusion and the exclusion of more competitive actors (Olson 1982). Therefore, regulations also have the added purpose of giving incentives to outsiders to create new markets by taking the risk of investing in new products and services that generate increasing returns (Romer 1994, Aerni 2015b).

The coordination problem of cooperation arises from the asymmetric information between exchange partners, e.g. the agent (manager) of a company is more familiar with the business than the principal (investor), and the seller of a product knows more about the product quality than the buyer. As a consequence, the agent may have an incentive to use this information advantage at the expense of the principal (Akerlof 1970, Aerni 2006). Social networks in general and trusted ethnic and kinship networks in particular are a way to lower uncertainty and thus transaction costs by creating informal but binding rules and norms for transactions that are effectively enforced through the threat of exclusion (Olson

1965, Hindmoor 1998, Lyon 2000). They mostly emerge where the formal rules have been artificially imposed from outside and are not adequately enforced (Henrich 2011). In addition, coordination problems may also be resolved on a private basis through coordination efforts that go beyond tight-knit social networks. For example, before the spread of public standards for food safety in the 20th century, it was the food industry in 19th century Europe and the USA that designed and effectively implemented private food safety standards in the form of pre-competitive collaboration (Ping 2011, Freidberg 2009). The reason why all parties in industry were prepared to be inspected by a third party was the fact that deceiving the consumer, for example with diluted milk or false weight measurements, did not just affect the business of the cheater but led to a loss of trust in the whole industry. The resulting systems of reputation helped to overcome the problem of asymmetric information. When private standards eventually became international public standards through the creation of the International Organization for Standardization (ISO) and UN regulatory institutions, they could be effectively enforced only in countries where the coordination problem of cooperation in the private sector has previously been addressed effectively by private standards (Aerni 2013).

Finally, Beckert considers social legitimation a precondition for the emergence of stable markets. The definition of what is legal and what is illegal to buy and sell is determined by society and its norms and values rather than the economic actors (Jacobs 1970). However, norms and values change over time and with it the definition of legal and illegal transactions (Appiah 2011). Even though illegal markets may work similarly to legal markets, the way the coordination problem of cooperation is addressed is different. It is of existential importance to the illegal networks; if one party defects under the promise of impunity, the whole illegal business network may be dissolved and its members end up in prison. This also explains the strong embeddedness of economic activities in kinship-based illegal networks such as the Mafia (Gambetta 1996). So embeddedness may not always be desirable if the underlying norms and values of the respective network are not beneficial but harmful for society as a whole. This also applies to embedded economic systems with high transaction costs due to widespread corruption (De Sardan 1999).

Beckert concludes that the coordination problems point to the fundamental uncertainty that economic actors face in everyday economic interactions. As context-specific challenges they are a sort of blind spot of orthodox economic models and highlight the fact that the embeddedness of the economy may be a precondition for its functioning (Beckert 1996).

2.3 Embeddedness in the context of economic complexity

Recent research in economic complexity (Hidalgo 2015) largely confirms this view by pointing to the costs of establishing links to build purpose-oriented social networks designed to address context-specific coordination problems in long-term global collaborative networks of firms to adopt or even create innovation in global value chains (GVCs). These links are highly specific and recurrent and exact outcomes are not known in advance. They involve individuals and firms that must be understood as packages of specialized knowledge and know-how nested in a social structure that supports them. Such global networks designed to create a stream of revenue out of economic interaction are challenging to maintain because they are evolving and with it the knowledge and know-how they embody. Accumulating knowledge and know-how is difficult because creating the networks required to embody them is difficult. If they succeed in achieving their purpose and become economically successful, it is less because of standardization and technological change that decrease the costs of creating formal network links but because they are embedded in pre-existing cultural and social networks that are based on social capital, the trust among actors involved that is required to embark initially on informal rather than formal collaboration. Since losing trust has serious long-term consequences for the one who committed a breach of trust, this non-contractual form of collaboration is very effective in deterring fraud and malfeasance (Shapiro 1987, Molina-Morales 2010). At the same time, it works without the burden of lengthy legal documentation and costly enforcement procedures and as such makes it worthwhile to embark on risky joint commercial projects. This also explains why most employers are keen on hiring referrals because it is easier to trust someone with whom you share a friend (Granovetter 1995). Understanding how complex and purpose-oriented global networks work requires combined knowledge in transaction cost theory, which deals mostly with formal network links, and economic sociology, which looks at informal ties (Hidalgo 2015). The economic effects of preexisting social networks are important to understand the costs of links in context.

