

Towards Strengthening the Local Firms' Absorptive Capacities: Conceptual Framework

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Abstract :

In developing countries the foreign direct investments (FDIs) and, especially, in sort of multinational Companies (MNCs) are identified as the major source of industrial upgrading in the host countries. The present paper stresses to explore ways to improve the local firms' benefits of knowledge spillovers from the inwards FDIs, through the improvement of domestic firms' absorptive capacities.

The current study based on exploring literatures; to propose a conceptual framework showing the major organizational elements to improve local firm's absorptive capacity in order to enhance the benefits of domestic firms from foreign direct investments' knowledge spillovers.

The present paper determines five critical elements ought to be embedded in the local firms in developing countries in order to upgrade their absorptive capacities.

Keywords : Local Firms, Foreign Direct Investment (FDI), multinational Companies (MNCs), Absorptive Capacity.

Jel Classification Code : F23, L24, M54.

Résumé :

Dans les pays en développement, les investissements directs étrangers (IDE) et, en particulier, dans les sortes de sociétés multinationales (MNC) sont identifiés comme la principale source de modernisation industrielle dans les pays d'accueil. Cette étude met l'accent sur l'exploration des moyens d'améliorer les avantages pour les entreprises locales des retombées des connaissances provenant des IDE entrants, grâce à l'amélioration des capacités d'absorption des entreprises nationales.

L'étude actuelle basée sur l'exploration des littératures; proposer un cadre conceptuel montrant les principaux éléments organisationnels pour améliorer la capacité d'absorption des entreprises locales afin d'accroître les avantages

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des entreprises nationales des retombées de connaissances des investissements directs étrangers.

La présente étude détermine cinq éléments essentiels qui devraient être intégrés dans les entreprises locales des pays en développement afin d'améliorer leurs capacités d'absorption .

Mots clés : Entreprises locales, investissements directs étrangers (IDE), sociétés multinationales, capacité d'absorption.

Code de classification Jel : F23, L24, M54.

1-Introduction

Many developing countries have invested substantially to attract foreign direct investments (FDIs). Policy makers in developing countries are competing fiercely for FDIs. Foreign direct investments in sort of multinational companies (MNCs) precisely are widely thought to bring into the host country, an assortment of productive assets, including long-term foreign capital, entrepreneurship spirit, knowledge, skills, technology, innovative capacity and export marketing skills (Ikiara, 2003). The role of multinational companies (MNCs) as a source of capital and technology has increased over time, as other sources of capital have become scarcer and technical change has accelerated. MNCs continue to dominate the creation of technology; indeed, with the growing costs and risks of innovation their importance has risen (Lall & Narula, 2004).

Neoclassical theorists such as Romer, (1986) and Lucas, (1988), argue that FDIs urge long-run growth through such variables as research and development (R&D), production techniques, managerial skills and human capital.

The role of FDIs in developing countries can be critical; due to the lack of capacity of local firms in developing countries to undertake research and development activities and to generate technological innovations (Mucchielli & Jabbour, 2004). Therefore, FDIs in developing countries can potentially be identified as a major source of industrial upgrading and technology development through technical assistance, training and knowledge transfer (Ivarsson and Alvstam, 2005). It may also contribute to increase the rate of adoption of new technologies by local industries, as a result of processes of imitation and competition. In terms of employment, inward investors can generate new jobs directly, but they can also contribute to raising skill

levels, because their skills requirements may be higher than those required by domestic firms (Smallborne, 2007).

Thus, multinational Companies (MNCs) are seen as agents that increase competition in the host economy, transfer modern technology, and help achieve more efficient allocation of resources.

However, there is evidence that the flow of FDI doesn't necessarily lead to the development of local firms. Calagni (2003) & Smallbone (2007) maintain that empirical evidence demonstrate that the positive spillovers effects from FDIs do not necessarily occur in practice. Thus, researchers, policy makers, and managers debate highly and continually the different possible ways through which the knowledge linkages between MNCs and local firms are guaranteed. (Bathelt et al, 2004; Humphrey and Schmitz, 2002).

