International Political Economy

Interests and Institutions in the Global Economy

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APTER 8

ltinational Corporations
he Global Economy

Multinational corporations occupy a prominent and often controversial role in the global economy. When a corporation based in one country creates a new production facility in a foreign country or buys an existing one, it extends managerial control across national borders. This managerial control enables the firm to make decisions about how and where to employ resources that have consequences for the country in which it is based and for the country in which it invests. Jobs, income, and technology might be acquired or lost, and the economic agendas of national governments might be promoted or stymied as a result of the decisions made by such multinational corporations. In many instances, the decisions that firms make are based on global strategies for corporate success, rather than on the basis of conditions within any of the countries in which the firm conducts its business. As a result, multinational corporations, perhaps more than any other element of the international economic system, highlight the tensions inherent in an economy that is increasingly organized along global lines and political systems that continue to reflect exclusive national territories.

Because multinational corporations operate simultaneously in national political systems and global markets, they have been the subject of considerable controversy among governments and among observers of the international political economy. Some consider multinational corporations to be productive instruments of a liberal economic order: Multinational corporations ship capital to where it is scarce, transfer technology and management expertise from one country to another, and promote the efficient allocation of resources in the global economy. Others consider multinational corporations to be instruments of capitalist domination: Multinational corporations control critical sectors of their hosts' economies, make decisions about the use of resources with little regard for host-country needs, and weaken labor and environmental standards. About all that these two divergent perspectives agree on is that multinational corporations are both primary drivers of, and beneficiaries of, the dynamics of globalization.

This chapter and the next examine the economics and the politics of multinational corporations (MNCs). This chapter focuses on a few of the core economic issues concerning these geographically far-reaching organizations. The first section provides a

broad overview of MNCs in the global economy. We define what MNCs are, briefly examine their origins and development, and then examine some statistics that depict the rapid growth of MNCs over the last 20 years and the industries in which MNC activities are most heavily concentrated. The second section examines the standard economic theory that has been developed to explain the existence of MNCs. This theory will both deepen our understanding of the differences between MNCs and other firms and help us understand when we are likely to see MNCs operating and when we are likely to see national firms. The final section examines the impact of MNCs on the countries that host their foreign investments. We look first at the potential benefits that MNCs can bring to host countries and then examine how MNC activities sometimes limit the extent to which host countries are able to realize those benefits.

Multinational Corporations in the Global Economy

For many people, a multinational corporation and a firm that engages heavily in international activities are one and the same thing. Yet, an MNC is more than just a firm that engages in international activities, and many firms that engage heavily in international activities are not, strictly speaking, MNCs. MNCs are only a subset of internationally active firms. The standard definition of an MNC is a firm that "controls and manages production establishments—plants—in at least two countries" (Caves 1996, 1). This definition is a useful starting point, highlighting two critical aspects of MNCs. First, MNCs place multiple production facilities under the control of a single corporate structure. Thus, ownership of multiple facilities is a centrally important component of an MNC. Many firms are engaged in international activities, but do not own factories outside of their country of residence. Such firms are not MNCs. Second, MNCs are firms that have internationalized their activities: The production facilities that each MNC owns are located in different countries across the globe. Many firms may own multiple facilities, but in some cases all of these facilities are located within one country. Such firms are not MNCs. Putting these two characteristics together allows us to suggest that MNCs are distinguished from other firms by their extension of corporate ownership and corporate decision-making power across national borders.

The preceding definition does not capture the full range of MNC activities, however. MNCs are engaged simultaneously in economic production, international trade, and cross-border investment. Consider, for example, the U.S.–based company General Electric (GE), which is regularly ranked among the world's largest MNCs. GE controls some 250 plants located in 26 countries in North and South America, Europe, and Asia. Although production in these facilities is obviously important, the ability to engage in international trade is equally critical to GE's success. Many of the goods GE produces cross national borders, either as finished consumer goods or as components for other finished products. Washers, dryers, and microwave ovens that GE produces in Asia and Latin America, for example, are sold in the United States and Europe. Some of the jet engines GE produces in the United States are sold to Airbus. Finally, to create this global production and trade network, GE has had to make many cross-border investments. Each time that GE establishes a new production facility or upgrades an existing facility in a foreign country, it invests in that country. MNCs are thus also an important source of foreign capital for the countries that host their affiliates. Thus, even though

GE certainly controls and manages factories in at least two countries, this does not describe the full range of GE's international activities. Like all MNCs, GE engages simultaneously in production, trade, and cross-border investment.

MNCs are not recent inventions. They first emerged as significant and enduring components of the international economy during the late nineteenth century. This first wave of multinational businesses was dominated by Great Britain, the world's largest capital-exporting country in that century. British firms invested in natural resources and in manufacturing within the British Empire, the United States, Latin America, and Asia. In 1914, British investors controlled almost half of the world's total stock of foreign direct investment, and multinational manufacturing was taking place in a large number of industries, including chemicals, pharmaceuticals, the electrical industry, machinery, automobiles, tires, and processed food (Jones 1996, 29–30). American firms began investing abroad in the late nineteenth century. Singer Sewing Machines became the first American firm to create a permanent manufacturing facility abroad when it built a plant in Glasgow, Scotland, in 1867 (Wilkins 1970, 41–42). By the 1920s, the United States was overtaking Britain as the world's largest source of foreign direct investment (see Jones 1996).

American firms dominated foreign direct investment following the Second World War. Concerned with postwar reconstruction and unwilling to risk the balance-of-payments consequences of capital outflows, European and Japanese governments discouraged outward foreign direct investment. As a consequence, American firms accounted for two-thirds of all new MNC affiliates created between 1945 and 1960 (Dunning 1996). The largest share of American investment went to Europe, for manufacturing. The push by American firms to invest in Europe was given additional impetus by the formation of the European Economic Community in the late 1950s. Much U.S. investment was oriented toward gaining access to the newly integrating European market. Other American firms invested in developing countries, in Canada, and in Australia, and much of this investment was oriented toward extracting natural resources.

The dominance of American MNCs has diminished since 1960, when first European and then Japanese firms began to invest overseas. More recently, the increased role of MNCs based in other advanced industrialized countries has been accompanied by the emergence of foreign direct investment by MNCs based in Asia and Latin America. Thus, although American firms continue to play a large role in the international economy, they are not nearly as dominant today as they were in the early postwar period.

Although MNCs are not a recent innovation, what is novel is the rate at which firms have been transforming themselves into MNCs. We can see the unprecedented growth of MNCs in two different sets of statistics. The first tracks the number of MNCs operating in the global economy. (See Figure 8.1.) In 1969, just at the tail end of the period of American dominance, there were only about 7,300 MNC parent firms operating in the global economy. By 1988, 18,500 firms had entered the ranks of MNCs, an impressive growth in twenty years. During the next twelve years, however, the number of MNCs operating in the global economy more than tripled, rising to an estimated 61,582 parent firms in 2000. Together, these parents control a total of 926,948 foreign affiliates. Thus, in just over thirty years, the number of firms engaged in international production has increased about ninefold.

The second set of statistics tracks the growth of foreign direct investment over the same period. **Foreign direct investment** (FDI) occurs when a firm based in one country

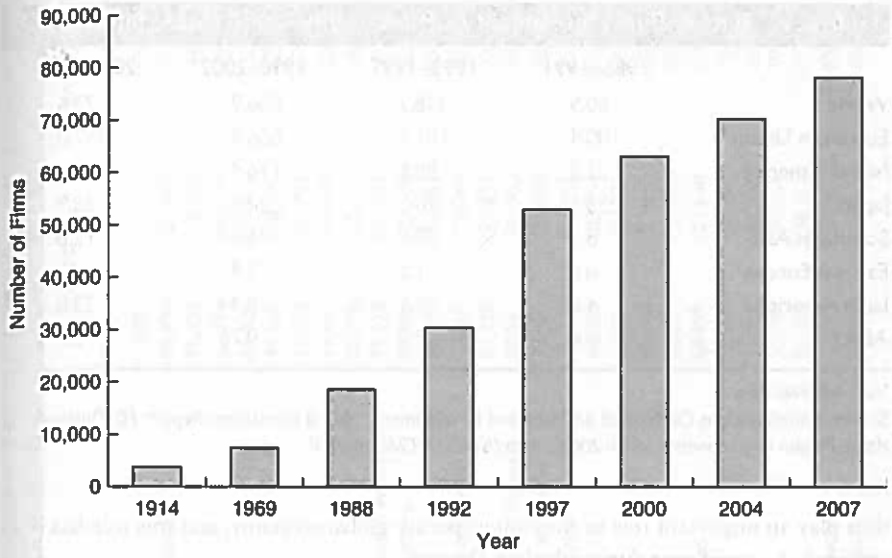

Figure 8.1 The Growth of Multinational Corporation Parent Firms.
Sources: Gable and Bruner 2003, 3; UNCTAD 2008, Annex Table A.1.8.