3. Economic globalization as a force of 'disembeddedness'

As the main drivers of economic globalization, MNEs are crucial in addressing coordination problems in GVCs by tapping the knowledge and know-how of their embedded internal and external networks to generate economic outcomes that ensure a continuous stream of revenue through scalable innovation (Andersson et al. 2002). Yet, in public, they have not been associated with embedded economic structures but actually more with the risk of 'disembeddeding' local traditional economies (Robinson 2014, Baker 2016).

MNE may indeed be a major force of economic globalization that has induced many locally embedded traditional industries to either transform or disappear. But this pressure on local economies started already in the 19th century in Europe, when the landlords of the feudalist system tried to compete in the new trade-oriented market economy not by introducing new forms of division of labor and technological innovation but by merely squeezing out more work obligations from their dependents (Braudel 1982). As a consequence, the old manorial system[3] faced a crisis in the form of massive escape. Peasants and servants were no longer willing to work merely for the benefit of their rent-seeking landlords because they had an opportunity to exit. They migrated to nearby expanding urban areas or overseas. This enabled them to take their destiny into their own hands. A risky and uncertain venture that eventually allowed them to unshackle the old fetters associated with traditional feudal economic systems and flourish in arrival cities (Saunders 2011). Therefore, the first wave of globalization may have disembedded the old manorial system, but it also created many economic opportunities for the outsiders in society, those who had no economic rights under the old rule (Aerni 2016).

3.1 Why disembedding traditional structures may help outsiders – with long-term benefit for society

The great migration of the underprivileged to new places with better economic opportunities jumpstarted a process of social mobility that forced the previously unchallenged aristocrats to deal on equal terms with entrepreneurial upstarts that emerged from the former peasant and servant class. Often the latter did not compete directly with the former who invested primarily in established capital-intensive industries but created entirely new markets addressing old needs in a new way (Etzkowitz 2004, Aerni 2007). All these new markets had to resolve Beckert's three primary coordination problems of embedded economies: the determination of the value of the new product, the securing of profit through an acceptable departure from perfect competition, and the ease of cooperating with other stakeholders on issues of common interest. Thanks to their ability to limit fraud and malfeasance in their practice through effectively addressing the coordination problem of cooperation, these new economic actors created the necessary social capital to gain a public license to operate in new and often untested fields of business (Cope et al. 2007, Aerni 2016). Their success in creating and scaling new markets allowed many of these upstarts to eventually grow into global corporations.

However, as the landed gentry before them, many emerging large corporations may have used their large profits, initially generated through innovation, to imitate the lavish lifestyle of the aristocrats and secure unproductive rents through real estate investments and political lobbying to keep competition at bay (Schluep and Aerni 2016). Moreover, if their untested technological innovations caused accidents, they refused to be liable or assume responsibility for the damage (Ice 1991). As such, they indeed may have caused the disembedding of traditional societies without offering any positive alternative to the originally very repressive system. In this context, Karl Polanyi (1944) rightly refers to the growing anger of the public toward reckless corporate behavior and how it eventually led to counter-reforms that improved social security and health coverage for the employed and helped create social safety nets for those who lost their employment or were unable to work in the first place. But this view fatally implies that disembeddedness merely happens through 'bad' private sector investment while re-embeddedness takes place exclusively through 'good' government intervention designed to repair the damage caused by the private sector.

This implicit view is also very much present in the assumption in embedded liberalism (Rodrik 2011) that opening up markets to international trade has to be accompanied by the expansion of the welfare state, as a sort of loser compensation, to obtain the approval of the voters in a democratic system. Even though it is indeed true that the private sector may not be able to provide for public goods, the public sector is only in a position to provide for important public goods if it is able to raise sufficient taxes from successful private sector activities (Desai 2003). Moreover, a government that distributes public resources only to those loyal to them, as it happens in traditional patron-client systems, will also fail to provide public goods even if the funds are available. Finally, many of the knowledge-based private sector innovations eventually end in the public realm and thus assume the character of a classical public good being non-rival and non-excludable. Therefore, the provision of public goods by governments should generally not be understood as correction for the damage done by private sector activities but as a result of the emergence of a formal, tax-paying private sector that also contributes to the effective management of public goods through its competences in the provision of client-oriented products and services (Aerni 2015b).

