Transnational corporations and the globalization process.

Grazia Ietto-Gillies

1. Introduction

The transnational corporation (TNC) as we know it today has developed mainly since World War II (WWII). Nonetheless its antecedents can be traced to more than a century ago; it might even be possible to go back much earlier – to the Medici Bank in Renaissance Italy or to the trading companies of the 17th, 18th and 19th centuries. However, the specificity and localization of their operations and their monopolistic charters makes these very early enterprises poor forerunners of the modern TNC. Most historians see the establishment of the joint stock company as the real breakthrough towards the later formation of companies that could operate directly abroad.

At this point we should clarify what is special about the TNC. However, before we do that let us clear the terminology issue. The most common expression for the corporation we are interested in is *multinational corporation or company* (MNC); the adjectives *international* or *transnational* are also widely used and *firms* or *enterprises* or *companies* are at times used instead of corporations/companies. They all denote the same institutions. Throughout this chapter the terms company and corporation will be used interchangeably; as regard the adjective, *transnational* will be used throughout unless in reference to authors who use a different terminology. The reason why the adjective transnational is here preferred is two fold. First, because it highlights the fact that the corporations operate across nation-states and not just in many of them; second, because it is the term used by the largest research and policy institution dealing with the TNCs: the Geneva-based United Nations Conference on Trade and Development (UNCTAD) who publishes regular studies on the TNCs.

The next two sections deal with definitional issues and with the salient characteristics and activities of TNCs. Section four gives a broad perspective on theories of the TNC; specifically the following theories are discussed: Hymer’s; the international product life cycle (Vernon), the internalization theory, Dunning’ eclectic approach, the evolutionary theory and the Scandinavian school theory. The section ends with a discussion of some key elements in the theories and a brief analysis of efficiency versus strategic approaches; this leads to the presentation of a theoretical approach in which the role of nation-states and of companies’ strategies towards labor play a very significant part in the explanation of TNCs’ activities. The possible effects of TNCs’ activities on the countries in which they operate are analyzed in section five. Finally, section six
discusses the role of TNCs in the globalization process; this leads to an analysis of the integration versus fragmentation roles of TNCs, their activities and strategies.

2. The modern TNC: some definitions

What makes a corporation transnational? What specific characteristic(s) should a company have to be considered a transnational? The first thought that comes to mind is that they must be corporations that operate across national borders; however, here we have a problem because there are many ways of conducting cross-country business: the oldest and most relevant is via trade that is via the importation and/or exportation of goods and services across national boundaries. This modality of business activity across frontiers has been in existence for thousands of years, well before the emergence of the nation-states. However, though many TNCs are involved in trade across frontiers, this type of activity per se does not make them transnationals. The defining characteristic of the TNC is linked to another type of activity: direct business/production activities – accompanied by the ownership of assets - in at least one foreign country.

Exports involve production in the home country and sales abroad; this is a business activity which many national and transnational firms engage in. However, some firms produce not only in their home country but also directly in one or more foreign countries with a view to selling their products in the host country or in other countries – which, at times, includes the very home country of the TNC if the good produced in the host country are exported back home. The home country is usually the country of origin of the corporation, the one where the main headquarters – the parent company - are located and where the company is legally registered; a few companies have more than one home country: Daimler-Chrysler is listed in both the US and Germany while Unilever has the UK and the Netherlands as home countries. The host country is the foreign country in which the TNC locates direct business activities.

Direct production abroad requires the ownership of assets abroad which are acquired via investment in the foreign country. Investment in host countries can be made via greenfield or brownfield investment or via mergers and acquisitions. Greenfield investment means the creation of new productive capacity for example by building a completely new factory; the term brownfield is reserved for a situation in which the new productive capacity emerges not from a ‘greenfield’ but from rebuilding where something was already in existence. In both cases the essential point to note is that it is investment that leads to the creation of new productive capacity. When the investment takes place via merger or acquisition (M&A) the TNC does not create new productive capacity but acquires some already in existence in the host country. This means that the investment does not lead to new capacity in the host country though the acquired company forms new capacity for the acquiring corporation.

From the standpoint of the home country the foreign direct investment (FDI) is called outward while from the point of view of the host country it is an inward FDI. Data for FDI are available as flow or stock. Through foreign direct investment – whether of the greenfield or M&A type – the parent company located in the home country establishes affiliates abroad which can be designated as associates – whenever the ownership stake in it by the parent is between 10 and 50 percent – and subsidiaries – whenever the stakes is over 50 percent.
3. TNCs: their characteristics and activities

The popular view of transnational corporations is that they are huge and powerful companies; on the whole this is true though it is not the whole truth. Let us probe a little further into the characteristics, patterns of development and activities of the modern TNCs. The very first type of TNC can be seen in the 19th century so-called *free-standing enterprise* by which term the business historian Mira Wilkins (1988) denoted those enterprises established abroad with foreign capital – from Britain or the Netherlands – and managed by people trusted and appointed by the parent; they were run with little interference and control from the home country. The reason why these affiliates had to be free-standing is that the communication system from the home to the host country was too poor for the headquarters of companies to be able to exercise direct managerial control. Here we come to the key issues of control.

