



# Language, ethnicity and intrafirm trade<sup>☆</sup>



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## ABSTRACT

We study the significant variation in intrafirm versus arm's-length trade with micro data. Exploiting the fact that Korean is an uncommon second language and that Korean culture is relatively homogenous, we show how intrafirm sourcing by South Korean affiliates abroad increases with their share of South Korean employees. This positive association is pervasive and nontrivial. Parsing the data more carefully, we find that South Korean employees are primarily high skilled, and that their presence matters for internal trade, not for trade with South Korea per se. The share of South Koreans is also higher in affiliates from nonroutine sectors in host countries that are culturally distant from South Korea. Our empirical evidence thus supports especially [Bergstrand and Egger \(2011\)](#)'s view of multinational in-house production for nonroutine activities that require adaptation and internal communication.

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## 1. Introduction

A common language and common ethnic background are known to facilitate transactions between countries. Language and ethnic differences, on the other hand, insert transaction and information costs into international exchanges, which make them more difficult. Ample evidence for foreign direct investment, international trade and migration flows between countries illustrates such regularities.<sup>1</sup> In the global economy that we live in, emerging economies play an increasingly

important role. Those emerging economies sometimes have languages and ethnicities that are distinct from those of the advanced economies. It is therefore worthwhile to study in greater detail the precise interaction of language and ethnicity with the organization of the firm. In this paper, we study the multinational corporation that is an active player in many international transactions and a key player in countries' economic development. We use language and ethnicity to better understand the boundaries of the multinational and the tradeoffs that it faces between its in-house and arm's-length transactions.

Multinationals and foreign direct investment are arguably characteristic features of the current wave of globalization.<sup>2</sup> Foreign direct investment flows have been substantial and multinationals employ ever more people. In Europe, for example, every fifth manufacturing worker is employed by a foreign-owned multinational, and so is every seventh in the U.S.<sup>3</sup> Multinationals also mediate a major portion of international trade: For the U.S., for example, exports by multinationals account for more than 50% of total exports.<sup>4</sup> In spite of multinationals' prominence, understanding their complex international organization is still a

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<sup>1</sup> In gravity equations that explain international trade flows, language differences often proxy for frictions or barriers; see [Bergstrand and Egger \(2011\)](#) for a survey. [Rauch \(2001\)](#) reviews social networks and how they facilitate international transactions. As he points out, empirical work often focuses on ethnic networks, not because they are the only important ones, but rather because many other types of networks are hard to observe or measure; see also [Rauch and Trindade \(2002\)](#). Language also plays a role in migration. The ability to speak English makes integration into the U.S. labor market easier and allows immigrants to perform more high level tasks; see [Peri and Sparber \(2009\)](#). Several papers use ethnic and national links as proxies for information or transaction costs in the literature on foreign direct investment as well; see [Head et al. \(1995\)](#) and [Debaere and Paik \(2010\)](#).

<sup>2</sup> See [Bordo et al. \(1999\)](#).

<sup>3</sup> [Navaretti and Venables \(2004\)](#).

<sup>4</sup> See [Slaughter \(2000\)](#).

challenge.<sup>5</sup> In this paper, we use a unique micro dataset for South Korean multinationals to investigate multinational transactions from the perspective of the affiliates that are spread around the globe. We exploit the fact that Korean is the language of a well-defined, relatively homogenous ethnic community that is not commonly studied and spoken as a second language. We find that the share of (mostly high skilled) South Koreans that are employed in affiliates abroad consistently predicts the extent to which affiliates source intrafirm versus at arm's length, whereas it does not help in predicting an affiliate's overall trade with South Korea. This evidence links South Korean workers to within-network communication. In addition, our results indicate that more South Korean workers are employed abroad by South Korean affiliates in especially less routine sectors and in environments in which communications within a South Korean network should be more challenging (i.e., in host countries that are culturally most different from South Korea). We argue that this novel evidence supports new interpretations of multinationals and intrafirm trade from the point of view of incomplete contracts. In particular, it is consistent with the view that multinationals internalize problem-solving tasks that require good internal communication and that are not easily described by contracts; see Costinot et al. (2011). We can also relate our evidence to theories about language and the boundaries of the firm; see Cremer and Prat (2007).

With an unpublished benchmark dataset for South Korean multinationals that links 850 affiliates from all over the world with 500 parents in South Korea, we study the variation in intrafirm vs. arm's-length sourcing of affiliates. Our micro-level analysis of intrafirm trade complements the emerging analyses of intrafirm trade at the more aggregate product or sector level. Antras (2003) studies the cross-country and cross-sector variation in the share of intrafirm trade as a fraction of overall trade, and so do the studies of Bernard et al. (2010), Nunn and Trefler (2008), and Costinot et al. (2011). Those papers emphasize the difference between multinational and stand-alone firms at the sector/goods level. They use country- and sector/goods level characteristics to explain the tradeoff between intrafirm and arm's length trade.<sup>6</sup> Instead, we study the tradeoff between intrafirm and arm's-length transactions at the level of the affiliate and explicitly allow for variation within sectors. This approach is warranted by the data themselves. It is not the case that all purchases of affiliates are intrafirm transactions, as is sometimes implicitly assumed. As a matter of fact, on average about 53% of affiliates' total purchases are *not* intrafirm. Moreover, there is significant variation in intrafirm transactions across affiliates. An additional benefit of our micro data is that we can include the international as well as the domestic intrafirm transactions. Like Feinberg and Keane (2006), our study is one of the few that has actual data on the intrafirm flows at the affiliate level.<sup>7</sup>

Our finding also relates to a growing business literature that recognizes the challenges of dealing with cultural and language differences

within multinationals; see Ghemawat (2011).<sup>8</sup> Ghemawat (2011) estimates that about 80% of General Electric's top managers are Americans even though GE earns about half of its revenue abroad and even though it should benefit from English as a popular second language. Also South Korean companies seem acutely aware of the language and cultural challenges that they face for internal communication. They sometimes rely on the Korean expatriate community abroad to resolve the tension between "localization" (affiliate abroad) and "global integration" (headquarters), see Kang (2009).<sup>9</sup>

In the next section we explicitly position our investigation to Costinot et al. (2011). In Section 3, we describe the data that we use. In Sections 4 and 5, we discuss our estimation results and conclude, respectively.

## 2. Investigating Costinot et al. (2011)

The literature on intrafirm trade has incomplete contracts at its core. Ethier (1986) and Markusen (1995) argue that trade secrets and intellectual property are more easily protected if the entire production process is kept within the firm. More recently, the focus has been on noncontractual relationship-specific costs that the headquarters and the supplier have to incur as in Antras (2003), Antras and Helpman (2004), Antras and Helpman (2008) and Costinot et al. (2011).

The stylized framework of Costinot et al. (2011) is relatively straightforward and easiest to apply to our analysis. A final goods producer can choose between executing tasks in-house and outsourcing tasks. Costinot et al. (2011) hypothesize that when problems arise ex post that could not be fully specified in a contract between supplier and headquarters, both parties have to adapt, which is costly. Adaptation is most efficient when it takes place within the firm because there is an internal communication structure in place within the firm and there is less room for opportunistic behavior. The premise of the analysis is that problems that require adaptation on both ends are more likely to arise the less routine the tasks that have to be executed are. Therefore, integration and intrafirm trade should be most prevalent; the less routine tasks are.