3.2 Disembedding post-colonial structures

The social and economic transformation through economic globalization in Europe in the 19th century is to some extent comparable to the transformation of developing economies in the 21st century. Foreign direct investments (FDI) by MNE in these countries are challenging and sometimes disembedding the prevailing traditional rent-seeking economies inherited from colonial times that have many similarities with the feudalist economies of the Ancien Régime in Europe. Colonial powers were rarely interested in disrupting existing economic and political systems in the countries they colonized. Instead, they preferred to collaborate with the respective local elite based on the Polanyi's principles of reciprocity, redistribution, and autarky (Polanyi 1944) that prevailed in the traditional embedded economy (Aerni 2007). The system of patronage still prevailed in postcolonial times. During the Cold War period, the feudalist economies in developing countries tended to become client states either of the United States or the Soviet Union. Both powers endowed the new indigenous leaders of the European ex-colonies in Africa with almost dictatorial powers and secured their rule with military support, as long as they remained loyal to either the market-oriented system propagated by the United States or the communist system propagated by the Soviet Union (McCormick 1995, Zubok 2009).

With the end of the Cold War and the fall of the Berlin Wall, such systems of patronage lost their purpose and faced growing criticism from within and without the developing world. Moreover, the economic rise of Asia illustrated that developing countries are not entrapped in an exploitative global economic system in which they merely serve as suppliers of raw materials. Countries like South Korea, Taiwan, Malaysia, and later China may have resented political interference of Western powers, but they very much realized the value of foreign direct investment (FDI) from the West. After all, if Western multinational corporations find it attractive to invest in their countries under the condition that they become partially embedded into their traditional economies (e.g. through joint ventures in special economic zones), this will enable the transfer of important know-how and technology that helps to upgrade their domestic economies to a level that will eventually enable the local export-oriented industry to compete with the established economies of the West (Yingming 2009). The institutional reforms required to attract long-term foreign direct investments led to unprecedented catch-up growth (Aerni 2011a) and the emergence of an entrepreneurial middle class that makes use of its economic empowerment to lobby also for political reforms that are more conducive to their economic interests (Woetzel 1989).

Catch up growth rates today are much higher than they used to be in earlier times since so much more goods and services, know-how, technology, and financial institutions are in existence today that could quickly transform a traditional rent-seeking economy (Romer 2010) provided that the respective governments are willing to create an institutional setting that is conducive to such a process of transformation.

Alas, governments hardly ever do so unless there is pressure from the domestic entrepreneurial middle class to carry out the necessary economic reforms. Since this middle class does not exist in traditional feudalist economies with patron-client systems, governments prefer to secure their rents by addressing the preferences of the powerful landlords and traditional leaders who, in return, ensure their re-election (Aerni 2006). As patrons, they ask their dependents or clients to vote for the ruling party in exchange for protection of their material interests and improved access to scarce government resources (Berman 1998).

3.3 The failure of foreign aid to empower local entrepreneurs through economic integration

At the same time, foreign aid contributions constitute a significant share of government resources in the feudalist economies in developing countries. Foreign development agencies are primarily focused on addressing the preferences of the taxpayers and donors of the country that sponsors their activities. The preferences of people in affluent economies are, however, similar to the preferences of the aristocrats of Europe in the 19th century (Aerni 2006). They increasingly resent economic globalization because it challenges their economic and political supremacy and as a result, they prefer to support projects that protect traditional communities from the forces of economic globalization rather than enable their economic integration. Ignoring the demands of reformist forces makes foreign donors often part of the problem since it leads to a total neglect of the needs of the educated and entrepreneurial outsiders in the domestic economy who do not see a future in their embedded rent-seeking economy and seek a better life in the growing cities or abroad.

There may be some timid initiatives to promote entrepreneurial rights, but they are primarily focused on improving livelihoods in the informal sector[4]. Such efforts have little impact on the overall economic situation, employment, and economic opportunities because operating in the informal economy does not allow an entrepreneur to grow and formally employ people, as Arthur Lewis, an interdisciplinary social science scholar and Nobel Prize winning development economist, already noticed in 1955 (Lewis 1955). Why? Because only formally registered businesses that comply with standards and regulation and have a customer base beyond their neighborhoods attract investment and would eventually allow entrepreneurs to generate increasing returns and jobs in the formal sector (Aerni 2015b).

3.4 Recognizing the contribution of MNE subsidiaries to local economic empowerment

Enabling informal businesses to succeed as growth-oriented formally registered companies requires competent assistance, which is found in the private sector rather than government or civil society (Aerni et al. 2015). However, unlike donor agencies and NGOs, companies invest in local businesses only if they are confident that the business will eventually succeed. In other words, an investment must pay off, and in case it pays off, it will not just benefit the respective local business and its investor but the region as a whole through its contribution to endogenous (homegrown) economic development.