There are two meanings of control: ownership control in terms of the equity stake by the parent in the affiliate. What percentage of equity is necessary to exercise control over another enterprise, in this case over an affiliate? It partly depends on how fragmented the ownership is. If it is very fragmented, a relatively small stake is enough to exercise control; if ownership is concentrated, a larger stake is necessary. For the purpose of data collection and for the inclusion of foreign investment into the FDI category, it is considered that at least a 10 percent stake is necessary. The other meaning of control over the affiliates refers to managerial decisions: can the owners or top managers from the parent company exercise managerial control over an affiliate? Necessary conditions for this are the existence of (a) good communication and transportation infrastructures; and (b) an efficient organizational structure within the corporation. Since WWII these two last conditions have both applied and indeed greatly improved particularly in the last two decades with the development of the information and communication technologies (ICTs); this has made possible the development of a variety of patterns and characteristics to which we now turn.

*Geography*

The number of companies with direct business operations in at least one foreign country has increased tremendously since WWII from a few thousands to 78,411 by 2007, a year for which host economies exhibit a total of 777,647 affiliates located in them. In terms of geographical pattern the largest number of parent corporations (74 percent) are based in developed countries. However, the developing and former communist countries’ contribution to the total is increasing rapidly particularly due to the contribution of countries like China, India and Brazil. The developing and former communist countries are in receipt of the largest number of affiliates with 67 percent of the world total.

However, when we look at the FDI situation we see a slightly different pattern. In 2006 the largest share of outward FDI originated from developed countries (86 and 84 percent of stocks and flows respectively) with the share from developing and transition countries increasing steadily. The largest share of inward FDI is to be found also in developed countries (respectively 70 and 66 percent for stocks and flows). This means that, in effect, companies from developed countries invest mainly in other developed
countries. The discrepancies between the location of affiliates and the inward investment into developing and transition countries (with shares of, respectively, 67 and 34 percent) can be explained with that fact that most affiliates in non developed countries may be very small and entail small amounts of investment.

*Size*

Most large companies are transnational and most transnational companies are indeed large. However, an increasing number of medium to smallish size companies are branching out to invest directly into foreign countries: this is a development which is accelerating and is due to the positive impact of the ICTs as well as to the general globalization trends in the economy and society. The large TNCs have affiliates in many countries.⁵

*Modalities*

Direct production abroad - and the ownership of assets abroad - via FDI and the setting up of foreign affiliates is the main modality of internationalization by the TNCs as already discussed. Regarding FDI we have already considered the two main modalities of greenfield – and brownfield – FDI versus mergers and acquisitions; we shall return to this when analysing the effects of TNCs’ activities.

Among the other modalities of business operations we have already discussed imports and exports: these are modalities of internationalization which do not characterize the TNCs as a ‘transnational’ but are nonetheless of great relevance to these companies. Most TNCs are involved in trade and most of the world trade originates with TNCs on which more in section five.

Looking at the organization of production and businesses by the TNCs we can identify other modality of operations abroad. The TNC can operate directly or via contractual arrangements of which the main types are the following: franchising, licensing, subcontracting and joint ventures. All these type of collaborative agreements have increased in relevance in the last 25 years - within a single country and across countries – as part of the rationale and trends towards the downsizing of companies.⁶

The overall result is that companies and TNCs in particular can now be seen as network institutions in which the network extends geographically to many parts of the same country and to many countries and localities within each; it can also extend to several collaborators many of whom may be in position of dependence from the main company to whom they are linked by contracts as franchisees or licensees or suppliers, sub-contractors or distributors.

4. **Theories of the TNCs and FDI**

The growth of transnational corporations and of their activities on the scale we have witnessed after WWII was made possible by the development of specific favourable conditions as in box 1.⁷
Favorable conditions to the development of TNCs and their activities

Political environment. The post-war settlement reversed the pre-war protectionist policies and led to the dismantling of many international barriers to business; cooperation became the order of the day – at least in theory – among developed countries.

Technological environment. The development in the technologies of communication and transportation made it possible to manage units in far away countries. The changes have greatly accelerated in the last 25 years with the developments in ICTs.

Organizational development. The internal organization of private and public institutions has changed considerably in response to the need/desire for the growth of business and its geographical expansion. The changes have been made possible by the technological advances.