Costinot et al. (2011) employ sector-level data for U.S. imports that can be broken down into intrafirm vs. arm's-length transactions, to test their hypothesis. There is no reason, however, why the empirical analysis should be restricted to the sector level, or why the focus should only be on international transactions. We apply the basic idea of Costinot et al. (2011) at the micro level and to *all* (domestic and foreign) purchases of the affiliates of South Korean multinationals abroad. We investigate whether the share of intrafirm sourcing as a fraction of total purchases increases as nonroutine problems become more likely. A particular challenge we face is to provide affiliate-level measures that capture the likelihood that nonroutine tasks and problem solving are involved.

We rely on a measure of internal communication and the extent to which an affiliate facilitates the communication within the multinational. In particular, we use the share of South Korean workers in the total labor force of the affiliates that are spread across the globe. In doing so, we follow through on the link that Costinot et al.

<sup>5</sup> See Helpman (2006). Hanson et al. (2001) early on pointed out the significant variation in expansion strategies beyond those of the traditional theories. Alfaro and Charlton (2009) and Chen (2011) confirmed the complexity of multinational operations. Antras and Rossi-Hansberg (2009) more broadly call for integrating international economics and organizational economics.

<sup>6</sup> See also Fernandes and Tang (2010) who focus on Chinese export processing at the 6-digit level. Feenstra and Hanson (2005) also study processing from China and questions of control and ownership of the Chinese plant and the intermediate goods with HS 8-digit data.

<sup>7</sup> Kohler and Smolka (2011) and Corcos et al. (2009) were among the first to use firm-level data for both multinationals and stand-alone firms and they focus on explaining the different modes of operation of firms. Kohler and Smolka (2011) have qualitative information on the mode of sourcing (arm's length, domestic or international intrafirm) for Spanish firms which they link to firm productivity. Similarly, Corcos et al. (2009) relate whether or not French firms import intrafirm to firm characteristics.

<sup>8</sup> Govindarajan and Gupta (2001) report that executives view overcoming internal communication barriers and creating trust a key challenge in building a global organization. Ghemawat (2001) emphasizes the importance of distance, including cultural distance. Mor Barak (2005) surveys a variety of ways in which diversity will affect the workplace in a global context, emphasizing beyond the language barriers, the importance of cultural differences for communication.

<sup>9</sup> See also Khanna and Song (2011) for a description of Samsung's effort to increase language and cultural understanding within the multinational and especially for its MBAs and PhDs. Evidence for German multinationals points in the same direction: Chang (2004) reports that German multinationals rely on German expatriates in its South Korean affiliates to transfer know-how between the German headquarters and the Korean affiliate.

(2011) established between their analysis, which identifies internal communications as an important way of minimizing adaptation costs, and Cremer et al. (2007). Cremer et al. (2007) study language and the theory of the firm. They argue that there is a benefit of developing a common, specialized language to facilitate communication, especially in a complex environment. At the same time, developing such a language may make communication harder with those who do not share this language. Therefore, a specialized language should only be applied when it ensures most gains: in a complex environment with high skilled labor. Commenting on Cremer et al. (2007), Costinot et al. (2011) note that: “Building up (a) communications infrastructure is a superfluous expense when a standard contract can convey all necessary information to a supplier ex ante, but if problems arise ex post that a contract does not cover, a common language that headquarters and the supplier share will reduce the cost of the communication necessary to resolve them.” (p. 300). We apply this basic idea to communication in Korean.

Some 80 million people speak Korean. Predominantly, Korean is spoken in South Korea, North Korea and in some pockets of China. We hypothesize that employing South Koreans in affiliates abroad should facilitate the communication between the affiliate, the South Korean headquarters and the other affiliates, especially since Korean is not a very common second language and Korea is culturally fairly homogeneous.<sup>10</sup> In very influential books, Hofstede (1980) and Hofstede et al. (1997) found that differences in national cultures vary substantially along four dimensions (i.e., power distance, uncertainty avoidance, masculinity/femininity, and individualism). Hofstede created ordinal scales for countries for each of these dimensions based on a standardized factor analysis of questionnaires administered between 1968 and 1972 to 88,000 national employees in more than 40 overseas subsidiaries of a major American corporation. Most relevant for our analysis, Korea ranked 43rd (out of 50), implying that Korea is rather culturally different from other countries. At the same time, employing South Koreans locally is costly, as it complicates communication within the affiliate, inserting cultural and language differences in communication with the locals.<sup>11</sup> Accordingly, it is difficult to imagine that multinationals and affiliates would incur the cost of employing South Koreans abroad when production would involve strictly routine operations that can easily be covered by standard contracts. We therefore hypothesize that more South Korean employees will be active in the affiliates when it is increasingly likely that noncontractual issues may arise. In other words, more South Korean employees are needed especially in less routine activities and in culturally different environments from South Korea.

### 3. The data

Our dataset is one of the few that directly observes intrafirm vs. arm's-length transactions at the micro level. We draw on unpublished data from the South Korean Export-Import (EXIM) Bank. Since 2000, the EXIM Bank has been pursuing a benchmark survey of South Korean multinational affiliates abroad. The EXIM Bank has included increasingly more firms in the survey, starting with about 100 parents and their 200 foreign affiliates in 2000. The number of firms and affiliates that

<sup>10</sup> On Korean as a second language, see <http://www.nationsonline.org/oneworld/most-spoken-languages.htm>, which draws on Lewis (2005). See also Weber (1997).

<sup>11</sup> In a widely cited review paper of 40 years of research on diversity in organizations, Williams and O'Reilly (1998) conclude that ethnic diversity typically has a negative effect on social integration, communication and conflict and the ability of groups to function effectively over time. Alternatively, within culturally homogeneous groups, members will communicate more and also in more varied ways. With the exception of some laboratory experiments, most research strongly supports this conclusion. Applied to our research question, this evidence suggests that the communication between South Korean employees and others may be more difficult; at the same time, one would expect easier and more sophisticated communication among the South Koreans in the affiliate and in the parents. For a reference about the challenges of dealing with East-west cultural differences in the workplace, see Sanchez-Burks et al. (2003).

**Table 1**  
Intrafirm sourcing.

	Purchase from all related parties/ total purchase	Purchase from parent/total purchase	Korean workers/ total employees	Obs
1. Average	0.473	0.351	0.06	850
2. By region				
China	0.466	0.348	0.041	530
Asia excl. China	0.488	0.362	0.065	186
N. America	0.495	0.377	0.179	59
Europe	0.534	0.362	0.097	50
S. America	0.303	0.175	0.052	16
Rest of the World	0.407	0.292	0.062	9
3. By sector				
Food products	0.224	0.043	0.05	32
Textile	0.439	0.353	0.053	53
Apparel	0.492	0.366	0.031	70
Leather, bags, footwear	0.479	0.434	0.021	9
Wood products	0.441	0.104	0.018	3
Pulp, paper products	0	0	0.171	3
Publishing, printing products	0.276	0.276	0.506	4
Chemical	0.379	0.315	0.092	66
Rubber and plastic	0.502	0.383	0.077	17
Nonmetallic mineral	0.213	0.032	0.022	16
Primary metal	0.427	0.228	0.096	42
Fabricated metal	0.376	0.267	0.051	77
Machinery	0.477	0.375	0.059	47
Computer, office products	0.587	0.511	0.071	14
Electrical machinery	0.526	0.397	0.033	22
Electronics	0.572	0.436	0.054	180
Medical, scientific	0.486	0.473	0.168	23
Vehicle	0.568	0.413	0.035	114
Other vehicle	0.424	0.424	0.025	8
Other manufacturing	0.445	0.311	0.077	50

Data: Export-Import Bank of Korea.

are consistently surveyed each year varies too much to make a panel analysis meaningful. We therefore focus on the cross-section of 2006, which is the last year of the survey. We concentrate on manufacturing, which has more complete data than services. Manufacturing takes 65% of the data.<sup>12</sup> Note also that it is easier to identify the parents for manufacturing and link them with the KIS datasets that contain parent information; see below. After dropping affiliates with incomplete purchase and employment data, we are left with 500 parents and 850 foreign affiliates.