In this context, subsidiaries of MNE that are committed to local embeddedness have the potential to significantly contribute to sustainable change in the region in which they invest. This requires, however, that governments and civil society groups do not undercut business opportunities by already providing goods and services for free. This crowding out of private sector investments tends to be especially prominent in regions that are identified as ‘vulnerable’ (Farla et al. 2016, Ciaian et al. 2012)

3.5 Coping with business coordination problems through a strategy of 'principled embeddedness'

A corporate commitment to 'principled embeddedness' is essentially designed to jointly address the coordination problems of the market with local stakeholders responsibly. In this context, MNE from developed countries investing in developing economies realize that they have to abide by the global industry guiding principles, even if domestic regulation and weak legal enforcement power in host countries may allow them to ignore such with impunity. MNE are committed to principled embeddedness, not because of a normative ethical stance, but because it is in their enlightened self-interest to be perceived as a fair player in business and society, independent of the location in which they operate. At the same time, MNEs know that they do not operate in a vacuum. The local stakeholders in the region in which they invest will eventually raise the question to what extent the presence of the MNE also benefits the local economy as well as local society and the environment. If the MNE turns out to be a mere economic off-shore island of their country of origin that has no links to the local economy and no social impact in the region whatsoever, nationalist politicians may eventually want them to lose their license to operate or force them into compliance with rather rigid local content requirements or joint-ventures that may make little sense from a business point of view. So, no matter if they pay their taxes in the country in which they operate and comply with international business and human rights standards, they will have a local acceptance problem if perceived as generating profits for stakeholders abroad while shunning any interaction that might benefit the local economy and society (Schluep 2017).

Therefore, MNE with a long-term view are also prepared to negotiate with local stakeholders on how to integrate qualified local business partners into their global supply chains, invest in local capacity development and training programs to recruit more skilled local employees (to help upgrade informal business activities to a level where local businesses are able to comply with international standards and compete in the formal economy) and to sell a higher share of their goods locally. Such a commitment to 'principled embeddedness' helps the MNE to earn long-term social capital on a national as well as the international level.

4. The role of subsidiaries of MNE in developing countries

So far, this paper has portrayed MNEs as a homogenous entity located in wealthy OECD countries and investing in poorer non-OECD countries. This is misleading insofar as many of the globally expanding MNE originate from emerging economies rather than developed economies. MNEs from emerging economies tend to be encouraged by their governments to invest in the developing world. Instead of being monitored and eventually shamed for investing in 'high-risk' developing economies, as it is often the case in OECD countries, MNE from emerging economies even obtain active support from their governments in bidding processes for public procurement in less developed countries, for example through pre-financing agreements.

The portrayal of MNE is also misleading in the sense that they are not a homogenous entity. Their local subsidiaries often enjoy a substantial amount of autonomy, and frequently, they are as much involved with local stakeholders (external embeddedness) than their parent company (internal embeddedness) – which, depending on the industry and country context, may ultimately also benefit the parent company.

This double or multiple embeddedness (Meyer et al. 2011) exposes the subsidiary to internal and external institutional pressures: MNE that adapt their strategies and organizational practices to the local contexts are subject to constraints imposed by the available resources as well as institutional constraints imposed by their country of origin. If subsidiaries manage to combine external and internal resources successfully, they become centers of excellence on their own and as such may benefit the host country through their knowledge base and their commitment to sustainability and to collaboration with domestic business to a great extent (Andersson and Forsgren 2000).

The new attention in academic literature on the important and increasingly autonomous role of subsidiaries in MNE has led to a growing skepticism toward the former 'center-periphery' view, in which the firm-specific advantages of the MNE are developed and controlled by the parent company, while the foreign subsidiaries merely exploit these advantages in the local markets. This may still be the case at an early stage, when an MNE starts to explore opportunities to sell its products in another country. But once the MNE selects a country also as an important production base, the importance and autonomy of the subsidiary increases and with it the pressure to enhance embeddedness in the country (Andersson and Forsgren 2000). Another critical dimension of enhanced local embeddedness is related to the potential of the information age to change the distribution of competitive advantages across different categories of firms in global value chains (GVCs). Information and communication technologies (ICTs) have facilitated the emergence of new manufacturing technologies and cost-saving logistics that led to the increasing engagement of a wider variety of actors, including small and medium-sized enterprises (SMEs) in developing countries that would have previously been ignored due to high transaction costs. Enhanced use of ICTs in GVCs also leads to advances in product modularity. They can act as a substitute for relational governance, even when cultural differences among partners are high. In other words, fragmentation and modularity may make relationships among partner firms more immune to cultural differences (Alcácer et al. 2016). At the same time, they increase pressure to pursue a strategy of principled embeddedness in the host country because integrating local companies into global value chains requires them to adjust their business practices to international standards.