In many cases the local firms are neither able to acquire nor assimilate and exploit the knowledge applied by foreign direct investments, due to the lack of absorptive capacities in domestic firms.

Local firms need prior related knowledge and capacities in order to be able to absorb new knowledge and seize the benefits of FDIs as much as possible.

Many researchers agree that the absorptive capacity is a precondition for local firms to benefit from FDIs (Narula and Portelli (2004)).

Lall and Narula (2004), hold that absorptive capacity is significant for development because it allows local actors to capture knowledge that exists elsewhere. Where absorptive capacity is lacking in domestic firms, they may lose the reaping of knowledge benefits from MNCs.

The absorptive capacity is but one of several ways to upgrade the local firms from the MNCs' knowledge spillovers.

After reviewing a large number of previous studies in this field of research, there is almost a consensus about the critical importance of absorptive capacity in the improvement of local firms' benefits from knowledge spillovers of foreign direct investments (Kokko et al. (2001), Narula and Portelli (2004), Pedro Sánchez-Sellero et al (2016) ...). Whereas, there is a gap in literature about the practices ought to be followed by the indigenous firms to upgrade their absorptive capacities.

The present paper explores manners to maximize local firms' absorptive capacities of MNCs' knowledge spillovers, in order to overcome the limits of domestic firms' benefits from MNCs.

Research question :

What should local firms in host countries do to improve their absorptive capacities to maximize their benefits of knowledge spillovers from the inwards FDIs?

The current study is purely based on large number of theoretical and empirical previous studies. It analyzes the major organizational elements that are responsible for local firms' absorptive capacities upgrading.

2-The Concept of Absorptive Capacity

Kedia & Bhagat (1988) are first coined the term “absorptive capacity”, which then since received considerable attention after the seminal work of Cohen and Levinthal (1990). Absorptive capacity can be defined as a firm's ability to identify, assimilate, transform, and apply valuable external knowledge. In short, absorptive capacity is a limit to the rate or quantity of knowledge that a firm can absorb.

Zahra and George (2002) proposed four distinct dimensions to absorptive capacity, which are; acquisition, assimilation, transformation and exploitation. A definition of these four capabilities is displayed in the following paragraphs:

First Dimension : Acquisition capacity which refers to the firm's identification and acquisition of valuable external knowledge.

Second Dimension : Assimilation capacity is the firm's habits, methods, processes and routines that lead them to effective assessment, processing and understanding of the information and knowledge captured from external sources (Kim, L. 1997). The assimilation capacity is tightly linked to the understanding and interpretation of knowledge by individuals. Therefore, Knowledge assimilation capacity relays on the ability of a firm to get new external knowledge and make a sense of it.

Third Dimension: Transformation capacity refers to the combination of the newly acquired external knowledge and the firm's prior related knowledge. Zahra, S.A. & George (2002) suggest that this dimension “denotes a firm's capability to develop and refine the routines that facilitate combining existing knowledge and the newly acquired and assimilated knowledge”. This dimension is considered to be the most

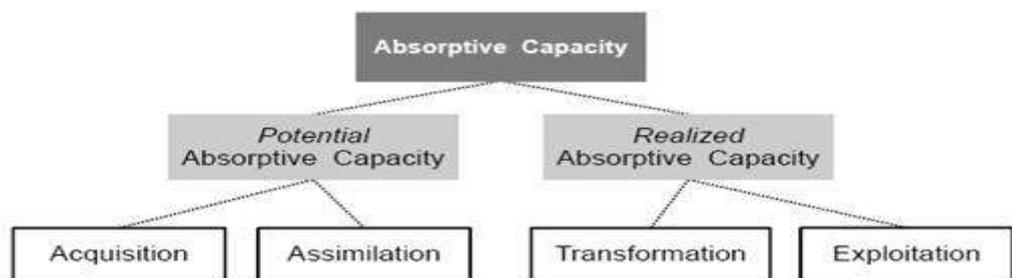
relevant. This could be obtained through adding or deleting knowledge or by the simple interpretation of knowledge in a different way.