The dataset provides the general information for the foreign affiliates such as their location, industry, sales, purchases, and employment numbers. Critical for our empirical analysis, the dataset includes information on the total employment of each affiliate as well as the number of South Korean employees, which lets us construct the share of Korean employees. The dataset also includes quite detailed information on the intrafirm trade values. In particular, the affiliate reports its total purchases that are composed of six items: purchases from the parent, purchases from other Korean firms, purchases from other affiliates sharing the same parent in the host country, purchases from others in the host country, purchases from other affiliates sharing the same parent abroad, and purchases from others abroad. It should be clear that the purchases from the parent and from the other affiliates in the host country or abroad comprise intrafirm sourcing. The rest constitute arm's-length sourcing.

<sup>12</sup> The survey reports representative affiliate data that are not exhaustive. It, for example, does not include the data of all foreign affiliates belonging to a parent firm, which is why we take the affiliate as the unit of analysis and do not aggregate by parent firm.

**Table 2**  
Intrafirm sourcing and networks.

	Intrafirm sourcing from parent	Intrafirm sourcing from all
Dummy on sourcing from local affiliates	−0.428*** (0.102)	
Dummy on sourcing from affiliates abroad	−0.322** (0.140)	
Dummy on export to parent	0.418*** (0.0790)	0.212*** (0.0791)
Dummy on sales to local affiliates	0.226** (0.0982)	0.681*** (0.0864)
Dummy on sales to affiliates abroad	−0.168 (0.126)	−0.178* (0.107)
Fixed effect sector	Yes	Yes
Fixed effect country	Yes	Yes
R2	0.211	0.192
Observations	850	850

The dependent variable is the ratio of intrafirm sourcing from the parent or all related parties out of total purchase of the affiliate. Robust standard errors are in parentheses. \* significant at 10%, \*\* significant at 5%, and \*\*\* significant at 1%.

The EXIM survey dataset does not provide information on the parent of the South Korean multinational. It only provides the parent firm identification number. We therefore link the data from the EXIM Bank with the Korean Information System (KIS) database of Korea Investors Services Co., Ltd. This latter, extensive dataset contains the balance sheets and the profit and loss statements of most South Korean firms that are registered as corporations in South Korea. Most of these corporations are listed on the Korea Stock Exchange. After merging both KIS and EXIM, we draw on the KIS data for information on the parents' sales and employment as well as on their capital stock. Obviously, the multinationals of the EXIM benchmark survey are but a sample of the overall population of South Korean multinationals. For reference: in 2006, the 500 parents we consider were responsible for about 50% of South Korea's total outward foreign direct investment.

Table 1 provides information about average intrafirm sourcing. The first column presents the affiliate's total purchases from related parties (including the parent) as a fraction of its total (intrafirm and arm's-length, domestic and international) purchases. The second column focuses on intrafirm purchases from the parent. The third column provides the share of Korean workers in an affiliate's work force. Table 1 also breaks the data down according to the regions and sectors in which the affiliates are active. The last column provides the number of affiliates that are active in each region and in each sector. As one can see, the majority of affiliates are located in Asia, particularly in China. Indeed in recent years, there has been a surge of South Korean multinational activity in China. The U.S. (North America) and Europe also account for a significant portion of the affiliate locations. As for the sectors in which the affiliates are active, they are clearly dominated by electronics and vehicles. Note that the affiliates and parents are classified by the two-digit Korean Standard Industrial Classification that is closely related to the Standard Industrial Classification (SIC) or the North America Industry Classification System.

By construction, the average share of intrafirm purchases is less than 1. On the average, the intrafirm purchases coming directly from the parent account for 35% of the affiliates' total purchases, and the sum of all intrafirm purchases (including the other affiliates) accounts for 47%. The data in the second and third columns clearly illustrate that it is not the case that all multinational trade is intrafirm trade as is sometimes assumed in the theory or implied by empirical literature that studies the variation of intrafirm trade to overall trade at the sector level. From our perspective, the significant variation in intrafirm vs. arm's-length transactions at the affiliate level warrants an analysis that tries to identify the specific characteristics at the affiliate and multinational level that can explain this variation.

Table 2 presents estimates from a simple regression of the share of intrafirm imports that come from the parent in an affiliate's total purchases on a set of dummies that specify the network. Note that we include a battery of country and sector dummies in the regression. Some results are quite intuitive and consistent with what one would expect. Affiliates that source more from affiliates abroad or domestically will source less from the parent.<sup>13</sup> Some of the other correlations are quite suggestive. Some time ago, Yi (2003) launched the hypothesis that intrafirm trade was perhaps an important factor to consider when explaining the growth of international trade. Interestingly enough, the dummy on whether an affiliate exports to the parent relates to the extent of imports from the parent in a nonnegligible way. Indeed, the positive and significant coefficient suggests the importance of back-and-forth trade between parents and affiliates. Finally, we find that sales to local affiliates increase the share of imports from the parent, whereas sales to the affiliates abroad (even though not significant) would tend to decrease the imports from the parent. These results are potentially suggestive about the role of the affiliate as an export platform. Table 2 also contains the regression results for the affiliate's total (parent plus affiliate) sourcing, which are largely consistent with those for sourcing from the parent.<sup>14</sup>

In this paper, we relate the share of South Korean workers to the literature on tasks in order to explain the variation in the extent of intrafirm sourcing. Before focusing on the firm-level data we have, we want to point out some sector-level evidence that supports for South Korea the hypothesis that less routine tasks are more likely to be associated with intrafirm trade than routine tasks. Costinot et al. (2011) perform for a whole range of countries and 77 sectors a pairwise comparison of sectors' ratio of intrafirm imports over total imports with a measure of routineness for these sectors. They report for South Korea a (significant) 59% correspondence in signs, which supports the notion that less routine sectors will have a higher share of intrafirm imports than routine sectors.