4.1 Selected cases of 'principled embeddedness' of subsidiaries of MNE

Based on the field research conducted by Master and PhD students in the CTI[5] project on local embeddedness of multinational enterprises in developing countries[6] and a panel discussion on the topic in a workshop on embeddedness in Zurich[7], the positive sustainability effects resulting from embeddedness of Swiss-based multinationals such as Chiquita, Nestlé, Syngenta (case studies) and Bata shoes (workshop presentation) were assessed. The field research required the collaboration with a local university to obtain external and independent assessments, in addition to the data provided by the company. Even though in each case, some shortcomings and challenges of the business of the respective country subsidiaries were identified, a commitment to 'principled embeddedness' were recognized in all case studies. Independent of the failures and scandals that all these large MNEs may be confronted with in the course of their operations in developing countries, it is worth pointing out what makes their commitment to principled embeddedness valuable for the local communities and the environment:

A first example is Nestle Philippines. The Swiss-based company set up its first subsidiary in the Philippines in 1911. In 1960, Nestlé S.A. and San Miguel Corporation entered into a partnership resulting in the formation of Nutritional Products, Inc. (Nutripro). In 1962, Nutripro's first factory started operations in Alabang, Muntinlupa to manufacture NESCAFÉ. In 1977, Filipro, Inc. and Nutripro Inc. merged under the name Filipro, Inc. In 1986, Filipro, Inc. changed to its present name as Nestlé Philippines, Inc. In late 1998, Nestlé Philippines became a wholly owned subsidiary of Nestlé S.A., following the latter's purchase of all of San Miguel Corporation's equity shareholding in the company[8]. Today Nescafé Philippines is not just sourcing its coffee beans from the Philippines but also processes and sells most of its end products domestically. Moreover, most of its employees in senior positions are Filipinos. As such the company is truly embedded in the local economy and perceived by most Filipinos as a Filipino-based company. Simultaneously Nestlé abides by its CSR standards and has even developed a NESCAFÉ Plan designed to ensure that coffee farmers grow viable, healthy crops, and that coffee farming remains sustainable. Together with the Rainforest Alliance, the Sustainable Agriculture Network (SAN), and the Common Code for the Coffee Community (4C), the company makes sure it complies with internationally recognized sustainability standards.

The Swiss-based agribusiness firm Syngenta (recently acquired by the Chinese firm ChemChina) also illustrates the positive impact of a self-interested commitment to embeddedness. The company has often been criticized by civil society activists for being an agent of industrial agriculture that generates profits at the expense of clueless small-scale farmers in developing countries. The fact is, however, that an innovation-driven agricultural company like Syngenta is unable to sell any products to such farmers unless they prove to benefit the farmer family in terms of revenues and improved natural resource management. In this context, the company has an active interest to invest in those small-scale farmers in developing countries who are determined to move from subsistence-oriented to business-oriented agriculture. For that purpose, it has built up a global stewardship network in collaboration with local NGOs that recognizes the potential of public-private partnerships for sustainable development[9]. The network aims at ensuring the safe application of the offered solution packages. Each year, Syngenta and its partners train around three million producers worldwide and help them to upgrade their agricultural productivity in a sustainable way. Growth-oriented small-scale farmers benefit from Syngenta's stewardship program by learning how to comply with the national and international labor and environmental standards, and this allows them to eventually produce food for the growing urban population worldwide while generating the necessary revenues to invest in the future of their offspring.

A needs assessment conducted in 2013 with stakeholders involved in agricultural extension in tropical countries on capacity development for agricultural innovation revealed that private sector capacity development is more appreciated by local farmers than public sector programs to enhance the capacity of farmers to innovate and become more productive[10]. This is not surprising given the fact that companies are under much greater pressure to deliver value for farmers. They need to understand their context and come up with tailor-made solutions, whereas public sector officials may offer services for free but they are less responsive to the actual needs of farmers and therefore less valuable to them (Aerni et al. 2015).