Forth Dimension: Exploitation capacity defined as “an organizational capability that is based on the routines that allow firms to refine, extend, and leverage existing competencies or to create new ones by incorporating acquired and transformed knowledge into its operations” (Zahra, S.A.; George 2002(p. 190)).

Exploitation capacity refers to the application of new external knowledge for commercial ends (Delmas, M, 2011).

The absorptive capacity can be divided in two main parts (*figure 01*); the first part is potential absorptive capacity, which is discussed at the inter-organizational level, and the second part is realized absorptive capacity which is discussed at the intra-organizational level, Zahra and George (2002) (*see figure 1*).

Figure n⁰¹ : Absorptive Capacity Types



Source: Zahra and George.2002, P.192 (Modified)

3- The Linkages between MNCs and Local Firms

The linkages between MNCs and local firms take several forms. Every variety of linkages could have its own special advantages to local firm; in knowledge spillovers matter. The current study presents three major styles of linkages, which are as follows: Backward linkages, Forward linkages, Horizontal linkages.

3-1. Backward Linkages

The backward linkage is defined as the relation between domestic and

foreign firms when the domestic firm operates as the input supplier of the sector that multinational operates in (Sayek and Koymen 2009). Dunning (1992) stresses that backward linkages with local purveyors are the extent to which raw materials, components and services are sourced from within the host economy. Researchers are consistent and supportive regarding the evidence of positive spillovers in the backward linkages with local suppliers, especially, in the case of developing countries (Smallbone 2007).

Backward linkages from FDI have many benefits to local suppliers, including but not limited to the following: improving the quality and the quantity of production, boosting local firms' output, pushing local firms towards creative solutions, implementing new technology and creative managerial capabilities. (Liu and Lin, 2004).

Backward linkages create technology spillovers through several mechanisms; among which:

- 1- MNCs may transfer knowledge directly to their local suppliers by training or technical assistance in order to increase the quality of supplier products (Sayek and Koymen, 2009);
- 2- Higher requirements for product quality and on-time delivery set by MNCs may provide incentives to local suppliers to improve their production process or technology.

3-2. Forward Linkages

Forward linkages take place when a MNC operates at the upstream sector of the domestic firm; in other words, the multinational operates as a supplier of the domestic firm (Sayek and Koymen, 2009). In the forward linkages, local firms may gain access to higher-quality of intermediate inputs and services, things which may improve levels of local firms' productivity (Javorcik, 2004 quoted by Sayek and Koymen, 2009).

Knowledge spillover benefits could be realized through forward linkages via numerous channels. First, domestic firms may benefit from supplies of intermediate goods and machinery from MNEs that possibly provide better quality products and lower costs. Secondly, local firms by serving as outlets for MNCs' products, they could receive support from MNCs in kind of training in sales techniques, getting developed sales equipment, and upgrading their marketing knowledge. Thirdly, the FDIs in host countries' infrastructures and business services affect positively and directly the local firms' productivity (Hoi Le and

Pomfret, 2008).

3-3. Horizontal Linkages

Horizontal spillovers take place when local firms benefit from foreign affiliates which are operating within the domestic firm's sector (Sayek and Koymen 2009). Horizontal spillovers refer to the technology leakage from MNCs to local firms in the same industry (Liu and Lin, 2004). The horizontal linkages potentially encompass three main types of spillover effects, which are the following: the human capital effect, the demonstration effect and the competition effect.

A- The human capital effect: Occurs when MNCs train workers and provide them with new knowledge and skills, which workers take with them if they move towards an indigenous company or establish their own business (Paus and Gallagher, 2006; Hoi Le and Pomfret, 2008);

B- The demonstration effect: Takes place when domestic firms learn from foreign ones by observing and imitating product innovations or novel managerial skills adapted to local conditions (Hoi Le and Pomfret, 2008; Sayek and Koymen 2009);

C- The competition effect: May appear from the Existence of foreign firms in local markets. With competition effect domestic firms possibly strive to catch up with MNCs through research and development activities and resources reallocation (Sayek and Koymen 2009; Blomstrom and Kokko, 1998).