Of primary importance for our analysis is the share of South Korean employees as a fraction of the affiliates' total employment. As the first line of Table 1 indicates, about 6% of the affiliates' total labor force is Korean. We do not have firm-level measures that assess the extent to which tasks are routine, but we can relate the sectoral routine measures mentioned above with the South Korean share as in Table 3. In order to do this, we aggregate the measures from Costinot et al. (2011) up to the 19 sectors in which our firm-level data are categorized. The share of South Korean workers increases as tasks are less routine (there are no comparable data for publishing). The 0.554 correlation in Table 4 between South Korean worker share and nonroutine tasks confirms an important intuition. This positive correlation is consistent with the notion that less routine tasks may need better communication with the South Korean parent (and the other essential affiliates). Also supportive of this association is Table 1, which indicates that the share of South Korean personnel is higher in the affiliates that are located in more advanced countries (the U.S. and Europe) where it is likely that higher-quality (more complex) goods are being produced. Consistent with the production of more complex (higher quality) goods is the fact that firms located in North America and Europe tend to be more capital-intensive and also more productive on average.<sup>15</sup>

The data in Table 4 also reveal a positive correlation of 0.406 between the share of South Korean employees and the skill intensity of the sector. Moreover, Table 5 shows that about 80% of South Koreans are active in director or nonproduction worker positions rather than in production positions. These qualifications together with their

<sup>13</sup> To make sure, this pattern is not just an accounting regularity since purchases also includes purchases from local unaffiliated firms.

<sup>14</sup> We do not include dummies for imports from different types of affiliates in this regression as they are included in the left-hand variable.

<sup>15</sup> For details, see working paper version, Debaere and Lee (2012).



**Table 3**  
South Korean workers' share vs. routineness.

Sector	South Korean share	Routineness
Wood products	0.018	0.440
Leather, bags, footwear	0.022	0.548
Nonmetallic mineral	0.023	0.463
Other vehicle	0.025	0.468
Apparel	0.032	0.523
Electrical machinery	0.033	0.437
Vehicle	0.036	0.477
Food products	0.050	0.526
Fabricated metal	0.052	0.443
Textile	0.054	0.513
Electronics	0.054	0.394
Machinery	0.059	0.443
Computer, office products	0.071	0.308
Other manufacturing	0.078	0.448
Rubber and plastic	0.078	0.449
Chemical	0.092	0.353
Primary metal	0.097	0.486
Medical, scientific	0.168	0.388
Pulp, paper products	0.171	0.353
Publishing, printing	0.507	

Routineness averages the measure from Costinot et al. (2011). Costinot et al. (2011) do not have a reference index for publishing and printing sector. The correlation between South Korean workers' share and nonroutineness is 0.554.

language competence suggests that South Koreans are more likely to communicate with the parent company and other affiliates of the same multinational, which is consistent with their role in handling nonroutine situations. Since South Koreans on average occupy about 23% of the high-skill positions (and about 80% of the management (directors) positions), the presence of South Korean nationals will significantly affect the culture of the firm and come at a cost for communication with the locals. It is consistent to see that this cost is more commonly incurred for what should be more human-capital-intensive and nonroutine activities.

To assess cultural distance (CD in the tables), we follow (Kogut and Singh, 1988), who use Hofstede (1980)'s seminal indices on cultural differences to construct a composite index on the deviation between the culture of the host countries of South Korea's affiliates and South Korea itself along the four cultural dimensions that Hofstede identified. Algebraically,

$$CD_j = \sum_{i=1}^4 \left[ \frac{(I_{ij} - I_{ijsk})^2}{V_i} \right] / 4$$

where  $I_{ij}$  stands for the index for the  $i$ th cultural dimension and  $j$ th country,  $V_i$  is the variance of the index of the  $i$ th dimension,  $sk$  indicates South Korea, and  $CD_j$  is the cultural difference of the  $j$ th country from South Korea. Important to note is that there are relatively high shares of South Korean workers in host countries that are relatively different from South Korea.<sup>16</sup> The share of South Korean workers increases as the degree of a host country's cultural difference from South Korea increases. The correlation is 0.4. This positive correlation is consistent with the notion that culturally tough environments may need better communication with the South Korean parent and the other essential affiliates. In addition, note also that there is a significant 0.16 correlation between the share of South Korean workers and the interaction of the nonroutineness of the sector and the cultural distance of the affiliate's host country. This correlation is quite suggestive, indicating that especially those tasks that need more internal communication with the multinational's internal network because they are less routine will make affiliates attract more South Korean

<sup>16</sup> Table 8 in the working paper version of this paper, Debaere et al. (2012), relates the cultural distance from South Korea to the South Korean workers' share.

**Table 4**  
Correlation.

	Korean workers' share	Capital-intensity	Skill-intensity	Nonroutineness
Korean workers' share	1			
Capital-intensity	0.329	1		
Skill-intensity	0.406	0.41	1	
Nonroutineness	0.554	0.226	0.499	1

The correlation of Korean workers' share with other variables is statistically significant at the 5% level. The correlation of Korean workers' share with capital-intensity and skill-intensity is at the affiliate level (850 observations) and with routineness is at the sector level (19 observations averaging Costinot et al., 2011).

workers especially when the environment is culturally different from South Korea.

Note that we also draw on the World Bank's World Development Indicators for the host country per capita GDP data (in nominal and purchasing power terms) as well as the industry share of GDP of the host country.

#### 4. Estimation equations and empirical results

There is a positive, unconditional correlation between the ratio of an affiliate's intrafirm transactions to its total purchases and South Korean workers. In this section, we first document that this correlation is very robust and not a proxy for other commonly used characteristics of the affiliate (multinational) that are omitted from the regression. Next, we parse the data carefully to tease out more clearly the meaning of the South Korean share. We trace it to the internal workings of the multinational, show how it is not necessarily related to trade with South Korea per se, and interact it with measures of cultural distance. We finally instrument the South Korean share with the interaction of sectoral nonroutineness and the cultural distance of the host country. The reduced form estimation equation that we propose for the analysis is the following:

$$\left( \frac{S_i}{S} \right)_{ijc} = \alpha_j + \alpha_c + \beta \left( \frac{L_{SK}}{L} \right)_{ijc} + Z' s + \varepsilon_{ijc} \quad (1)$$

where  $i$  represents the affiliate,  $j$  the sector, and  $c$  the host country. The dependent variable stands for intrafirm sourcing out of total sourcing. The South Korean share variable,  $\frac{L_{SK}}{L}$ , stands for the share of South Korean employees in the affiliates out of the total labor force. As indicated, we expect a positive  $\beta$  coefficient. The  $Z$ s are additional controls. We will include country and sector fixed effects, allowing us to investigate the intra sector/country variation that is not considered in sector-level studies. Table 6 reports summary statistics of the variables that we use.

Estimating Eq. (1) is not straightforward, however. The dependent variable is a fractional response variable that is bounded by 0 and 1. The usual OLS estimation is likely to produce predicted variables outside the bounds. That is, if the model is specified by  $E(y|x) = x\beta$  and  $y$  is bounded between 0 and 1, the effect of any particular  $x$  cannot be constant throughout the range of  $x$ . The most common econometric approach to overcome this problem is to use the log-odds ratio, which is defined by  $E(\log[y/(1-y)]|x) = x\beta$ . In this way, the

**Table 5**  
Workers' occupation.

	Directors	Nonproduction	Production	Other
Korean workers	27%	53%	13%	7%
Local workers	1%	16%	77%	6%
Korean share	82%	19%	2%	16%

Data: Export–Import Bank of Korea.