builds a new plant or a factory, or purchases an existing one, in a second country. A national corporation thus becomes an MNC by making a foreign direct investment. As Table 8.1 illustrates, the total volume of foreign direct investment has grown dramatically during the last 17 years. During the late 1980s, cross-border FDI flows equaled about $180 billion per year. The figure almost doubled by the mid-1990s and then continued to increase throughout the second half of the 1990s. FDI peaked at more than $1 trillion per year in 1999 and 2000, before falling back during the last five years. As a consequence, the world's stock of FDI, the total amount of foreign investment in operation, has grown from $692.7 billion in 1980 to $8.2 trillion in 2003, close to a twelvefold increase in a twenty-three year period (UNCTAD 2004, 376). Both sets of statistics highlight the same pattern: The last twenty-three years have brought a dramatic acceleration of the number of firms that are internationalizing their activities.

As the number of MNCs has increased, the role that they play in the global economy has likewise gained in importance. The United Nations (UN) estimates that MNCs currently produce about 10 percent of the world's total gross domestic product (GDP) and employ some 54.2 million people worldwide (UNCTAD 2004, 8–9). Much of this activity is concentrated in a relatively small number of firms. The one hundred largest MNCs (half of which are listed in Table 8.2) account for more than 12 percent of the total foreign assets controlled by all MNCs, for 14 percent of all MNC sales, and for 13 percent of all MNC employment (UNCTAD 2004, 9). MNCs also conduct about one-third of the world's trade (UNCTAD 2004, 9). Much of this is intrafirm trade—that is, trade that takes place between an MNC parent and its foreign affiliates. In the United States, for example, one-third of all exports are intrafirm exports, and as much as 40 percent of imports are intrafirm imports (Grimwade 2000, 134). It has been estimated that intrafirm trade accounts for 30 to 40 percent of world trade (Dunning 1996, 77). MNCs

Table 8.1 Foreign Direct Investment Outflows, 1986–2006 ($U.S. Billions)

	1986–1991	1992–1997	1998–2002	2003–2006
World	80.5	328.2	856.9	872.6
European Union	100.4	161.7	566.5	457.0
North America	31.3	88.6	176.4	180.4
Japan	33.1	20.2	29.8	38.9
Southeast Asia	8.3	39.0	46.3	12.6
Eastern Europe	n.a.*	1.2	2.4	14.4
Latin America	n.a.	9.5	8.44	33.6
Africa	n.a.	2.2	0.76	3.5

*n.a., not available.

Source: United Nations Conference on Trade and Development, "World Investment Report: FDI Outflows, by Home Region and Economy, 1970–2004," *http://stats.UNCTAD.org/FDI.*

thus play an important role in the contemporary global economy, and this role has been growing at a rapid pace during the last 25 years.

Although MNCs, of course, have a global reach, MNC activities are overwhelmingly concentrated in the advanced industrialized countries. We can see just how concentrated MNC operations are by looking at some statistics on the nationality of parent firms and on the global distribution of FDI flows. It is hardly surprising that the advanced industrialized countries are home to the world's largest MNCs and provide the largest share of the world's FDI. Ninety-seven of the one hundred largest MNCs are headquartered in the United States, Western Europe, or Japan, and about 75 percent of all MNC parent corporations are based in advanced industrial countries. (See Table 8.3.) The advanced industrialized countries historically have been the largest suppliers of FDI as well. During most of the 1980s, the United States, Western Europe, and Japan together supplied about 90 percent of FDI. (See Table 8.1.) Their share fell to about 82 percent during the early 1990s with the emergence of new East Asian MNCs as important foreign investors. Over the last five years, however, the distribution reverted to the earlier pattern, with the advanced industrialized countries providing 92 percent of all FDI between 1998 and 2003 (UNCTAD 2004, 372).

The advanced industrialized countries also have been the most important recipients of the world's FDI. Throughout most of the postwar period and up until the late 1980s, Western Europe and the United States regularly attracted a little more than three-quarters of the world's total FDI inflows each year. (See Table 8.4.) This share fell during the 1990s, and by 1997 the share of FDI flowing into Western Europe and the United States had dropped to about half the total. (See Figure 8.2.) As with FDI outflows, however, this trend has reversed itself during the last five years: Between 2003 and 2006, Europe and North America attracted about 60 percent of all FDI. Although the future evolution of the precise distribution of new investments between the advanced industrialized and developing worlds bears watching, this should not disguise the fact that whether we look at parent firms or FDI flows, we see quite clearly that the vast majority of MNC activities is concentrated in the advanced industrialized world. That is, most such activities involve American and Japanese firms investing in

Table 8.2 The World's Top Fifty Nonfinancial Multinational Corporations, Ranked by Foreign Assets, 2005

				Assets*		Employment†	
Rank	Firm	Country	Industry	Foreign	Total	Foreign	
1	General Electric	United States	Electronics	412,692	673,342	155,000	
2	Vodafone Group PLC	United Kingdom	Telecommunications	196,396	220,499	51,052	
3	General Motors	United States	Automotive	175,254	476,078	194,000	
4	British Petroleum Company PLC	United Kingdom	Petroleum	161,174	206,914	78,100	
5	Royal Dutch/Shell Group	United Kingdom, Netherlands	Petroleum	151,324	219,516	92,000	
6	ExxonMobil	United States	Petroleum	143,860	208,335	52,920	
7	Toyota Motor Corporation	Japan	Automotive	131,676	244,391	107,763	
8	Ford Motor	United States	Automotive	119,131	269,476	160,000	
9	Total	France	Petroleum	108,098	125,717	64,126	
10	Électricité de France	France	Electricity, Gas, and Water	91,478	202,431	17,801	
11	France Télécom	France	Telecommunications	87,186	129,514	82,034	
12	Volkswagen	Germany	Automotive	82,579	157,621	165,849	
13	RWE Group	Germany	Electricity, Gas, and Water	82,569	128,060	42,349	
14	Chevron Corp.	United States	Petroleum	81,225	125,833	32,000	
15	E.ON	Germany	Electricity, Gas, and Water	80,941	149,900	45,820	
16	Suez	France	Electricity, Gas, and Water	78,400	95,085	96,741	
17	Deutsche Telekom AG	Germany	Telecommunications	78,378	151,461	75,820	
18	Siemens AG	Germany	Electronics	66,854	103,754	296,000	
19	Honda Motor Company Limited	Japan	Automotive	66,682	89,923	126,122	
20	Hutchison Whampoa	Hong Kong, China	Diversified	61,607	77,018	165,590	
21	Procter & Gamble	United States	Diversified	60,251	135,695	69,835	
22	Sanofi-Aventis	France	Pharmaceuticals	58,999	102,638	69,186	
23	ConocoPhillips	United States	Petroleum	55,906	106,999	15,931	
24	BMW AG	Germany	Automotive	55,308	88,316	25,924	
25	Nissan Motor Company Limited	Japan	Automotive	53,747	97,661	89,336	
26	Daimler Chrysler	United States, Germany	Automotive	51,342	238,813	103,184	
27	Nestle SA	Switzerland	Food and Beverages	51,112	78,602	245,777	
28	Pfizer Inc	United States	Pharmaceuticals	49,909	117,565	64,701	

(continued)

Table 8.2 The World's Top Fifty Nonfinancial Multinational Corporations, Ranked by Foreign Assets, 2005 (continued)