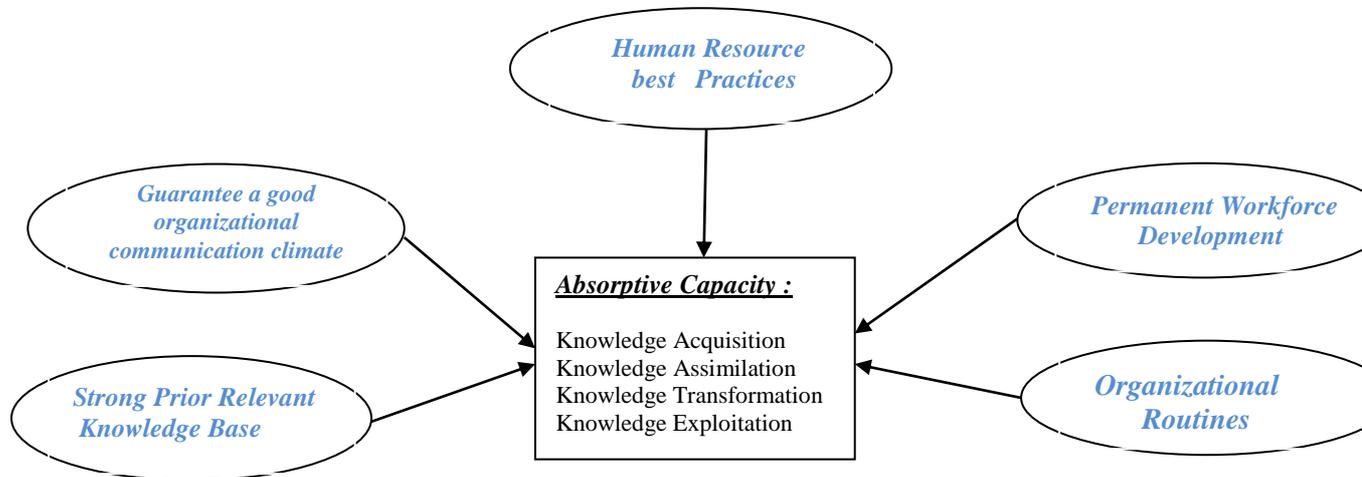
4- Building Absorptive Capacity for Local Firms

In order to upgrade the absorptive capacity of local firms, the current study proposes a conceptual framework based on large number of theoretical and empirical previous studies.

The current paper proposes five major organizational elements ought to be included into developing countries' firms in order to improve their absorptive capacity (*figurer 2*). Those elements are as follows:

- 1- Human Resource Best Practices;
- 2- Guarantee a good organizational communication climate;
- 3- Strong Prior Relevant Knowledge Base;
- 4- Permanent Workforce Development;
- 5- Organizational Routines.

Figure n° 2 : The Conceptual Framework Model



Source: Developed by the author.

4-1.Human Resource Best Practices

The human capital level of indigenous firms is important in the sense that it is a part of firm's knowledge and technological capability. In other words, domestic firms that possess higher levels of human capital are more able to absorb tremendous amount of knowledge from foreign entrants (Sayek and Koymen 2009). Organizations can gain and maintain high human capital level through the implementation of human resource best practices (Mirta Diaz et al, 2017).

Human Resource best practices are a set of Human Resources Management processes and actions that work universally, that can increase a company's performance. When these best practices are amalgamated, their impact will be more profound.

Minbaeva et al, (2003) and Minbaeva, (2005) support the idea that absorptive capacity can be enhanced by investing in human resource management practices, that support the motivation and ability of the employees to absorb and knowledge.