**Table 6**  
Summary statistics.

	Mean	St. dev
Sourcing from all related parties	0.473	0.4
Sourcing from parent	0.351	0.372
$L_{SK}/L$	0.06	0.155
$L_{SK.SI}/L$	0.041	0.105
$L_{SK.Directors}/L$	0.016	0.069
$\ln(K/L)$	3.313	1.638
$\ln(\text{Labor productivity})$	4.087	1.886
Skill intensity	0.195	0.207
$\ln(\text{Age})$	2.188	0.489
$\ln(\text{Intangible asset})$	0.793	1.598
Cultural distance (CD)	2.22	0.868

Affiliate level variables are from Export–Import Bank of Korea. As shown in Table 5, the occupation of workers is categorized into directors, nonproduction workers, production workers, and others. We group directors and nonproduction workers as skilled workers. Cultural distance is constructed according to Kogut and Singh (1988).

left-hand side variable can be bounded between 0 and 1. A concern with the log-odds ratio is, however, that the equation cannot be true if  $y$  takes on the values 0 or 1 with positive probability, which happens in some instances in our case.

Papke and Wooldridge (1996) introduce quasi-maximum likelihood estimator (QMLE) to overcome those shortcomings. They assume that there is a known function  $G(\cdot)$  that satisfies  $0 < G(z) < 1$  for all  $z \in \mathbb{R}$ , so that for all  $i$ ,

$$E(y_i|x_i) = G(x_i\beta) \tag{2}$$

This ensures that the predicted values of  $y$  lie in the interval (0,1) and the equation is defined even if  $y_i$  can take on 0 or 1 with positive probability. The two most popular functions chosen for  $G(\cdot)$  are the logit function and the standard normal cdf. To simplify the computational implementation and produce efficient estimates, Papke and Wooldridge (1996) propose the following Bernoulli log-likelihood function<sup>17</sup>:

$$l_i(b) = y_i \log[G(x_i b)] + (1 - y_i) \log[1 - G(x_i b)]$$

which is well defined for  $0 < G(\cdot) < 1$ . The QML estimator of  $\beta$  obtained from the maximization problem  $\max_b \sum l_i(b)$  is consistent for  $\beta$  provided that Eq. (3) holds. Using the Bernoulli QMLE, our estimation equation becomes Eq. (4).<sup>18</sup>

$$E\left[\frac{S_i}{S}\right]_{ijc} | X = G\left(\alpha_j + \alpha_c + \beta \left(\frac{L_{SK}}{L}\right)_{ijc} + Z' s + \varepsilon_{ijc}\right) \tag{3}$$

We take  $G(\cdot)$  to be the standard normal cdf.<sup>19</sup> The partial effect of  $\left(\frac{L_{SK}}{L}\right)$  on  $E\left[\frac{S_i}{S}\right] | X$  is  $dE\left[\frac{S_i}{S}\right] | X / d\left(\frac{L_{SK}}{L}\right)$ , or, for specification (4),  $g(\cdot)\beta$ , where  $g(\cdot)$  is the standard normal pdf.

In Table 7 we find the estimation results for the ratio of total intrafirm purchases to overall affiliate purchases. We gradually add explanatory variables to the South Korean share variable in our estimation equation that contains industry and country effects. As we add explanatory variables, the share of South Korean employees remains positively and significantly correlated with the extent of intrafirm sourcing. We first establish that this correlation is very

<sup>17</sup> Estimating Eq. (3) using nonlinear least squares (NLS) produces consistent but inefficient estimates because  $var(y_i|x_i)$  is unlikely to be constant when  $0 < y < 1$ . At the same time, obtaining NLS estimates and heteroscedasticity-robust standard errors and test statistics requires additional and special programming.

<sup>18</sup> From a qualitative perspective, note that regular OLS estimates will be fairly consistent with our QMLE estimates for the variables of interest. Results are available upon request.

<sup>19</sup> In the implementation, we use the Stata *glm* command with the option of Bernoulli distribution and probit function.

robust and pervasive before we parse the data more finely to provide more evidence that is the interpretation of our findings in line with Costinot et al. (2011).

The fixed effects let us focus on the intra sector/country variation. Country effects should capture the extent to which access to the markets or physical distance from South Korea plays a role in affecting intrafirm trade, or the extent to which factor price differences between South Korea and the host countries matter for the organization of the firm. Similarly, to the extent that firms in some sectors are more prone to sourcing, they should be captured by the sector effects. More importantly, the fixed effects also ensure that unobservable sector- and country-level characteristics are not behind the correlation between the South Korean share and the share of intrafirm sourcing. For example, a larger market might trigger more of an orientation to the local market and thus change the composition of South Korean versus local employees since locals might have more information about the local markets.

One may be concerned that the share of South Korean employees might just pick other characteristics of the affiliate that are associated with the literature that tests Antras (2003) and Antras and Helpman (2004). We include the affiliate's labor productivity, proxied for by the sales-to-labor ratio. Only in some instances is affiliate productivity significant and does it positively affect intrafirm trade.<sup>20</sup> We also include the affiliate's capital intensity, as this is sometimes considered a proxy for a firm's residual right or investment intensity. For fear that the South Korean share captures skill intensity, we introduce the affiliate's skill-labor intensity as well.<sup>21</sup> Neither capital nor skill intensity prove to be significant. In all the above instances, the South Korean share remains positive and significant.

Affiliates are part of the production network of a multinational. From column (2), we want to control for this. As is well known, there are large business organizations called *chaebol* in South Korea that sometimes cover multiple sectors. As Rauch (2001) surveys the literature on (business) networks, he points out several reasons why internal trade might be affected by a business conglomerate such as a *chaebol* or *keiretsu*. Members of a *chaebol* may, for example, drop the markups on internal trade in an attempt to increase overall *chaebol* profits. Another possibility is that affiliates that are part of a *chaebol* have to make relationship-specific investments that are hard to observe and that may look like collusion to the outsider.<sup>22</sup> Additionally, *chaebol* may simply have more extended vertically integrated production networks. To control for these potential impacts of *chaebol* membership, we include a dummy in case an affiliate is part of a *chaebol* network. In our dataset, 47% of the affiliates are part of a *chaebol* network. The *chaebol* membership seems to compete with productivity and only in some instances is it positive and significant. The share of South Korean employees remains positive and significant, however.

In a following step from column (3), we add a whole battery of dummies to characterize the network among the affiliates beyond *Chaebol* membership. In particular, one might be worried that the higher share of South Korean employees might be a function of the sales orientation of the affiliate, in which South Koreans might be especially useful. In particular, if selling to affiliates abroad or domestically is a prime focus, it might be that the multinational decides to

<sup>20</sup> While it is well known that there are nonnegligible productivity differences between multinationals and nonmultinationals, it is, perhaps not surprising, that productivity has a harder time telling different types of multinationals apart.

<sup>21</sup> We take the ratio of directors and nonproduction workers relative to total workers as the proxy for skill-labor intensity. See the result in Appendix A1, column (1) of the working paper version of Debaere et al. (2012).

<sup>22</sup> Spencer and Qiu (2001) consider relationship-specific investments in a *Keiretsu* that may be unobservable to outsiders and justify a higher price. Head et al. (2004) find evidence that in the production of auto parts, Japan's *keiretsu* system promotes relationship-specific investments, resulting in improved competitiveness relative to the U.S.