Rank	Firm	Country	Industry	Assets*		Employment†	
				Foreign	Total	Foreign	
29	ENI	Italy	Petroleum	46,804	99,312	32,073	
30	IBM	United States	Electronics	45,662	105,748	195,406	
31	Telecom Italia Spa	Italy	Telecommunications	45,494	113,714	13,497	
32	Mitsubishi Corporation	Japan	Wholesale Trade	44,827	88,558	18,322	
33	Fiat Spa	Italy	Automotive	44,672	73,971	96,595	
34	Roche Group	Switzerland	Pharmaceuticals	44,564	52,731	60,358	
35	Deutsche Post AG	Germany	Transport and Storage	41,847	203,590	17,857	
36	Wal-Mart Stores	United States	Retail	41,474	138,187	500,000	
37	Mitsui & Company Limited	Japan	Wholesale Trade	40,335	72,927	8,587	
38	Anglo American	United Kingdom	Mining and Quarrying	39,433	51,890	155,000	
39	Sony Corporation	Japan	Electronics	38,559	90,230	96,900	
40	Compagnie de Saint-Goban SA	France	Nonmetallic Products	36,525	48,321	137,837	
41	Hewlett Packard	United States	Electronics	36,243	77,317	85,962	
42	GlaxoSmithKline	United Kingdom	Pharmaceuticals	34,659	46,802	56,729	
43	Carrefour	France	Retail	33,998	54,778	301,474	
44	Philips Electronics	Netherlands	Electronics	32,926	40,105	133,116	
45	Novartis	Switzerland	Pharmaceuticals	32,146	57,732	47,365	
46	RepsolYPF SA	Spain	Petroleum	32,075	54,224	17,696	
47	BASF AG	Germany	Chemicals	31,272	50,030	35,325	
48	Altria Group	United States	Tobacco	30,530	107,949	81,670	
49	Lafarge SA	France	Nonmetallic Products	30,158	33,039	55,541	
50	Renault SA	France	Automotive	30,075	81,026	56,673	

*In millions of dollars.
†Number of employees.
Source: United Nations Conference on Trade and Development, "World Investment Report 2007," *www.unctad.org/Templates/WebFlyer.asp?intItemID=4361&lang=1.*

Table 8.3 Parent Corporations and Affiliates by Region, 2007

	Year	Parent Corporations Based in Economy	Foreign Affiliates Located in Economy
Developed Economies	2007	58,239	259,942
European Union	2007	43,824	211,806
United States	2002	2,418	24,607
Japan	2005	4,563	4,500
Other Developed Economies	2007	6,329	8,658
Developing Economies	2007	18,521	406,967
Africa	2007	736	6,406
Latin America and the Caribbean	2007	2,037	37,728
Asia	2007	15,733	362,393
Southeast Europe and the Commonwealth of Independent States	2007	1,651	110,738

Source: United Nations Conference on Trade and Development. "World Investment Report 2007, Annex Table A.5," *www.unctad.org/Templates/Download.asp?docid=9001&lang=1&intItemID=4361.*

Table 8.4 Foreign Direct Investment Inflows, 1986–2006 ($U.S. Billions)

	1986–1991	1992–1997	1998–2002	2003–2006
World	180.5	310.9	842.4	889.5
Western Europe	100.4	100.8	452.5	369.6
North America	31.3	68.3	231.4	142.6
Japan	3.1	1.2	7.9	2.6
Southeast Asia	8.3	69.6	106.5	38.1
Eastern Europe*	n.a†	11.5	25.4	15.8
Latin America	n.a.	38.2	68.9	74.6
Africa	n.a.	5.9	12.2	25.5

*After 1999 Eastern Europe figures are included in European Union.
†n.a., not available.
Source: United Nations Conference on Trade and Development, "World Investment Report: Inward FDI Flows, by Host Region and Economy, 1970–2004," *www.unctad.org/sections/dite_dir/docs/wir2008_inflows_en.xls.*

Europe, European and Japanese firms investing in the United States, and American and European firms investing in Japan.

Although MNC activities are concentrated in the advanced industrialized world, MNC activities in the developing world have increased substantially during the last twenty years. They have done so in two ways. Historically, developing countries have hosted MNC investments, but the amount of FDI they have attracted has been relatively small. Since the late 1980s, however, MNCs have been investing more heavily in developing countries. As a group, the developing world saw its share of FDI inflows rise from one-quarter to almost one-half of total world investment between 1980 and 1997.

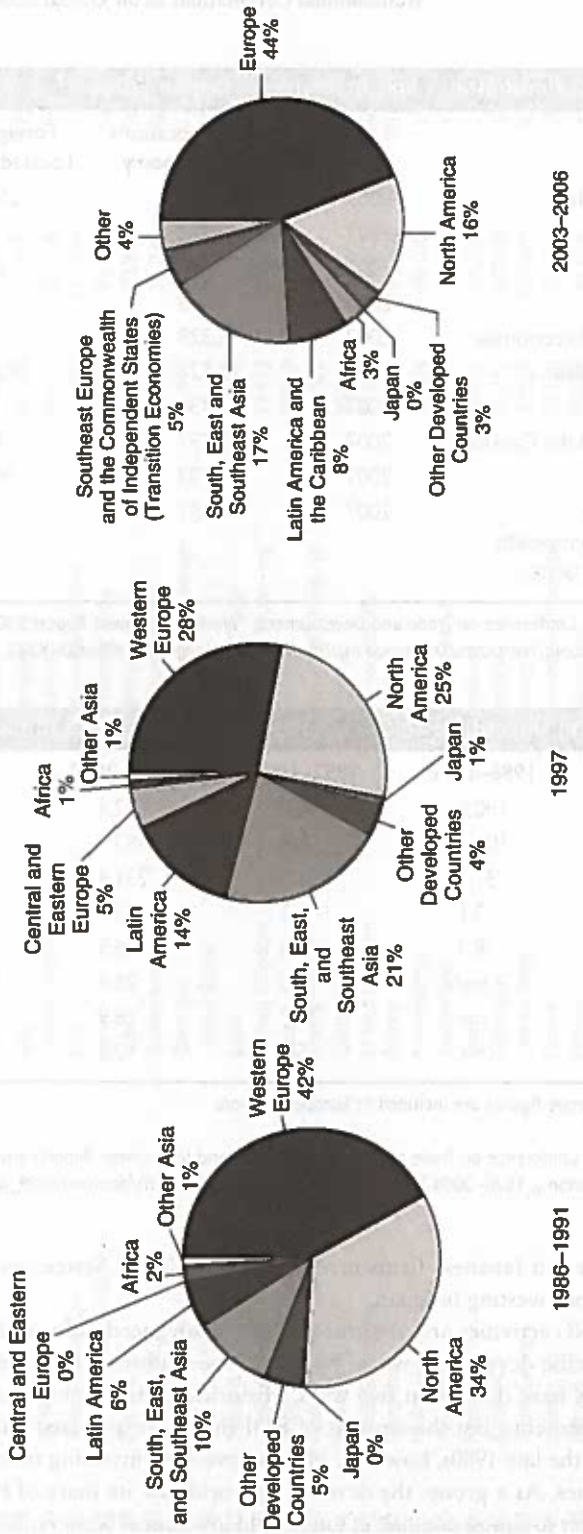

Figure 8.2 The Global Distribution of Foreign Direct Investment Inflows, 1986–2006.
Source: http://stats.UNCTAD.org/FDI.

(See Table 8.4 and Figure 8.2.) These greater investments were not evenly distributed across the developing world, however, but have been heavily concentrated in a small number of Asian and Latin American countries. Asia's share of FDI inflows doubled, rising from one-tenth to one-fifth of the total, between 1986 and 1997, with China alone attracting more than half of all FDI inflows into East Asia between 1993 and 1997. Latin America's share of world FDI inflows also more than doubled over the same period, increasing from 6 percent of total world FDI in the late 1980s to 14 percent in 1997. Yet, only four countries—Brazil, Argentina, Chile, and Mexico—captured 53 percent of these inflows. Thus, MNC investment in the developing world has increased during the last twenty years, but the majority of this investment has been concentrated in a very small number of developing countries. Much of the developing world, and particularly sub-Saharan Africa, saw little increase in FDI during the period.