These conditions have led to a favourable environment for the expansion of transnational business activities; they may indeed be considered as the necessary conditions for such large expansion to take place. They help to explain why it was possible for TNCs to increase their direct business activities abroad; however, they do not tell us much about why the companies wanted to take the direct international route. On this issue we do not have ready made answers; we have a series of theories explaining why companies find it profitable/necessary to invest abroad. To these we now turn by giving a brief sketch of the main theoretical explanations for FDI and the TNC.

4a. Hymer and market power

The theory of the TNC originated after WWII with the work of Stephen Hymer, a Canadian economist doing research in the US at the Massachusetts Institute of Technology (MIT). His theory (Hymer 1960, published 1976) was developed as part of his doctoral dissertation and published after his premature death. Hymer starts by criticizing existing theories of international investment and draws a distinction between portfolio investment – led by a desire for speculative financial gains – and direct investment, motivated by a desire to control profitable business activities. This demarcation is a major key to our understanding of transnational direct business activities. It is a demarcation used today in identifying FDI.

Hymer then goes on to specify the following two main determinants of direct investment abroad: (a) the existence of firm specific advantages that can be exploited abroad in the search for better investment opportunities; and (b) the removal of conflicts with rival firms; the conflicts arise from the existence of market power on the part of firms; by acquiring assets abroad through foreign direct investment, our firm acquires further power over its rival and thus removes the conflict at least temporarily.

Thus Hymer’s theory is developed by looking for motives in imperfect market structures specifically in the oligopolistic8 structures of many of the industries in which US international firms were operating. His theory emphasizes how one way to get ahead
of rival firms is to invest abroad. Hymer’s work is considered seminal and many of his points are still debated and further developed.\(^9\)

4b. Vernon and the international product life cycle theory

Raymond Vernon’s theory (1966) - like Hymer’s - was also developed in the USA, at Harvard University in the same town where Hymer was working: Cambridge, Massachusetts. Vernon took the product as the basis for his analysis; specifically, he was interested in product innovations. The innovative firm will have a monopoly over the new product at least in the initial stages before imitations begin; this position will give the firm an advantage over its rivals. Developments throughout the life of the product are an essential element of the theory which is known as International Product Life Cycle Theory (IPLCT).

The new product is developed in the US, an economy with the following characteristics: (i) it is a very large market; (ii) it is one in which consumers have high incomes per capita; (iii) it is a production environment in which there is abundance of capital and labour scarcity leading to high unit labour costs.

The product will be developed, produced and first marketed in the US. It will then be exported to other rich countries in Europe; this will soon be followed by direct production in European countries for which our innovative firm will have to invest directly in Europe. Meanwhile other firms will gradually start imitating the product and our firm will lose its monopolistic position; it is then likely that it will try to compete via costs reduction by shifting production facilities into developing countries: a move designed to take advantage of low labour costs and made possible by the gradual standardization of the product. The product will then be exported from the host developing country to developed countries where the markets are; this may include importation into the US, the country in which the product first originated.

The theory is based on the product and its innovations; issues of market structure and its changing configuration are considered. The theory tries to explain both direct investment with production abroad and international trade: the product is exported from the US to Europe and later from the host developing country to developed countries; FDI from the US is directed first to Europe and then to developing countries. The theory is very dynamic because within it the situation changes constantly: firm and countries’ advantages in the product are eroded and this leads to new strategies of location. The dynamic pattern follows changes in the life of the product from innovation to maturity to standardization.

The focus on the product means that the theory fails to cover the cases of multi-product firms and their potential for getting ahead of rivals via multi-products strategies.\(^10\) Moreover, historically the changing macro environment in Europe has led to erosion in the initial advantages that the US had over Europe in innovation and production facilities: this is a point made by Vernon (1979) himself in an excellent self critical article. Changes in the international environment have also led to shorter life cycles for products and to shorter imitation lags on the part of other firms. The international innovation environment has changed so much since the 1960s that the theory may have a more limited applicability (Cantwell 1995). Nonetheless, it has been a very important and influential theory merging various strands of thought from innovation
to life of the product to countries’ comparative advantages to the dynamics of firms’ strategies.

4c. The internalization theory

In 1937 Ronald Coase published an article characterizing the firm as an institution in which the allocation of resources takes place via planning and central command. He asked why – if the market is the best allocator of resources as claimed by neo-classical economic theory – are not all resources allocated via the market: in other words he asked ‘why do firms exist’? The answer he found in the fact that though he saw the market with its price mechanisms as the best allocator of resources, market operations are subject to transaction costs. These are costs such as those for gathering information on the price and quality of the product or the trustworthiness of the supplier or the legal costs of stipulating contracts. Within the firm these costs disappear or are minimized because the managers know what to expect from their own products and production processes. It is therefore the existence of transaction costs that explains the existence and growth of the firm. Williamson (1975 and 1981) further developed the case for why firms grow and why high levels of resources are allocated internally to the firm rather than via the market and the price mechanism.