**Table 7**  
Estimation results on intrafirm sourcing from all related parties.

	1	2	3	4	5	6	7	8	9	10	11	12
$L_{SK}/L$	0.937*** (0.307)	1.049*** (0.319)	1.075*** (0.341)	1.078*** (0.340)	1.013** (0.478)	1.281** (0.563)	1.014*** (0.347)			−0.848 (0.562)	2.606*** (0.700)	1.944*** (0.491)
$L_{SK,SL}/L$								1.862*** (0.534)				
$L_{SK,Directors}/L$									2.758** (1.185)			
ln(K/L)	−0.0150 (0.0320)	−0.0316 (0.0331)	−0.0361 (0.0335)	−0.0518 (0.0348)	0.0703 (0.0587)	0.0935 (0.0687)	−1.982 (3.851)	−0.0559 (0.0349)	−0.0282 (0.0340)	−0.0538 (0.0349)	−0.0464 (0.0349)	−0.0602* (0.0358)
ln(Y/L)	0.0495* (0.0266)	0.0349 (0.0280)	0.0137 (0.0284)	0.0268 (0.0298)	−0.0508 (0.0513)	−0.0889* (0.0532)	1.958 (3.857)	0.0281 (0.0297)	0.0285 (0.0301)	0.0219 (0.0299)	0.0237 (0.0297)	0.0210 (0.0299)
<i>Chaebol</i>		0.172** (0.0847)	0.121 (0.0866)	0.130 (0.0868)			0.137 (0.0873)	0.136 (0.0867)	0.111 (0.0868)	0.157* (0.0863)	0.143* (0.0867)	0.165* (0.0895)
D(Export parent)			0.198** (0.0797)	0.208*** (0.0803)	0.216 (0.138)	0.190 (0.152)	0.207*** (0.0805)	0.210*** (0.0804)	0.213*** (0.0806)	0.217*** (0.0808)	0.210*** (0.0806)	0.216*** (0.0820)
D(Sales local aff.)			0.653*** (0.0899)	0.652*** (0.0898)	0.218* (0.130)	0.193 (0.140)	0.652*** (0.0898)	0.655*** (0.0891)	0.667*** (0.0892)	0.659*** (0.0903)	0.644*** (0.0897)	0.666*** (0.0896)
D(Sales aff. abroad)			−0.190* (0.111)	−0.171 (0.112)	0.00343 (0.147)	−0.00591 (0.157)	−0.173 (0.112)	−0.167 (0.112)	−0.192* (0.112)	−0.167 (0.112)	−0.159 (0.112)	−0.158 (0.114)
ln(Age)				−0.153* (0.0894)	−0.478*** (0.157)	−0.425** (0.172)	−0.153* (0.0891)	−0.148* (0.0897)	−0.130 (0.0907)	−0.157* (0.0895)	−0.155* (0.0896)	−0.129 (0.0901)
ln(Intangible asset)							−1.929 (3.844)					
$L_{SK}/L$ x cultural dist.										0.846*** (0.229)		
$L_{SK}/L$ x Asia											−1.878** (0.770)	
$L_{SK}/L$ x size												−0.289** (0.116)
Fixed effect sector	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fixed effect country	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fixed effect parent	No	No	No	No	Yes	Yes	No	No	No	No	No	No
R2	0.143	0.15	0.203	0.204	0.683	0.702	0.204	0.202	0.196	0.207	0.206	0.205
Observations	836	836	836	836	488	386	834	836	835	819	823	823

The dependent variable is the ratio of intrafirm sourcing from all related parties out of total purchases of the affiliate. Robust standard errors are in parentheses. \* significant at 10%, \*\* significant at 5%, and \*\*\* significant at 1%.

hire more South Korean workers. Including sales to the parent and to affiliates abroad and at home does not affect the positive and significant correlation between South Koreans and intrafirm sourcing.

Finally, one may be concerned that there is a dynamic story behind intrafirm trade that we cannot capture in the cross-section. In his review of the literature on social networks, Rauch (2001) explains that an ethnic affiliation can often be especially valuable when it provides market information about preferences, reliable suppliers, etc. The longer affiliates are present in the host country, however, the more one expects them to become familiar with the economic environment of the host country. In this case, affiliates might gather more information as to what the good suppliers are, for example, and rely less on the South Korean supplies from the parent the longer they operate. To capture this effect, we include the log value of the affiliate age in the regressions from column (4).<sup>23</sup> As expected, the age of the affiliate decreases the ratio of intrafirm imports in some instances. However, inserting the age of the affiliate does not alter the correlation between the South Korean share and intrafirm trade.

In column (5) of Table 7, we focus on a subset of our affiliates that have one and the same parent, since they allow us to control more accurately for any unobserved characteristics of the parent that might confound the impact of our share variable. In particular, by including a parent-fixed effect, we want to exploit the variation between the subsidiaries of one and the same parent and control especially for any differences in quality between firms. There are 144 parents that have multiple affiliates with 488 affiliates in total. The parent fixed effect does not undo the positive and significant relation between the share of South Korean employees and intrafirm trade. In column (6) we

<sup>23</sup> We subtract the year of establishment from 2007. The average age of South Korean affiliates in the data is 7 years.

narrow the specification down to only those affiliates that have the same parent in the same industry. In light of the input quality complementary hypothesis of Kugler and Verhoogen (2012), the estimates show that it is not the case our correlation between South Korean workers and intrafirm trade is just evidence of higher quality firms requiring more skilled South Korean workers, since quality is controlled for with the parent fixed effect.<sup>24</sup> In column (7) we include the intangible assets of the affiliate that also may capture quality differences. The results hold up.

In the empirical analysis so far, we have emphasized the predictive power of the regression and the correlation between the South Korean share and intrafirm sourcing. This correlation turns out to be very robust. The coefficient estimates do not vary too much as other controls are inserted. The correlation is also economically meaningful. Consider the marginal effects associated with the estimates in column (4) of Table 7. The marginal effect for the South Korean share (evaluated at the sample mean) would be 0.346, implying that an increase in one standard error of the South Korean share would be associated with about 5% increase in the share of intrafirm trade. The effect of affiliate age is −0.049, implying that one standard deviation increase in age would bring about a 2.5% decrease in the share of intrafirm trade. One can also calculate the marginal effects of dummy variables. Being a *chaebol* increases intrafirm trade by 4%. If the affiliate exports back to the parent or sells to other local affiliates, intrafirm trade increases by 7% or 25%, respectively. On the other hand, if the affiliate exports abroad, intrafirm trade decreases by 5%.

In what follows, we cut the data in various ways to support the interpretation of our findings as in line with Costinot et al. (2011). One

<sup>24</sup> The results for the remaining affiliates remain significant as well, see column (2) in Table A1 of the working paper version, Debaere et al. (2012).

could imagine there could be an almost mechanical relationship between intrafirm sourcing and the South Korean share. For example, if transactions with the multinational require many logistical interactions with the affiliate and the parent, an increase in intrafirm sourcing would almost automatically require an increase the South Korean share in a way that would not support our interpretation. The fact that the South Korean employees are high skilled and in many instances even part of management makes such a trivial interpretation implausible. As a matter of fact, should the intrafirm sourcing require multiple communications with high skilled employees and management, it is quite likely that the reason for these communications would be problem-solving or other (unobservable) headquarters services, which is consistent with our reading of the evidence. To drive home this point, we specifically choose a variant for our share variable. We exclude all South Koreans in low skilled positions from the numerator in column (8). In column (9), we go one step further and only consider the ratio of South Koreans in core management positions (these are the directors) as a fraction of the affiliate's total number of employees. In both instances, we obtain a positive and significant coefficient.