The last twenty years also have seen some developing countries emerge as home bases for MNC parent firms. According to the UN, one-quarter of the world's MNC parent firms in 2002 were based in developing countries. Again, however, this development is limited to a small number of countries, such as Hong Kong, China, South Korea, Singapore, Taiwan, Venezuela, Mexico, and Brazil. Moreover, these developing-world MNCs are considerably smaller than MNCs based in the advanced industrialized world. Only three developing-country MNCs (Cemex, a Mexican construction materials company; Samsung, the South Korean electronics giant; and Hutchison Whampoa, a Hong Kong–based diversified company) ranked among the world's one hundred largest MNCs in 2002. As a group, the fifty largest MNCs from developing countries control only a combined $195 billion of foreign assets, less than 10 percent of the foreign assets controlled by the fifty largest MNCs based in the advanced industrialized countries (UNCTAD 2004, 21–23). Even though MNCs based in developing countries are small, the emergence of these MNCs is nonetheless a significant change in the global economy. It indicates that, for the first time in history, some developing countries really are shifting from a position in which they are only the host to foreign MNCs to a position in which they are both host of foreign firms and home to domestic MNCs.

The rapid growth of MNCs during the last twenty-five years has pushed these firms into the center of the debate about globalization. Indeed, practically every aspect of globalization has been linked to the activities of MNCs. Ross Perot, for example, claimed during his unsuccessful bid for the presidency in 1992 that the North American Free Trade Agreement (NAFTA) would produce a "giant sucking sound" as American MNCs shifted jobs from the United States to their affiliates located in Mexico. Other critics of globalization claim that MNC affiliates based in developing countries are sweatshops engaged in the systematic exploitation of workers in those countries. Still others argue that the ability of MNCs to move production wherever they want is gradually eroding a broad range of government regulations designed to protect workers, consumers, and the environment. We will examine these arguments in greater detail in Chapter 16. For our purposes here, it is sufficient to note that criticism of MNC activities has emerged from the growing sense that the last twenty years have seen a fundamental change in the nature of corporate behavior within the global economy. Falling trade barriers and improvements in communications technology have made it substantially easier for firms to internationalize their activities. Firms have responded to these changes by internationalizing at historically unprecedented rates.

Economic Explanations for Multinational Corporations

Although firms have been internationalizing their activities at unprecedented rates, the prevalence of MNCs in the contemporary international economy is puzzling to neoclassical economists. It is puzzling because firms choose how they will participate in the global economy, and opting to make a large investment in a far-off country is not the obvious first choice.

In fact, one might wonder why all of the economic transactions that occur between MNC parent firms and their foreign affiliates are not simply handled through the market. When the GAP or the Limited acquire clothes from producers in Bangladesh, they handle most of these transactions through the market. They sign contracts with locally owned Bangladeshi firms that produce clothes and then sell them to the retailer. The GAP and the Limited do not own the firms that produce their clothes. In other instances, however, almost identical transactions are taken out of the market. When Volkswagen decided to assemble some of its cars in Mexico, it could have signed contracts with locally owned Mexican firms, which then could have produced components that met Volkswagen's specifications; assembled them into Jettas, Beetles, and Golfs; and sold the finished cars to Volkswagen. Volkswagen, however, didn't opt for this market-based approach, but instead built an assembly plant in Mexico. Volkswagen thus took the economic transactions that would otherwise have taken place between suppliers of components, assemblers, and corporate headquarters out of the market and placed them under the sole control of Volkswagen headquarters. The rapid growth of MNCs implies that an increasing number of firms have opted to take their international transactions out of the market and to internalize them within a single corporate structure. Why have they done so?

In finding an answer to this puzzle, we deepen our understanding of how MNCs are something more distinctive than simply "large firms." Many MNCs *are* large, but what truly distinguishes them from other firms is the fact that they organize and manage their international activities very differently than other firms do. A traditional firm relies on markets; it acquires its inputs from independently owned firms and it sells its outputs to other individually owned firms. An MNC, by contrast, buys inputs from factories that it owns, and it sells a portion of its output to factories that it owns. And a firm's decision about whether to conduct international transactions through the market or instead to internalize these transactions inside a single corporation reflects some specific characteristics of the economic environment in which it operates. In conceptualizing how this environment shapes the firm's decision, economists have placed the greatest emphasis on the interaction between locational advantages and market imperfections.

Locational Advantages

As a first step, we need to understand the factors that encourage a firm to internationalize its activities–that is, what factors determine when a firm will stop sourcing all of its inputs and selling all of its output at home and begin acquiring its inputs or selling a portion of its output in foreign markets? At a very broad level, it is obvious that a firm will internationalize its activities when it believes that it can profit by doing so. **Locational advantages** derive from specific country characteristics that provide such opportunities. Historically, locational advantages have been based on one of three specific country characteristics: a large reserve of natural resources, a large local market, and opportunities to enhance the efficiency of the firm's operations. A firm based in one country will internationalize its activities in an attempt to profit from one of these characteristics in a foreign country.

Locational advantages in **natural-resource investments** arise from the presence of large deposits of a particular natural resource in a foreign country. The desire to profit from the extraction of these natural resources was perhaps the earliest motivation for international activities. The American copper firms Anaconda and Kennecott, for example, made large direct investments in mining operations in Chile in order to secure supplies for production in the United States. American and European oil companies have invested heavily in the Middle East because the countries of that region hold so large a proportion of the world's petroleum reserves. Many European companies invested heavily in mining and other natural-resource-intensive industries in sub-Saharan Africa and Latin America during the late nineteenth century. And the desire to gain access to natural resources remains important today. Indeed, as Table 8.5 illustrates, petroleum and mining together account for about 2 percent of the one hundred largest MNCs currently in operation. Complementary assets—that is, the infrastructure necessary to support drilling, mining, or farming—are also important for natural-resource-oriented direct investments. Complementary assets include (1) the state of the host country's infrastructure, such as the rail system and seaports, which allows firms to transport raw materials from the source to the final market, and (2) the availability and cost of utilities, such as water and electricity.

Locational advantages for **market-oriented investments** arise from large consumer markets that are expected to grow rapidly over time. This type of advantage is typically created by tariff and nontariff barriers that make it difficult for foreign firms to export to

Table 8.5 Industry Composition of the Top One Hundred MNCs (percent)

	1990	1998	2005
Electronics/electrical equipment/computers	14	17	10
Motor vehicle and parts	13	14	11
Petroleum (exploration, refining, distribution) and mining	13	11	12
Food, beverages, tobacco	9	10	7
Chemicals	12	8	3
Pharmaceuticals	6	8	9
Diversified	2	6	5
Telecommunications	2	6	9
Trading	7	4	3
Retailing	0	3	5
Utilities	0	3	3
Metals	6	2	4
Media	2	2	1
Construction	4	1	1
Machinery/engineering	3	-	1
Other	7	5	11

Source: UNCTAD 2000, 78; UNCTAD 2007, 229–230.

the market. By investing inside the country, firms essentially jump over such barriers to produce and sell in the local market. Firms looking to sell their products in foreign markets clearly prefer countries with large and growing demand to those with small and stagnant demand. In addition, the degree of industry competition within the host country is important. The less indigenous competition there is in a particular foreign market, the easier it will be for the MNC to sell its products in that market. Finally, the existence of tariff and nontariff barriers to imports is another important consideration for this type of investment. Countries that have large and fast-growing markets, with a relatively small number of indigenous firms in the particular industry, and that are sheltered from international competition represent attractive opportunities for market-oriented MNC investment. By this logic, the European Union (EU), the United States, China, and India may offer attractive locations for firms contemplating a market-oriented investment, whereas Costa Rica, Madagascar, and Burma would be much less attractive.

Much of the cross-border investment in auto production within the advanced industrialized world fits into this category. During the 1960s, many American automotive MNCs made direct investments in the EU to gain access to the emerging common market. During the 1980s and early 1990s, Japanese and German automotive MNCs, such as Toyota, Nissan, Honda, BMW, and Mercedes, built production facilities in the United States in response to the emergence of voluntary export restraints (VERs) that limited auto imports. As Table 8.5 indicates, like petroleum and mining, the auto industry is heavily represented among the largest MNCs, accounting for another 11 percent of the one hundred largest. Of course, the desire to gain access to foreign markets has not been limited to the auto industry, but has been an important motivation for much FDI in manufacturing as well.