Human resource best practices have been proven to have positive relationships to absorptive capacity (Huselid, 1995). For Kamoche and Mueller, (1998) managing human resources to achieve better knowledge-related outcomes means; retaining personnel, building their

expertise into the organizational routines via learning processes, and setting up mechanisms for the distribution of benefits arising from the exploitation of this expertise.

Human Resource best Practices can be very instrumental in the development of local firms' absorptive capacities. Jeffrey Pfeffer In his books (1994,1998) proposed seven Human Resource best practices, which are as follows :

- 1- Employment security;
- 2- Selective hiring;
- 3- Self-managed and effective teams;
- 4- Contingent compensation;
- 5- Extensive training;
- 6- Reduction of status difference;
- 7- Information and knowledge sharing.

4-2.Guarantee a good organizational communication climate

Communications climate is the atmosphere that defines the accepted communication behavior within the organization. The communication climate could facilitate or hinder the communication processes (Brown, 1997). Several previous studies have confirmed that an open, supportive climate can significantly boost employees' ability to learn, which leads to effective and efficient implementation of new ideas.

Nevis et al (1995) regard a "climate of openness" as one of the factors facilitating organizational learning. Furthermore, Levinson and Asahi (1995) mention that an open culture, which views change as positive, can facilitate organizational learning. Another important element of an open climate is "safe failing" that encourages risk-taking. Learning is in fact a trial and error process that requires an experimental mind-set (Nevis et al., 1995). The communications climate is a key factor to improve a firm's absorptive capacity.

Therefore, there is a need to establish effective communication channels to enhance organizational knowledge sharing, and this can be achieved through many manners, such as regular discussions, internships, workshops or virtual meetings by utilizing information and communication technology such as: Face-to-face interaction, tele-conferencing, emails, web-discussion-forum, web-conferencing, wikis, blogging, and others (Chua Alton 2003).

4-3.Strong Prior Relevant Knowledge Base

Cohen and Levinthal (1990) argue that absorptive capacity is

dependent to prior relevant knowledge because experience and prior knowledge facilitate the use of new knowledge. As a consequence, absorptive capacity is cumulative. The cumulative nature of knowledge is also correlated to employees' level of education. The higher the level of education and training an employee receives, the higher their individual ability to identify and exploit new knowledge will be. A firm's absorptive capacity is however not merely the summation of the absorptive capacities of their individual employees. Cohen & Levinthal (1990) reach a conclusion that absorptive capacity relies mainly on the ability of an organization as a whole to organize and stimulate the transfer of knowledge across departments, functions and individuals. Firms' absorptive capacities depend on those of their employees, the general level of education; experience and training their employees receive (Thornton, 2008).

Cohen & Levinthal's (1990) assume that prior related knowledge is the most important antecedent to absorptive capacity. The absorptive capacity is deemed as a firm-level construct, and could be seen as an ability the firm makes it grow over time by accumulating a relevant base of knowledge. Cohen & Levinthal's (1990) proclaim that organizational units which acquire relevant prior knowledge are likely to have a better understanding of new technology that can generate new ideas and develop new products.

As new knowledge is built on the existing knowledge structures, it would not be possible to identify new knowledge without prior related knowledge (Nonaka & Takeuchi, 1995). The prior knowledge should be enough pertinent to facilitate understanding and therefore improve learning processes (Cohen & Levinthal 1990).

4-4. Permanent Workforce Development

In a rapidly-evolving world, firms need to implement a system to anticipate and adapt with the continual and permanent changes. Workforce development is deemed as an important element to keep up the organizations with rapid and continuous changing.

Jacobs & Hawley (2008) define workforce development as: "The coordination of public and private-sector policies and programs that provides individuals with the opportunity for a sustainable livelihood and helps organizations achieve exemplary goals, consistent with the societal context" (P.12).

Workforce development is an interrelated set of solutions to meet employment needs. Workforce development can include changes to organizational culture, modifications on attitudes, and changes to people's potential that help to positively influence a business' future success.