In column (10), we introduce an interaction that is key for our overall interpretation. We interact the South Korean share with a measure of the cultural difference between the host country of the affiliate and South Korea. The positive coefficient for the interaction term between the South Korean share and cultural distance is quite intuitive. It suggests that intrafirm trade is more prevalent in those countries that are culturally more different from South Korea so long as there are more (high skilled) South Korean employees active in the affiliate. It is important to note in this context that the South Korean workers tend to be especially high skilled. Note that this result also helps explain why a simple interaction of nonroutineness and the South Korean employees that does not correct for the cultural environment of the host country is not significant.<sup>25</sup>

To reinforce the importance of language/ethnic differences, we also substitute the cultural difference measure in the interaction term with a dummy for Asia in column (11) in Table 7. We obtain a negative coefficient, which confirms our interpretation. Note that if we were to narrow the Asia dummy to the countries where Chinese, Japanese, Korean and Vietnamese (all languages that are sometimes argued to have been significantly influenced by classical Chinese) are spoken, the interaction with South Korean share would remain significant. To some extent, one might also interpret the negative sign of the interaction between the subsidiary size and the South Korean share in column (12) as consistent with the hypothesis.<sup>26</sup> It suggests that the larger the affiliates are, the less dependent they are on South Korean employees for international transactions.

As estimates in Table 8 indicate, the interaction between cultural difference and the share of South Korean labor is quite robust. In columns (2) through (7) we insert as additional controls the interaction of the South Korean labor share with respectively the per capita GDP (in purchasing power parity or in nominal terms) of the host country, as well as the size of the host country's industry (as a share of the GDP the host country or just its size in dollar terms). By including these additional interactions we want to make sure that the cultural difference variable does not proxy for other host country characteristics and that different development levels or a smaller industries in the host country might be a reason to source inputs from abroad. As we introduce the variables sequentially, one can see that the magnitude of the coefficient of the interaction between cultural difference and

the South Korean labor share only changes marginally. In addition, this coefficient of interest remains significant in all cases.

Columns (8) through (10) of Table 8 also help clarify the interpretation of our results. In column (8) we provide the standard regression with a slight change. Instead of employing our regular variable that interacts the cultural difference and the South Korean labor share, we insert the interaction between the cultural difference and the sector-level nonroutineness variable. As the results in column (8) indicate, the estimated coefficient is positive and significant. This is in line with the expectations as less routine jobs in a cultural environment that is increasingly different from South Korea encourage more intrafirm sourcing. Note that when we additionally insert the South Korean labor share as well as the original interaction of the South Korean labor share with the cultural difference variable in this regression, the significance of the interaction term with sectoral nonroutineness disappears. The latter is consistent with our interpretation of the South Korean labor share as a proxy for the nonroutineness aspect of production in the affiliates.<sup>27</sup>

So far, we have considered the share of the total amount of intrafirm trade as a fraction of all sourcing expenses. Since the imports from the parent are the most important part of intrafirm sourcing, we run our main regression with as left-hand side variable sourcing from the parent as a share of the affiliate purchases. The results are largely consistent with the ones presented above, and we report the main regression in column (1) of Table 9. We also include a regression with the more limited, international intrafirm sourcing from South Korea. In particular, we consider the ratio of intrafirm imports from South Korea over the affiliate's total imports from South Korea as the left-hand side variable. We focus on international sourcing from South Korean, as this is consistent with the typical left-hand side variable that more aggregate studies of intrafirm trade have studied at the sector level. Note that the average ratio of imports from South Korean parents over total imports from South Korea is 0.86, and there is also less variation. The specification with South Korean sourcing as the left-hand side variable has the advantage that distance or any other characteristics that are specific to sourcing from South Korea will be neutralized. This specification confirms the previous results and is reported in column (2) of Table 9. Finally, especially since we emphasize the importance of South Korean workers especially for internal communication (related to complex tasks), it is important to parse the data even more. In column (3) we consider the ratio of the affiliate's imports from unaffiliated South Korean firms out of its total outsourcing as the left-hand side variable. As the estimates suggest, this specification does not produce any significant results. This finding is important for our overall interpretation. The insignificant estimate suggests that internal communication with the network of other affiliates, in South Korea and abroad, is the key and that communication with South Korea per se is not.

## 5. Conclusion

Since World War II, there has been a fairly persistent increase in globalization that has manifested itself in more international trade, more foreign direct investment and also in significant waves of migration. In this global economy, emerging economies are playing an ever more pronounced role. Accompanying this trend has been the rhetoric of a world that is flat and of truly global corporations that are footloose and stateless.<sup>28</sup> However, as more goods, people and financial flows have crossed borders and connected countries, we have

<sup>25</sup> As mentioned before, the share of South Korean employees is positively correlated with the interaction of nonroutineness and the cultural difference. It is also worth emphasizing that the positive correlation that we obtain in column (10) conditions on having decided to open a subsidiary in a particular part of the world. Note also that a triple interaction of South Korean share, nonroutineness and cultural difference (while including the relevant double interactions) gets an insignificant sign.

<sup>26</sup> We put the subsidiary size separately and it is insignificant.

<sup>27</sup> In additional specifications we have used the interaction between sectoral nonroutineness and cultural distance as instrumental variable for the South Korean share. Even though the results are consistent with our findings, we don't want to emphasize the IV results, since it is hard to argue exogeneity when studying the interaction between the different parts of a multinational.

<sup>28</sup> See Ghemawat (2011).