Finally, locational advantages in **efficiency-oriented investments** arise from the availability at a lower cost of the factors of production that are used intensively in the production of a specific product. In these efficiency-oriented investments, parent firms allocate different stages of the production process to different parts of the world, matching the factor intensity of a production stage to the factor abundance of particular countries. In computers, electronics, and electrical equipment, for example, the human and physical capital-intensive stages of production, such as design and chip fabrication, are performed in the capital-abundant advanced industrialized countries, whereas the more labor-intensive assembly stages of production are performed in labor-abundant developing countries. In the auto industry, the capital–intensive design and production of individual parts such as body panels, engines, and transmissions is performed in advanced industrialized countries, and the more labor-intensive assembly of the individual components into automobiles is performed in developing countries. Locational advantages thus arise from factor endowments. When the contemplated investment is in low-skilled, labor-intensive production, labor-abundant countries have obvious advantages over labor-scarce countries. When the contemplated investment draws heavily upon advanced technology, the availability of a pool of highly trained scientists is important. American firms in the computer industry, for example, have opted to base many of their overseas activities in East Asian countries, where the average skill level is very high, rather than in Latin America, where, on average, skill levels are lower.

Locational advantages thus provide the economic rationale for a firm's decision to internationalize its activities. These advantages can arise from a country's underlying

comparative advantage, as in mineral deposits or abundant labor. They can also be a product of government policies, as in the existence of high tariffs or the creation of a reliable economic infrastructure. Whatever the underlying source, locational advantages create a compelling motivation for a firm based in one country to engage in economic transactions with a foreign country. Locational advantages thus help us understand why some firms opt to internationalize their activities and some do not, because some firms can profit from internationalizing their activities, whereas others cannot. The concept also helps us understand why a firm elects to engage in economic transactions with one country rather than another, for some countries offer potential benefits from cross-border exchange, whereas others do not.

Market Imperfections

Locational advantages help us understand why some firms opt to internationalize their activities, but they do not help us understand why firms sometimes choose to take the resulting transactions out of the market and place them within a single corporate structure. Why didn't American firms simply buy copper from Chilean firms, rather than establish their own mining operations in Chile? Why didn't American computer firms simply buy semiconductors and other components from indigenous East Asian firms, rather than create their own chip fabrication factories in East Asia? Why didn't American auto firms simply export to the EU and Brazil, rather than build assembly plants in those countries?

To understand why firms sometimes take their transactions out of the market and place them under the control of a single corporate structure, we need to examine the impact of market imperfections. A market imperfection arises when the price mechanism fails to promote a welfare-improving transaction. In the global economy, this means that, under certain conditions, firms will be unable to profit from an existing locational advantage unless they internalize the international transaction. Two different market imperfections have been used to understand two different types of internalization: horizontal integration and vertical integration.

Horizontal integration occurs when a firm creates multiple production facilities, each of which produces the same good or goods. In the international economy, horizontally integrated MNCs produce the same product in multiple national markets. Auto producers are a good example. Ford, General Motors, Volkswagen, and the major Japanese auto producers each produce essentially the same line of cars in factories located in the United States, Western Europe, and Japan. Firms integrate horizontally when a cost advantage is gained by placing a number of plants under common administrative control (Caves 1996, 2). Such cost advantages most often arise when intangible assets are the most important source of a firm's revenue.

An **intangible asset** is something whose value is derived from knowledge or from "a set of skills or repertory routines possessed by the firm's team of human (and other) inputs" (Caves 1996, 3). An intangible asset can be based on a patented process or design, or it can arise from "know-how shared among employees of the firm" (Caves 1996, 3). Coca-Cola, for example, transformed a single piece of knowledge—the formula for Coke—into a global soft-drink empire. The income of most pharmaceutical firms is also based on knowledge, in the form of the chemical composition of the drugs they produce. Microsoft is able to dominate the global software industry in part because its programmers have a

deep understanding of the operating system used on most PCs. Microsoft programmers can use this knowledge to develop software that performs better on Windows-based computers than the software produced by its competitors. In all of these examples, firms are deriving income from an intangible asset—that is, from knowledge in some form.

Intangible assets often give rise to horizontally integrated firms because those assets are difficult to sell or license to other firms at a price that accurately reflects their true value. In other words, markets will fail to promote exchanges between a willing seller of an intangible asset and a willing buyer. The market failure arises because owners of knowledge-based assets confront what has been called the "fundamental paradox of information": "[The] value [of the information] for the purchaser is not known until he has the information, but then he has in effect acquired it without cost" (Teece 1993, 172). In other words, in order to convey the full value of an intangible asset, the owner must reveal so much of the information upon which the asset's value is based that the potential purchaser no longer needs to pay to acquire the asset. If the owner is unwilling to reveal that information, potential buyers will be unsure of the asset's true value and will therefore be reluctant to pay for the asset.

Suppose, for example, that I have developed a production process that reduces by one-half the cost of manufacturing cars. This innovation is purely a matter of how the production process is organized and managed, and has nothing to do with the machines and technology actually used to produce cars. I try to sell this knowledge to Ford Motor Company, but, in our negotiations, Ford's board of directors is skeptical of my claim that I can cut the firm's costs by 50 percent. The board members insist that I disclose fully how I will accomplish this before they will even consider purchasing my knowledge, and they want specifics. Once I disclose all of the details, however, they will know exactly what changes they need to make in order to realize the cost reductions. As soon as they have this knowledge, they have no reason to pay me to acquire it. Like all other owners of intangible assets, I will receive less than my asset's true worth when I sell it to another firm.

Such market failures create incentives for horizontal integration. Suppose an individual owns an intangible asset that can generate more revenue than is currently being earned, because demand for the goods produced with the use of this asset will be greater than can be met from the existing production facility. How can the owner earn the additional revenue that the asset will generate? The only way he or she can do so is to create additional production sites—that is, to integrate horizontally and allow each of these facilities to make use of the intangible asset. Because the same firm owns all of the production sites, it can realize the full value of its intangible asset without having to try to sell it in an open market. Horizontal integration, therefore, internalizes economic transactions for intangible assets.

Vertical integration refers to instances in which firms internalize their transactions for intermediate goods. An intermediate good is an output of one production process that serves as an input into another production process. Standard Oil, which dominated the American oil industry in the late nineteenth century, is a classic example of a vertically integrated firm. Standard Oil owned oil wells, the network through which crude oil was transported from the well to the refinery, the refineries, and the retail outlets at which the final product was sold. Thus, each stage of the production process was contained within a single corporate structure. Why would a single firm incorporate the various stages of the production process under a single administrative control, rather than purchase its inputs from independent producers and sell outputs to other independent firms, either as inputs into additional production or as final goods to independent retailers?

To explain the internalization of transactions within a single vertically integrated firm, economists have focused on problems caused by specific assets. A **specific asset** is an investment that is dedicated to a particular long-term economic relationship. Consider a hypothetical case of a shipowner and a railroad. The shipowner would like to transport the goods he delivers to his dock to market by rail. He contacts the railroad and asks that a rail spur be built from the main line down to the dock so that he can offload goods directly onto railcars. If the railroad agrees to build the spur, then this spur will be dedicated to the transport of that particular shipowner's goods to the main rail line. Moreover, once the rail spur down to the dock is built, the resources used to build it can be reallocated at some cost to the railroad. In other words, this rail spur is an asset—an investment that will yield a return—that is dedicated to, or specific to, the ongoing relationship between the shipowner and the railroad owner. That is to say, the rail spur is a specific asset.

Specific assets create incentives for vertical integration because it is difficult to write and enforce long-term contracts. Returning to our example of the shipowner and the railroad, suppose that, under the terms of the initial agreement, the shipowner agreed to pay the railroad a certain fee per ton to carry goods to market once the spur was built. This initial fee made it profitable for the railroad to build the spur. Once the spur has been built, however, the shipowner has an incentive to renegotiate the initial contract to achieve a more favorable shipping rate. The shipowner recognizes that, because the railroad must incur costs if it decides to reallocate the resources it used to build the spur, the railroad owner will be better off accepting renegotiated terms than refusing to carry the goods. Thus, the existence of a specific asset creates possibilities for opportunistic behavior once the investment has been made: One party in the long-term relationship can take advantage of the specific nature of the asset to extract a larger share of the value from the transaction (Teece 1993, 166–169; Williamson 1985).

This problem would disappear if it were costless to enforce the initial contract. But even when the judicial system will enforce contracts, the legal fees associated with the dispute, along with the income lost by the railroad as the dispute works its way through civil litigation, can be substantial. The railroad owner might be better off accepting a renegotiated contract at slightly lower rates than paying the costs arising from enforcing the initial contract.