The international company Bata illustrates how many benefits MNE subsidiaries can create for the local people if they do not primarily focus on merely exporting their products to affluent markets abroad but instead tailor them to the needs of the domestic market. Bata initially started in the Czech Republic but then quickly expanded into many other countries in the course of the 20th century. For many decades, the company has run subsidiaries in several African countries where its shoes are primarily produced for the local market. As a result, most Africans who buy shoes buy Bata shoes because that is what they can afford and what suits the local circumstances. Moreover, thousands of Africans were employed, housed, and trained in the business of shoemaking since Bata first invested in Africa in the mid 20th century. As a consequence, Bata has earned the company an enormous amount of social capital because its shoes have generated considerable welfare effects for the less privileged.

Finally, the company Chiquita is an interesting case because it has a long history of embeddedness. The history of United Fruit Company, as the company was called before changing its name in the 1980s, was characterized by political rather than economic embeddedness. It played a crucial role during the Cold War period as a company that enjoyed the backing of the US government as well as the national land-owning elites in Latin American countries that fought against communism. As a consequence, the company's name became associated with client states that had more interest in serving US interests than the interests of its people. Chiquita was determined in the early 1990s to leave the past behind and embark on a fundamental corporate transformation. It decided to fundamentally change the mode of producing and exporting bananas in developing countries. As one of the very first MNE, it asked its country subsidiaries to collaborate with the Rainforest Alliance (RA) to improve its social and environmental sustainability performance in the early 1990s. In 2000 all Chiquita-owned farms were RA certified, and by 2012 it upgraded 75% of its local suppliers to become compatible with the RA standard. In this period, its subsidiaries started with a homeownership program for their employees, local nature and community projects such as 'Nogal' in Costa Rica together with the Swiss retailer Migros, the Mesoamerican Reef Project with WWF, and the Panama Biodiversity Project ('San San') with the German retailer REWE.

In addition, the company continuously improved the strict implementation of sustainability practices in banana cultivation and processing, reduced its carbon footprint (in collaboration with the Massachusetts Institute of Technology, MIT) as well as its water footprint in collaboration with WWF International. Its efforts have been widely acknowledged by external reviews[11] and reported in the Economist in 2012 under the title 'Going Bananas' (because all these investments in sustainable change would not have paid off in terms of an improved reputation). Its commitment to local embeddedness has been documented by three master theses conducted in Guatemala, Costa Rica, and Panama at ETH Zurich in 2016. These theses were part of a project on the impact of local embeddedness of Swiss-based MNE on sustainability in developing countries[12]. The critical field research conducted by the students discovered many positive side effects for the local economy that resulted from the commitment of Chiquita subsidiaries to embed themselves into the domestic economy. Often these side effects were not documented in Chiquita's sustainability report because they attributed them to the long-term business strategy rather than a concrete sustainability strategy. But the students also uncovered local challenges due to local institutional and economic uncertainties that the company may be able to address more effectively. Despite the fact that Chiquita turned from a public into a private company in 2015 after having been acquired by the Brazilian fruit juice producer Cutrale, Chiquita continued to stick to its progressive CSR strategy and remained open-minded to critical issues that the students raised in their field research. Many large retailers in Europe refuse to acknowledge Chiquita's record as a pioneer in the field of CSR and sustainability in banana production (Schwab 2017). These retailers tend to point out that consumers still do not associate Chiquita with sustainability. As a consequence, many large retailers prefer to exclusively sell Fairtrade and organic bananas to their consumers to signal their sustainability commitment (Aerni 2013). In addition Migros came up with its own model project of banana production in collaboration with WWF. However, Migros has yet to provide evidence of sustainability improvements it has attained that go beyond the performance achieved in collaboration with Chiquita (Schwab 2017). In fact, the so-called COSA study that compares the performance of different sustainability standards in agriculture suggests that organic and Fairtrade have improved little in performance compared to less known labels such as UTZ and the Rainforest Alliance[13]. The challenges of organic farming labels in developing countries are also documented in numerous publications (Dragusanu et al. 2014, Ronald & Adamchak 2008, Paarlberg & Paarlberg 2008). What is especially odd in organic banana production is the fact that water is considered a natural ingredient and therefore its use is unrestricted. This explains why organic banana production is mostly found in rather arid zones because it relies heavily on irrigation. The fairness of Fair Trade has been questioned by Fridell (2007). More recently, Clark & Hussey (2016) argued that describing fair trade as an effort to re-embed the agricultural economy in the way Polanyi envisioned it is misleading. Stakeholders in the developed world define fair trade standards, not the local people; and local fair trade production is not designed for domestic consumption but for affluent consumers abroad who are prepared to pay a premium price to feel good about their ethical behavior. The unwillingness of fair trade cooperatives to embed themselves into national sustainability strategies has become apparent in Costa Rica, a country which aspires to be the leader in sustainable banana production in tropical countries. In this context, the Corporación Bananera Nacional Corbana, S.A. (CORBANA), an organization partially owned by the banana growers of Costa Rica, seeks to get the geographical indication (GI) accreditation of 'Banano de Costa Rica' as a national sustainability label for banana production[14]. As such it collaborates with all key stakeholders in the banana business and sustainability certification. Oddly, fair trade cooperatives are not part of this collaboration. They argue that they have to follow the instructions demanded by the retailers in importing countries.