**Table 8**  
Estimation results on various interactions.

	1	2	3	4	5	6	7	8	9	10
$L_{SK}/L$	−0.848 (0.562)	−3.580 (2.687)	−2.489 (1.705)	2.945 (1.985)	2.171 (1.698)	4.180 (4.669)	1.779 (3.967)		1.056*** (0.342)	−0.903 (0.612)
ln(K/L)	−0.0538 (0.0349)	−0.0506 (0.0351)	−0.0507 (0.0351)	−0.0488 (0.0348)	−0.0496 (0.0348)	−0.0494 (0.0350)	−0.0493 (0.0350)	−0.0127 (0.0335)	−0.0509 (0.0352)	−0.0549 (0.0351)
ln(Y/L)	0.0219 (0.0299)	0.0212 (0.0299)	0.0209 (0.0300)	0.0229 (0.0298)	0.0239 (0.0298)	0.0233 (0.0299)	0.0238 (0.0299)	0.0313 (0.0304)	0.0222 (0.0302)	0.0188 (0.0301)
<i>Chaebol</i>	0.157* (0.0863)	0.151* (0.0863)	0.151* (0.0863)	0.142 (0.0864)	0.142 (0.0865)	0.142 (0.0866)	0.142 (0.0867)	0.0991 (0.0863)	0.151* (0.0876)	0.164* (0.0866)
D(Export parent)	0.217*** (0.0808)	0.214*** (0.0810)	0.214*** (0.0810)	0.214*** (0.0810)	0.216*** (0.0809)	0.214*** (0.0811)	0.215*** (0.0811)	0.179** (0.0815)	0.189** (0.0814)	0.202** (0.0817)
D(Sales local aff.)	0.659*** (0.0903)	0.658*** (0.0901)	0.658*** (0.0901)	0.664*** (0.0893)	0.664*** (0.0893)	0.665*** (0.0894)	0.664*** (0.0894)	0.655*** (0.0894)	0.654*** (0.0900)	0.655*** (0.0904)
D(Sales aff. abroad)	−0.167 (0.112)	−0.168 (0.112)	−0.168 (0.112)	−0.171 (0.112)	−0.173 (0.112)	−0.172 (0.112)	−0.173 (0.112)	−0.196* (0.111)	−0.173 (0.111)	−0.164 (0.112)
ln(Age)	−0.157* (0.0895)	−0.158* (0.0896)	−0.158* (0.0896)	−0.153* (0.0898)	−0.153* (0.0897)	−0.152* (0.0899)	−0.153* (0.0898)	−0.132 (0.0914)	−0.132 (0.0903)	−0.141 (0.0899)
$L_{SK}/L \times$ Cultural Dist.	0.846*** (0.229)	0.608** (0.288)	0.602** (0.292)	0.537* (0.308)	0.697** (0.280)	0.578* (0.312)	0.677** (0.293)			0.904*** (0.274)
$L_{SK}/L \times$ per cap GDP(PPP)		0.371 (0.333)				−0.120 (0.393)	0.0423 (0.370)			
$L_{SK}/L \times$ per cap GDP(nominal)			0.271 (0.240)							
$L_{SK}/L \times$ industry share				−0.0776* (0.0396)		−0.0845* (0.0455)				
$L_{SK}/L \times$ industry size					−0.243* (0.129)		−0.237* (0.139)			
Sectoral nonroutineness $\times$ cultural dist.							1.809* (1.048)	1.801* (1.055)	1.684 (1.051)	
Fixed effect sector	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fixed effect country	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R2	0.207	0.208	0.208	0.211	0.211	0.211	0.211	0.187	0.2	0.206
Observations	819	819	819	819	819	819	819	816	816	816

The dependent variable is the ratio of intrafirm sourcing from all related parties out of total purchases of the affiliate. Robust standard errors are in parentheses. \* significant at 10%, \*\* significant at 5%, and \*\*\* significant at 1%.

grown increasingly aware of what makes international transactions more difficult. There is a long tradition of considering differences in language and differences in ethnic origins as potential sources of friction in international transactions. In this paper, we extend this

**Table 9**  
Estimation results on different dep. variables.

	1	2	3
$L_{SK}/L$	0.953*** (0.316)	1.449** (0.629)	−0.153 (0.461)
ln(K/L)	−0.0366 (0.0354)	−0.146** (0.0631)	0.0214 (0.0653)
ln(Y/L)	0.0199 (0.0311)	0.0661 (0.0504)	0.0579 (0.0481)
<i>Chaebol</i>	0.184** (0.0860)	0.01000 (0.149)	0.0440 (0.148)
D(Sourcing local aff.)	−0.478*** (0.101)	0.0978 (0.168)	−0.177 (0.158)
D(Sourcing aff. abroad)	−0.371** (0.147)	−0.299 (0.202)	0.0777 (0.188)
D(Export parent)	0.412*** (0.0802)	0.644*** (0.135)	−0.205* (0.119)
D(Sales local aff.)	0.214** (0.0991)	−0.145 (0.160)	0.317** (0.143)
D(Sales aff. abroad)	−0.167 (0.131)	−0.336* (0.180)	0.159 (0.173)
ln(Aff. age)	−0.104 (0.0912)	−0.0854 (0.152)	−0.177 (0.160)
Fixed effect sector	Yes	Yes	Yes
Fixed effect country	Yes	Yes	Yes
R2	0.224	0.209	0.113
Observations	836	635	669

The dependent variable in (1) and (2) is the ratio of intrafirm sourcing from parent out of total purchases and out of total imports from Korea, respectively. The dependent variable in (3) is the ratio of outsourcing from South Korea out of total outsourcing. Robust standard errors are in parentheses. \* significant at 10%, \*\* significant at 5%, and \*\*\* significant at 1%.

tradition and take language and ethnicity inside the operations of the multinational, an issue that may be increasingly relevant as emerging economies with cultures and ethnicities that sometimes differ from those of advanced economies extend their global reach. We exploit the fact that Korean is the language of a relatively homogenous community that is not often studied as second language to better understand the transactions and borders of the multinationals. In particular, using a micro dataset on South Korean affiliates we find that the share of South Korean employees working in affiliates is a good predictor of the extent to which a South Korean affiliate sources intrafirm vs. arm's length. We provide evidence that this correlation is pervasive and nontrivial and also show how it emerges. In particular, we show that the share of South Korean employees increases with the nonroutineness of the affiliates' tasks in culturally distant host countries.

In the context of studies that use micro data, one sometimes wonders about how general the empirical findings are. Future research should document to what extent we indeed observe across countries that the share of affiliate employees that stem from the multinational's country of origin positively relates to intrafirm transactions. We hypothesize that such a relationship should be more outspoken for more homogenous countries with languages that are not very popular as second language, which is why we applied the study to South Korea. We would expect comparable results for countries such as, say, Japan (less open, uncommon second language), and weaker results for countries such as German (more open, uncommon second language) and Canada or the U.S. (more open, common second language).<sup>29</sup> It should be clear, however, that our primary interest in using the share of South Korean affiliate employment in the empirical analysis is to get at key determinants of intrafirm

<sup>29</sup> This hypothesis builds on the assessment of cultural differences in Hofstede (1980) and Hofstede et al. (1997).

transactions that should be pervasive across multinationals of any country but that are hard to measure: the importance of internal communication between parent and affiliate, the need for adaptation by headquarters and affiliate especially in nonroutine activities, or more broadly, the use of headquarters services in the affiliates abroad. The nice thing about the South Korean case is that because of language and cultural barriers, the share of South Koreans in affiliates can be seen as a proxy for these hard-to-observe attributes of multinational activity.

In their operations, multinationals have to make decisions as to what activities are performed in-house and which ones are kept at arm's-length. Less routine tasks are hard to fully describe in contracts between multinational headquarters and their suppliers. Problems that are not easily captured by contracts are likely to arise and dealing with such problems will require adaptation on the part of both the supplier and the headquarters. In order to minimize such adaptation costs, to avoid adverse incentives and to take advantage of internal communication, multinationals are likely to decide that such tasks should be performed in-house. Our evidence, which links intrafirm trade and the share of South Korean employees that are primarily high skilled, captures this idea.

By choosing language and ethnicity as a way to illuminate the intricate interaction between multinational and affiliate, our study relates to analyses of specialized languages and the boundary of the firm. A specialized language improves the efficiency of communication, but it also implies costs, since communication with those who do not speak that language becomes more difficult. Therefore, specialized languages should only be used when most appropriate (i.e., when the gains are largest or in a complex, nonroutine environment). In our view, this basic insight is applicable in many different contexts that go beyond the strictly technical language and leads into the realms where often cultural aspects play a role. It is here that the analysis of international transactions meets the insights of psychology, management, and daily practice, and it is here that insights from organizational economics can inform future international analysis.

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