The recognition that asset specificity creates incentives for opportunistic behavior after the investment has been made can cause economic actors to refuse to make investments. In our example, the railroad owner will recognize that the shipowner has an incentive to behave opportunistically after the spur is built; therefore, quite rationally, the railroad owner will refuse to build the spur. As a result, a mutually beneficial transaction between the shipper and the railroad—the creation of a rail spur in exchange for payments for transporting goods from the dock to market—will go unrealized.

By incorporating the two parties to the transaction within the same ownership structure, vertical integration eliminates the problems arising from specific assets. If the shipowner also owned the railroad (or vice versa), there would be little incentive for opportunistic behavior once the rail spur had been built. The shipping division of this now vertically integrated firm could pay the firm's railroad division a smaller fee for transporting its goods, but this would simply shift revenues and expenditures between

units of the same firm; the firm's overall bottom line would remain constant. By internalizing transactions involving specific assets, therefore, vertical integration enables welfare-improving investments that would not otherwise be made.

Firms thus internalize their transactions—take them out of the market and place them under the control of a single corporate structure—in response to market imperfections. When firms earn a substantial share of their revenues from intangible assets, they face strong incentives to integrate horizontally—that is, to create multiple production facilities all controlled by a single corporate headquarters. When firms earn a substantial share of their revenues from specific assets, they face strong incentives to integrate vertically—that is, to place all of the various stages of production under the control of a single corporate structure. In both cases, the incentive to take transactions out of the market and place them within a single corporate structure arises from the inability of the market to accurately price the value of the asset that generates the firm's income.

Locational Advantages, Market Imperfections, and Multinational Corporations

Although locational advantages and market imperfections often occur independently of each other, we expect to see MNCs—firms that internalize economic transactions across national borders—when both factors are present. Locational advantages tell us that cross-border activity will be profitable, whereas market imperfections tell us that the firm can take advantage of these opportunities only by internalizing the transactions within a single corporate structure.

Table 8.6 illustrates how the interaction between locational advantages and market imperfections shapes the kinds of firms we expect to see in the global economy. When locational advantages and intangible assets are both present, we expect to find horizontally integrated MNCs that have undertaken foreign investment to gain market access. Horizontally integrated MNCs are therefore often present in manufacturing sectors. FDIs by auto producers in the markets of other advanced industrial countries are perhaps the prototypical example of this type of MNC. In the auto industry, intangible assets arising from knowledge about the production process are of great value to individual firms, but are hard to price accurately in the market. Together with important locational advantages—especially the availability of large local markets—intangible assets induce foreign investment. Western Europe and the United States offer large markets for

Table 8.6 Market Imperfections, Locational Advantages, and Multinational Corporations (MNCs)

		Market Imperfection	
		Intangible Assets	Specific Assets
Locational Advantages	Yes	Horizontally integrated MNC Market based	Vertically integrated MNC Natural resource based Cost based
	No	Horizontally integrated domestic firm	Vertically integrated domestic firm

automobiles, and governments in the EU and in the United States have used VERs to restrict imports from foreign auto producers. The combination of market imperfections and locational advantages in the auto industry therefore has led to considerable FDI by all of the major auto producers in the European and American markets.

When locational advantages combine with specific assets, we expect to find vertically integrated MNCs that have invested in a foreign country either to gain secure access to natural resources or to reduce their costs of production. The best example of firms investing to secure access to natural resources is found in the oil industry. An oil refinery must have repeated transactions with the firms that are drilling for oil. The refinery is highly vulnerable to threats to shut off the flow of oil, because an inconsistent supply would be highly disruptive to the refinery and its distribution networks. Thus, we would expect a high degree of vertical integration in the oil industry. This knowledge helps us understand why petroleum companies are so heavily represented in the world's one hundred largest MNCs.

The best example of firms investing abroad to reduce the cost of production may be found in the factories built by auto producers in developing countries. The individual components involved in auto production are complex and specific to the final good: One cannot produce a Ford with parts designed for a Nissan. Thus, auto producers must have long-term relationships with their parts suppliers, and these relationships create incentives for vertical integration across borders. It is no surprise, therefore, that the auto industry also is heavily represented in the one hundred largest MNCs.

The matrix presented in Table 8.6 also points to those industries in which we would not expect to find a significant amount of MNC activity. When locational advantages exist, but there are neither intangible nor specific assets, we do not expect to find a significant amount of MNC activity. Instead, firms will prefer to purchase their inputs from independent suppliers and to sell their products through international trade, or they will prefer to enter into subcontracting arrangements with firms located in the foreign country and owned by foreign residents. Apparel production fits nicely into this category. Apparel production is a labor-intensive activity and is increasingly done in labor-abundant developing countries. The major retailers in the advanced industrialized world, such as the GAP and the Limited, rely heavily upon producers located in developing countries, but they rarely own the firms that produce the apparel they sell. Instead, they enter into contracting relationships with independent firms.

Nor would we expect to find significant amounts of MNC activity in those industries in which market imperfections exist, but locational advantages are absent. In such instances, firms do have an incentive to integrate horizontally and vertically, but integrated firms cannot easily expand sales into foreign markets, are not heavily dependent on foreign sources of raw materials, and cannot easily reduce their costs by exploiting cost differentials between their home country and foreign countries. As a result, firms in these industries have little incentive to extend their activities across national borders. Such firms are most typically found in the nontraded-goods sector of the economy.

In sum, MNCs are more than just large firms. MNCs are firms that have responded in predictable ways to the specific characteristics of the economic environment in which they operate. The creation of an MNC is most often the result of a corporate response to a locational advantage and a market imperfection. Locational advantages create incentives to extend operations across borders in order to extract natural resources, sell in

foreign markets, or achieve cost reductions. Intangible and specific assets create incentives for firms to shift their economic transactions out of the market and into a single corporate structure. When locational advantages and market imperfections coexist, we expect to find MNCs—firms that have internalized transactions across national borders.

Multinational Corporations and Host Countries

Up to this point, we have focused exclusively on what MNCs are, where they operate, and why they are established. In doing so, we have neglected the impact of MNCs on the countries that host their affiliates. We conclude the chapter by looking at this important dimension of MNC activity. FDI creates a dilemma for host countries. On the one hand, FDI has the potential to make a positive contribution to the host country's economic welfare by providing resources that are not readily available elsewhere. On the other hand, because MNC affiliates are managed by decision makers based in foreign countries, there is no guarantee that FDI will in fact make such a contribution. The politics of host country–MNC relations, a topic that we explore in depth in the next chapter, revolves largely around governments' efforts to manage this dilemma. Here, we look at the benefits that FDI confers on host countries in theory, as well as at a few MNC practices that can erode these benefits.

MNCs can bring to host countries important resources that are not easily acquired otherwise. Access to these resources thus offers the potential for substantial economic gains for host countries. Three such resources are perhaps the most important. First, FDI can transfer savings from one country to another. Economic growth is dependent on investment—in physical capital (buildings and machines) as well as in human capital. To invest, however, a society needs to save, and in the absence of some form of foreign investment, a society can invest only as much as it is able to save. Foreign investment allows a society to draw on the savings of the rest of the world. By doing so, the country can enjoy faster growth than would be possible if it were forced to rely solely on its domestic savings. Moreover, because MNCs create fixed investments—they build factories that are not easily removed from the country—this type of cross-border capital flow is not subject to many of the problems posed by other kinds of capital flows. In particular, fixed investments are substantially more stable than financial capital flows and thus do not generate the boom and bust cycles we will examine in Chapter 14 and Chapter 15. In addition, because MNCs invest by creating domestic affiliates, direct investment does not raise host countries' external indebtedness. Of the many possible ways that savings can be transferred across borders, direct investment might be the most stable and least burdensome for the host countries.

MNCs also can bring technology and managerial expertise to host countries. Because MNCs control intangible assets based on specialized knowledge, the investments they make in host countries often can lead to this knowledge being transferred to indigenous firms. In Malaysia, for example, Motorola Malaysia transferred the technology required to produce a particular type of printed circuit board to a Malaysian firm, which then developed the capacity to produce these circuit boards on its own (Moran 1999, 77–78). In the absence of the technology transfer, the indigenous firm would not have been able to produce the products.