4.2 Embeddedness and its link to sustainability and corporate responsibility

The case studies in the previous chapter illustrate that the term 'embeddedness' also has a strong relationship to corporate responsibility and sustainability. After all, a private organization that is locally embedded and abides by its self-imposed principles of corporate responsibility is more likely to assume active responsibility for the local people and their environment and bring prosperity to the region.

The ISO 26000 Standard on Corporate Social Responsibility (CSR) as well as the OECD Guidelines for Multinational Enterprises (MNEs) point out that multinational corporations should get involved in local community development. 'Community Development and Involvement' is, in fact, one of the priority areas of ISO 26000 and can be interpreted as a commitment to local embeddedness. However, the wording of the ISO 26000 standard very much reflects the spirit of the UN Guiding Principles on Business and Human Rights (UNGP) and its focus on minimizing potential risks of FDI for human rights. In accordance with the view of embedded liberalism (Ruggie 1982), the common goal of ISO26000, as well as UNGP, is to tell MNEs how to become good corporate citizens by refraining from doing bad things to people and the environment while contributing to general wellbeing. The narrative is implicitly still guided by Karl Polanyi's argument that a self-regulating market leads to social disruption and causes disembeddedness of local traditional economies.

5. Concluding remarks

Karl Polanyi's highly influential book 'The Great Transformation', published in 1944, addressed a lot of important concerns related to the global expansion of the formal market economy and its potential to disrupt and disembed traditional economic systems. In many ways, he proved to be a visionary in anticipation of the increased ability and agility of MNE to act beyond existing national regulatory regimes in the age of the globalization. The view of a global economy dominated by rootless MNE that would undermine national solidarity, decrease the bargaining power of national stakeholders, increase social inequality, and thrive on poor working conditions in developing countries has caused a backlash against economic globalization.

It is undeniable that economic globalization produces winners and losers and that the losers need to be not just compensated but also coached in their efforts to become re-integrated into economic life. But what is exactly the alternative to a modern trade-oriented and innovation-driven market economy? History shows that there has never been a past, as often imagined by the critics of globalization, where people lived in harmony with nature, and were able to ensure that everyone has enough for a productive and fulfilling life. The past was instead characterized by war-mongering feudalist regimes that were dominated by rent-seeking elites that oppressed and exploited their subjects for the sake of achieving particular political and military goals. They mostly competed for land not through trade deals but by waging war. These regimes that became rich through war rather than trade produced a much greater percentage share of losers than today's trade regimes that leave room for social mobility and economic empowerment. This probably explains why Polanyi does not distinguish between empires that became rich through trade and those that became rich through war.

Polanyi's normative view of economic globalization as a force of disembeddedness has nevertheless become very popular in affluent economies. The line of argumentation is that MNEs are merely disembedding traditional economies in developing countries and that therefore development cooperation and philanthropic activities need to be focused on efforts to compensate or protect these embedded traditional economies. This view tends to cement existing structures rather than induce structural change because these countries need economic integration, not isolation to cope with population growth and the resulting economic, social, and environmental challenges.

Despite their potential contribution to economic integration, MNE that invest in fragile developing countries may increasingly face reputation problems because their primary goal is indeed to generate a return on investment rather than to provide development assistance to the poor. It is therefore quite easy for anti-MNE activists to denounce FDI in fragile developing economies as 'land-grabbing' or 'exploitation of poor labor and environmental standards'. As a consequence, many MNE prefer to focus again on domestic investments in advanced, stable economies and divestments in high-risk developing economies; even though the potential positive long-term impact of their investments would be lowest in the former, the affluent minority world, and greatest in the latter, the struggling majority world. In other words, they focus on managing and preserving prosperity rather than spreading it. This is hardly desirable given the general insight that private sector involvement is necessary for the global effort to achieve the UN Sustainable Development Goals (SDGs) by 2030.