Workforce development is considered a more long-term, ongoing strategy to help improve employees, builds a workforce's tangible and intangible abilities to manage and deal with future challenges. Workforce development is different from workplace training, which often focused on a specific job or skill that is necessary to know immediately in order to perform a precise job.

Work force development endeavors to sustain the readiness of local firms' employees to acquire and assimilate new knowledge. Thus; workforce development programs would enhance local firms' absorptive capacity and thereby promote MNCs-local firms linkages.

4-5. Organizational Routines

Organizational routines are a central characteristic of human organizations and an explanatory mechanism in many accepted theories. The concept of organizational routine was introduced by Sten (1940). Organizational routines have been deemed as the primary means by which organizations achieve much of their goals. Organizational routines are repetitive, perceptible patterns of interconnected actions, carried out by multiple actors (Feldman & Pentland, 2003).

Organizational routines are recommended to be fundamental components of organizational behavior and repositories of organizational capabilities (Nelson & Winter, 1982, M. C. Becker et al).

Organizational routines are in some cases designed to produce change, such as new product development routines, and in other cases routines encompass and provide analytical access to sources of endogenous change (Becker et al, 2005; Nelson & Winter, 1982). Some researchers define innovation as new combination of existing routines (Parmigiani & Howard-Grenville, 2011) and for the same reason, organizational routines are argued to be completely valuable in providing a deeper understanding of organizational innovation (Becker et al., 2005). Organizational routines can be viewed as essential mechanisms for knowledge creation, utilization and storage.

Absorptive capacity can be defined as a “...a set of organizational routines and strategic processes, by which firms acquire, assimilate, transform, and exploit knowledge for purpose of value creation.” (Zahra and George, 2002, p.192). A large number of routines and processes are defined by Lewin et al (2010) as components of absorptive capacity. They disaggregated absorptive capacities into three sets of high level routines as follows:

- 1-The internal absorptive capacity: involves informal and formal routines to enable emergence of new ideas, selection of ideas for further development, knowledge sharing and combination, and finally routines for reflecting on, updating, and replacing old practices;
- 2- The external absorptive capacity : entails routines for identifying external knowledge and routines for learning from external organizations;
- 3- The interfaces between the internal and external absorptive capacity: include management of adaptive tension and transferring the knowledge back to the organization.

5-Conclusion

Foreign direct investment is a great opportunity for the host countries, and especially for their local enterprises. FDI can play a critical role in the growth of domestic firms. But just having the presence of FDI is not enough to get the local firms developed. The host countries are in need to support the linkages between MNCs and their local firms. And to do so, local firms need to work hard on different axes. The current study focused on one axis, which is improving the Absorptive capacity of the local firms.

The absorptive capacity of local firms could be strengthened through many organizational elements, and the most important ones are :

- 1- Human Resource best Practices based on seven main dimensions are as follows: (1) Employment security, (2) Selective hiring, (3) Self-managed and effective teams, (4) Contingent compensation, (5) Extensive training, (6) Reduction of status difference and (7) Information sharing.
- 2- The implementation of effective and trustful communication climate to enhance organizational knowledge sharing, and that could

be attained through many means, including but not limited to personalized emails, regular meetings, face to face interactions, telephone communication, chat over lunch or coffee-break, a written memo, and the establishment of a common database and guarantee a free access to it by the employees.

3- The prior related knowledge is the most salient antecedent of absorptive capacity. In short, companies in host country need to acquire the initial development of related knowledge and capacities to facilitate the absorption of new knowledge and reap the benefits of FDI as much as possible. Therefore, local firms ought to maximize their organizational knowledge base.

4- Permanent Workforce Development through learning, projecting future workforce requirements, forecasting future job creation and the corresponding skills requirements are important to guarantee that the supply of labor meets the demands of the industry.

5- Organizational Routines are critical elements in inter-organizational knowledge sharing and learning. Consequently, Absorptive capacity can be deemed as a set of organizational routines and processes, through which firms acquire, assimilate, transform, and exploit new knowledge.

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