Such technology transfers can generate significant positive externalities with wider implications for development (see Graham 1996, 123–130). **Positive externalities** arise

when economic actors in the host country that are not directly involved in the transfer of technology from an MNC to a local affiliate also benefit from this transaction. If, for example, the Malaysian Motorola affiliate were able to use the technology it acquired from Motorola to produce inputs for other Malaysian firms at a lower cost than these inputs were available elsewhere, then the technology transfer would have a positive externality on the Malaysian economy.

MNCs can also transfer managerial expertise to host countries. Greater experience at managing large firms allows MNC personnel to organize production and coordinate the activities of multiple enterprises more efficiently than host-country managers can. This knowledge is applied to the host-country affiliates, allowing them to operate more efficiently as well. Indigenous managers in these affiliates learn these management practices and can then apply them to indigenous firms. In this way, managerial expertise is transferred from the MNC to the host country.

Finally, MNCs can enable host-country producers to gain access to marketing networks. When direct investments are made as part of a global production strategy, the local affiliates of the MNC and the domestic firms that supply these affiliates become integrated into a global marketing chain. Such integration creates export opportunities that would otherwise be unavailable to indigenous producers. The Malaysian firm to which Motorola transferred the printed circuit board technology, for example, not only wound up supplying Motorola Malaysia, but also began to supply components to 11 Motorola plants worldwide. These opportunities would not have arisen had the firm not been able to link up with Motorola Malaysia.

MNCs thus offer substantial benefits to the countries that host their affiliates. They bring foreign savings to the host country, thereby enabling the host to enjoy a higher rate of investment. They transfer technology and managerial expertise to the host country, thereby enabling the host to experience substantial productivity gains. They provide the host country with access to global marketing networks, thereby enabling the host to expand production beyond what would be possible otherwise.

MNCs provide these benefits at a price, however. To capture the benefits that MNCs offer, a country must be willing to allow foreign corporate decision makers to make decisions about how resources will be used in the host country. As long as foreign managers make decisions about how much capital and technology are transferred to the host country, about how the resources MNCs bring to the host country will be combined with local inputs, and about how the revenues generated by the local affiliate will be used, there will be some chance that a particular investment will not enhance, and may even detract from, the welfare of the host country.

MNCs can reduce, rather than increase, the amount of funds available for investment in the host country, as a result of a number of different practices. MNCs sometimes borrow on the host country's capital market instead of bringing capital from their home country. This practice crowds out domestic investment; that is, by using scarce domestic savings, the MNC prevents domestic firms from making investments. MNCs also often earn rents on their products and repatriate most of these earnings. Consequently, the excess profits wind up in the MNC's home country rather than remaining in the host country, where they could be used for additional investment.

In addition, MNCs typically charge their host-country affiliates licensing fees or royalties for any technology that is transferred. When the affiliates pay these fees,

additional funds are transferred out of the host country to the MNC's home base. Finally, MNCs often require the local affiliate to purchase inputs from other subsidiaries of the same corporation. These internal transactions take place at prices that are determined by the MNC parent, a practice called transfer pricing. Because such transactions are internal to the MNC, the parent can set the prices at whatever level best suits its global strategy. When the parent overcharges an affiliate for the goods it imports from affiliates based in other countries and underprices the same affiliate's exports, revenues are transferred from the local affiliate to the MNC parent. Sometimes such transfers can be very large: An investigation revealed that Colombia paid $3 billion more for pharmaceutical imports through MNCs than it would have paid in market-based transactions. All of these practices reduce the amount of funds that are available to finance new projects in the host country. In extreme cases, MNCs might *reduce* the total amount of funds available for investment, rather than increase them.

An MNC might also drive established host-country firms out of business. Suppose an MNC enters an industry already populated by local firms. Suppose also that the MNC controls technology or management skills that enable it to produce at a lower cost than the local firms. As the MNC affiliate's local production expands, the established local firms will begin to lose sales to this new low-cost competitor. Some of these businesses will eventually fail. The failure of the local final-good producers may have a secondary impact on local input suppliers. Local firms often acquire their inputs from local firms. In contrast, most MNCs source their inputs from global networks of suppliers. If the new MNC affiliate drives local firms out of business, then the demand for the inputs provided by local firms will fall. The local input suppliers will thus face serious pressure, and many of them will probably go out of business as well. Although such instances may be an example of a more efficient firm replacing less efficient competitors, the dynamic is one in which local firms are gradually replaced by foreign firms and local managers by foreign managers. If the transfer of skills and technology from foreign to local producers is one of the purported benefits of FDI, then a dynamic in which foreign firms drive local firms out of business suggests that very little technology transfer is occurring.

Technology transfers can be further limited by the incentive that MNCs have to maintain fairly tight control over technology and managerial positions. As we have seen, one of the principal reasons for MNC investment arises from the desire to maintain control over intangible assets. Given this desire, it is hard to understand why an MNC would make a large fixed investment in order to retain control over its technology, but then transfer that technology to host-country firms. The transfer of managerial expertise also may be limited because MNCs are often reluctant to hire host-country residents into top-level managerial positions. Thus, the second purported benefit of MNCs—the transfer of technology and managerial expertise—can be stymied by the very logic that causes MNCs to undertake FDI. If this happens, MNC affiliates will function like enclaves, failing to be tightly integrated into the rest of the host-country economy and never realizing any spillover effects.

Finally, the decisions by MNCs about how to use the revenues generated by their affiliates may bear no relationship to the host-country government's economic objectives. In a world in which governments cared little about the type of economic activity that was conducted within their borders, this would be of little consequence. But when governments use a wide variety of policy instruments to try to promote certain types of

A CLOSER LOOK

REDISTRIBUTING VENEZUELAN OIL PROFITS

The relationship between major international oil companies and Venezuela's President Hugo Chavez richly illustrates the potential for distributional conflict between host-country governments and MNCs over the income generated by the exploitation of natural resources via FDI.

In 1976, the Venezuelan government nationalized its oil sector, thereby ending foreign participation. The government reversed this policy in the late 1980s, however, as it confronted severe budgetary pressure. Oil revenues fell sharply in the 1980s as Venezuelan oil production stagnated and world oil prices fell sharply. The Venezuelan government turned to the International Monetary Fund and The World Bank for financial assistance and accepted a broad structural adjustment program. In connection with these reforms, Venezuela reopened the oil sector to foreign investment. The rationale for doing so was straightforward. The government hoped foreign oil companies would bring the capital and technology needed to boost oil production. Expanded production would in turn provide revenues to ease its budgetary and balance-of-payments constraints. Given Venezuela's large known reserves, the world's oil companies rushed to invest. By 1996, Venezuela had become the world's most attractive location for investment in oil exploration and production (Vogel 1996).

Although foreign firms believed that investment in Venezuela was relatively low risk (indeed, as one energy market analyst commented at the time, "the opening is not reversible"; Vogel 1996), by the early 2000s, newly elected Hugo Chavez was moving to renegotiate the terms of foreign participation in Venezuela's oil sector. Working through Venezuela's state-owned enterprise, Petroleos de Venezeuela (PDV), Chavez first forced foreign companies to renegotiate the terms governing their investments in the marginal oil fields. Through these renegotiations, Chavez pressed the major oil companies to transform their local affiliates into joint ventures in which PDV held a controlling interest (at least 60 percent ownership). As a consequence, approximately $3.7 billion of income over the life of the investment was transferred from the foreign firms to PDV (Reed and Ixer 2006).

Chavez then focused on four major projects in Venezuela's Orinoco Belt. The Orinoco Belt holds an unknown quantity of heavy crude, a tar-like oil that is somewhat complex to extract and refine. The Venezuelan government estimates the Belt could hold as much as 275 billion barrels, which, if accurate, would give Venezuela one of the largest known oil reserves. Six foreign oil companies, France's Total, the Norwegian firm Statoil, Britain's BP, and the American firms ExxonMobil, Chevron, and ConocoPhillips had together invested more than $15 billion in this region since the late 1990s. The initial agreement under which they invested required them to pay only 16.7 percent royalty and 34 percent income tax. In early 2007, Chavez announced his intention to reassert control over these resources. He seized operational control of the oil fields on May 1, 2007. In doing so he announced, "Today we are ending this perverse era." "We have buried this policy of the opening up of our oil . . . an opening that was nothing more than an

(continued)

attempt to take away from Venezuelans their most powerful and biggest natural resource" (Romero 2007). In the course of the year he raised the royalty rate to 30 percent and the income tax to 50 percent, and forced the foreign firms to transform their local affiliates into joint ventures in which PDV held majority ownership. Any firm that refused to form a joint venture was forced to leave.