Since knowledge-based MNE are often at the core of expanding global formal and informal networks related to GVCs, they play a crucial role in the economic integration of less developed regions by decreasing the transaction costs of doing business. Local businesses that receive the necessary investment to comply with the global standards of the respective GVC become suppliers of the foreign MNE. As such they automatically attract more investment, hire more local people and enhance local economic opportunities for the outsiders in the region. As such, MNEs are not merely replacing informal transactions with formal transactions but are creating alternative informal and formal networks in the region with low transaction costs. These are not replacing traditional economic networks but must be conceived as complementary to pre-existing ones that are often still characterized by feudal structures. They increase the choice for local people in search of economic opportunities and may prove more attractive to local people if they manage to address the three coordination problems related to value, competition, and cooperation in an effective and fair way.

MNE address these coordination problems by involving local social and economic networks in defining the terms of reference of market interaction. As a consequence, an MNE that is interested in long-term investments in a particular country will encourage its subsidiary there to engage with local stakeholders to learn what they expect from the presence of the MNE in their country. If the MNE is committed to 'principled embeddedness' in the sense that it has many ties to the local economy while simultaneously sticking to its own corporate responsibility principles, it may eventually earn social capital in the form of public trust within the region. This enhances its freedom to operate and lowers its transaction costs of doing business. In other words, 'principled embeddedness' has nothing to do with disembedding first local economic structures and then compensating for the damage done. Instead it is all about benefiting the foreign investor as much as the local stakeholders. So the foreign investor is not disembedding but enhancing the value of the locally embedded economy by contributing to its diversification, its technological and managerial upgrading, and its integration into global value chains.

The strategy of 'principled embeddedness' of MNE and how their subsidiaries concretely implement it has been illustrated using four brief but actual case descriptions in this paper. They all show that such a strategy significantly contributes to the flourishing of the local economy as well as to achieving the UN SDGs since their local public-private partnerships do not just benefit the MNE and its employees but also contribute to poverty reduction, better education, improved health, and more economic opportunities for the local people.

For sure MNE are no saints and abuses of their economic and political clout in fragile developing economies are well-documented. But rather than merely focusing on minimizing the potential risks of foreign FDI, CSR ratings should also award the 'moral courage' of those MNE that invest in such high-risk economies by following a strategy of principled embeddedness that enables the local private sector to benefit from the knowledge and know-how of global networks related to GVCs.

MNEs that have this moral courage are of crucial importance in the spread of prosperity to people who are trapped in informal and traditional economies that do not generate sufficient and decent work for a growing young population and are dominated by embedded structures that are based on rent-seeking patron-client systems that prevent economic empowerment. This makes their embedded foreign direct investment more valuable in efforts to achieve the UN SDGs than the widely communicated corporate social responsibility activities and are now being linked to numerous SDGs.

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Endnotes

1 See http://www.ohchr.org/EN/Issues/Business/Pages/BusinessIndex.aspx

2 See https://www.iso.org/iso-26000-social-responsibility.html

3 The basic unit of the manorial system was the manor, a self-sufficient landed estate, or fief, which was under the control of a lord. As a representative of the aristocracy or the clergy, the lord enjoyed a variety of rights over the estate and the peasants attached to it by means of serfdom.

4 See for example the UNDP initiative on livelihood and jobs: http://www.undp.org/content/undp/en/home/ourwork/sustainable-development/development-planning-and-inclusive-sustainable-growth/livelihoods-and-jobs.html

5 CTI is the Swiss Federal Commission on Technology and Innovation (https://www.kti.admin.ch/kti/en/home.html). It sponsors research at universities that is considered to be of commercial value in the private sector.

6 See http://www.ccrs.uzh.ch/en/research/sustainable-impact/projekte/local-embeddedness.html

7 See http://www.ccrs.uzh.ch/en/News/embeddedness-panel-en.html

8 See https://www.nestle.com.ph/aboutus/history

9 See https://www.vsointernational.org/fighting-poverty/improving-livelihoods/improving-food-security-for-smallholder-farmers-in-bangladesh

10 See http://www.fao.org/in-action/tropical-agriculture-platform/resources/reports/en/

11 See Chiquita Assessment funded by the Fondation Guilé (http://www.guile.org/wp-content/uploads/2015/06/Book-Interactif_300dpi.pdf)

12 See http://www.ccrs.uzh.ch/en/research/sustainable-impact/projekte/local-embeddedness.html

13 See https://thecosa.org/wp-content/uploads/2014/01/The-COSA-Measuring-Sustainability-Report.pdf

14 See http://www.wipo.int/ipadvantage/en/details.jsp?id=3111

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