In less than two years, therefore, Chavez dramatically altered how income generated from Venezuelan oil reserves is distributed between foreign oil companies and the Venezuelan state. Two key factors enabled Chavez to successfully redistribute this income. First, the major oil companies have few alternatives to Venezuela. Oil is not evenly distributed across the globe, and most of the countries that have large oil reserves are less open to foreign participation than Chavez's Venezuela. Chavez also benefited from the fact that his predecessors opened Venezuela to foreign investment. By 2006, foreign oil companies had invested billions in Venezuela that they could neither afford to abandon nor could easily remove from Venezuela. It is unlikely that Chavez could have captured for Venezuela as large a share of the oil revenues had he been trying to attract new investment rather than renegotiating the terms of existing investment. We will look more systematically at how these factors shape bargaining in Chapter 9.

The open question is what impact this renegotiation will have on oil production in Venezuela. The risk, for Venezuela, is that as a consequence of Chavez's renegotiation international oil companies now view Venezuela as too risky for investment. If they do, they will invest less, with potentially negative consequences for the productivity of Venezuelan oil. If this does occur, one might suggest that Chavez redistributed income from foreign oil companies to the Venezuelan state today at the expense of the future.

economic activity, whether it be manufacturing in a developing country or high-technology industries in an advanced industrialized country, foreign control of these revenues can pose serious obstacles to government policy. If, for example, a country's export earnings derive entirely from copper exports, but an MNC controls the country's copper-mining operations, then decisions about how to use the country's foreign exchange earnings will be made by the MNC rather than by the government. Or, if the revenues generated by the local affiliate are sufficient to finance additional investment, decisions about whether this investment will be made in the host country or somewhere else and, if in the host country, then in which sector, are made by the MNC rather than by the government. In short, control by MNCs over the revenues generated by their affiliates makes it difficult for governments to channel resources toward the economic activities they are trying to encourage.

Host countries therefore face a dilemma in their relationships with MNCs. On the one hand, MNCs can provide resources to host countries, including access to new sources of capital, innovative technologies, managerial expertise, and market linkages that are not available elsewhere. These resources have the potential to make important contributions to the host country's economy, and they are not readily acquired without accepting FDI. On the other hand, because FDI extends foreign managerial control into the host country's economy, there is no guarantee that a particular investment will in fact yield the aforesaid benefits. An MNC might consume scarce local savings, replace local firms, refuse to transfer technology, and repatriate all of its earnings. This dilemma has led many to suggest that governments may need to play an active role in structuring the conditions under which MNCs operate within their economies. As we will see in the next chapter, much of the politics of MNCs revolve around government efforts to shape these conditions in order to extract as many benefits from MNCs that they can and to minimize the costs of ceding managerial control to foreign decision makers.

Conclusion

The last twenty years have seen rapid growth in the number of MNCs operating in the global economy. As we enter the twenty-first century, the number of such corporations is nine times the number in operation in the early 1980s. As that number has increased, the role these firms play in global production, trade, and cross-border investment has also increased. The activities of contemporary MNCs are heavily concentrated in the advanced industrialized countries. Most FDI in the global economy involves a firm based in one advanced industrialized country establishing a facility in another advanced industrialized country. Although MNCs have recently begun to shift more of their activities to the developing world, only a small number of developing countries have received substantial amounts of investment. It will take many more years of investment before the developing world's share of MNC activities approaches the share of the advanced industrialized countries.

MNCs are more than just large firms. They are firms that organize and manage their activities quite differently than traditional firms do. In particular, they have opted to remove many of their international transactions from the market and to place them within a single corporate structure. Thus, even though many firms engage in international activities, only a subset of these firms—those that own productive establishments in at least two countries—can be classified as MNCs. MNCs have opted for this distinctive organization structure because they face opportunities to profit from international exchange; but, because they earn a substantial share of their income from intangible and specific assets, they can capture these profits only by internalizing the associated transactions. Thus, the modern MNC has emerged as an organizational response to a specific economic problem in the global economy.

Most analysts of MNC activities believe that FDI can benefit the host country as well as the investing firm. Such investments can transfer savings, technology, and managerial expertise to host countries and can allow local producers to link into global marketing networks. None of these resources are readily available to host countries—especially developing host countries—unless they are willing to open themselves to MNC activity. Yet, opening a country to MNC activity does not guarantee that the benefits will be realized. MNCs are profit-making enterprises, and their activities are oriented toward that end and not toward raising the welfare of their host countries. Consequently, societies that host MNCs face a dilemma: They need to attract MNCs to capture the benefits that FDI can offer, but they need to ensure that activities by MNCs actually deliver those benefits. As we shall see in the next chapter, most of the politics of MNCs revolve around government efforts to manage this dilemma.

Key Terms

Efficiency-Oriented Investment
Foreign Direct Investment
Horizontal Integration
Intangible Asset
Locational Advantages
Market-Oriented Investment
Natural-Resource Investment
Positive Externalities
Specific Asset
Vertical Integration

Web Links

General information about MNCs: The United Nations Conference on Trade and Development publishes an annual volume, called *World Investment Report,* that surveys trends in foreign direct investment. The full text of this publication, as well as that of other UNCTAD publications related to MNCs, can be found at *www.unctadorg/wir/contents/wir01content.en.htm.*

The monthly periodical *Multinational Monitor* maintains a website from which you can access many of their articles. Visit *www.essential.org/monitor/.*

The Electronic Development and Environment Information System (ELDIS), based at the Institute of Development Studies in Sussex, England, maintains a website with good links to information about MNCs. This page can be found at *www.eldis.org.*

Suggestions for Further Reading

For a good introduction to the economics of MNCS, see Richard E. Caves, *Multinational Enterprise and Economic Analysis* (Cambridge, UK: Cambridge University Press, 1996). Another excellent source is John H. Dunning, *Multinational Enterprises and the Global Economy* (Reading, MA: Addison Wesley, 1993).

The best single source on the history of MNCs is Geoffrey Jones, *The Evolution of International Business: An Introduction* (London: Routledge, 1996). The most comprehensive treatment of American MNCs is Myra Wilkins, *The Emergence of Multinational Enterprise: American Business Abroad from the Colonial Era to 1914* (Cambridge, MA: Harvard University Press, 1970). Current challenges confronted by MNCs are examined in Raymond Vernon, *In the Hurricane's Eye: The Troubled Prospects of Multinational Enterprises* (Cambridge, MA: Harvard University Press, 1998).

CHAPTER 9
The Politics of Multinational Corporations

Tip O'Neill, a former Speaker of the U.S. House of Representatives, once said, "All politics is local." He might have said the same thing about economic production. For no matter how "globalized" the world economy becomes, economic production will always be based in local communities and will always employ resources drawn from those communities. Multinational Corporations (MNCs) do not alter this basic reality. MNCs do alter the nature of economic decision making, however. Historically, decisions about production have been made by local business owners with reference to local conditions. When MNCs are involved, however, foreign managers make production decisions with reference to global conditions. Yet, whereas the frame of reference for much economic decision making has shifted, the frame of reference for *political* decision making has not. Governments continue to address local concerns in response to the demands of local interest groups. As one prominent scholar of MNCs has written, "the regime of nation states is built on the principle that the people in any national jurisdiction have a right to try to maximize their well-being, as they define it, within that jurisdiction. The MNC, on the other hand, is bent on maximizing the well-being of its stakeholders from global operations, without accepting any responsibility for the consequences of its actions in individual national jurisdictions" (Vernon 1998, 28).

The tension inherent in these overlapping decision-making frameworks shapes the domestic and international politics of MNCs. In the domestic arena, most governments have been unwilling to forgo the potential benefits of foreign investment, yet few have been willing to allow foreign firms to operate without restriction. Consequently, most governments have used national regulations and have bargained with individual MNCs to ensure that the operations of foreign firms are consistent with national objectives. Governments' efforts to regulate the activities by MNCs carry over into international politics. Host countries, especially in the developing world, pursue international rules that codify their right to control the activities of foreign firms operating within their borders. Countries that serve as home bases for MNCs—essentially, the advanced