It is from these bases that McManus (1972) and Buckley and Casson (1976) developed a theory of the multinational enterprise (MNE) based on internalization. In effect Coase sparked off a trend towards explaining why more and more resources are internalized – allocated internally – within the firm. McManus and Buckley-Casson used internalization to explain why firms grow across frontiers.

The starting point again is market imperfections; however, the imperfections on which Buckley and Casson concentrate are not structural imperfections – market imperfections due to non competitive markets – but transactional market imperfections; that is imperfection due to existence of transaction costs arising from imperfect knowledge, low trust between buyer and seller and legal costs. Products which are knowledge and research intensive are particular susceptible to internalization because the sellers want to make sure that they retain the monopoly over their knowledge. The development of direct production after WWII has indeed been largely in products requiring considerable research and development. Buckley and Casson write on this issue:

“There is a special reason for believing that internalization of the knowledge market will generate a high degree of multinationality among firms. Because knowledge is a public good which is easily transmitted across national boundaries, its exploitation is logically an international operation.” (p. 45)

Their conclusion is therefore that markets are imperfect in a transactional sense and therefore generate incentives to internalize; the market for knowledge is highly imperfect, so there are strong benefits in internalizing it. Knowledge is a public good within the firm: this means that it can be used in various branches of the firm at little or no extra cost. Moreover, knowledge is easily transmittable across national boundaries, so products that are knowledge-intensive will tend to be produced internally to the firm rather than via external contracts. The theory is therefore designed to explain why the firm may produce
all components of a product internally rather than buying some from external suppliers and why the modality of direct production is preferred to licensing. However, the theory cannot explain why the firm does not use the export modality for servicing foreign markets, why, in other words, it does not internalize production at home and sell abroad via exports.\textsuperscript{12}

4d. Dunning’s eclectic framework

John Dunning - based at the University of Reading in Britain - had been working on issue of international business since the 1950s. In the 1970s he came out with a wide-ranging theory which he characterized as ‘eclectic’ and which has been later referred to as ‘a framework’ or ‘paradigm’. Dunning (1977) tries to explain the ‘why, where and when’ of international production; that is why and when would companies prefer the direct investment and production route to exportation or licensing; how they decide on location of production. This is done by an analysis of three types of advantages as in box 2.

<table>
<thead>
<tr>
<th>Box 2</th>
<th>Dunning’s OLI advantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• <strong>Ownership advantages</strong> are specific to a particular company. They constitute competitive advantages towards rivals and enable the company to take advantage of investment opportunities wherever they arise.</td>
<td></td>
</tr>
<tr>
<td>• <strong>Locational advantages</strong> are those advantages specific to a country which are likely to make it attractive for foreign investors.</td>
<td></td>
</tr>
<tr>
<td>• <strong>Internalization advantages</strong> are all those benefits that derive from producing internally to the firm; they allow it to bypass external markets and the transaction costs associated with them. They are, essentially, benefits of operating internally within an institution rather than through the market.</td>
<td></td>
</tr>
</tbody>
</table>

Dunning gives a long list for each of the three types of advantages. Ownership (O) advantages may relate to such elements as the availability of superior technology or special access to inputs or superior organizational knowledge or acquired experience of operating abroad; on this point there is an analogy between the works of Dunning and Hymer. In the locational (L) advantages he lists all those elements that make a country more attractive as an investment location compared to others. They are linked to the geographical and political space and include elements such as: quality of transportation and communication; legal and commercial infrastructure; government policies; quality and price of inputs. The internalization (I) advantages are the same as we saw in the theory of Buckley and Casson who were, at the time, working at the same university as Dunning.

The OLI framework has been very successful in the academic international business community partly because it gives a ready made set of rules/elements that can be applied to a variety of industries, companies, locations. In a way this wide-ranging application is also a weakness of the theory and Dunning (2002a) himself has recognized the danger of slipping into a ‘shopping list’ of variables. To face up to this problem he
recommends operationalization and contextualization of the various variables linked to his OLI framework (Dunning 1993 and 2002b).

4e. The evolutionary theory

The vision of the firm as an evolutionary institution goes back to Nelson and Winter’s work in 1982. The evolution is linked to accumulation of knowledge, technological capabilities and ability to exploit them via organizational knowledge. In this vein, Kogut and Zander (1993) start with a critique of the internalization theory for its view on knowledge which they see as being one that can be easily packaged and transferred to other locations. Indeed, Kogut and Zander see knowledge largely as tacit knowledge – that is knowledge that is embedded in peoples’ skills and experiences including the experience of team work - and cannot be easily transferred outside the human, social and technological environment in which it was developed. In this vision internalization and the growth of the firm emerge not so much because of costs of transaction and the inefficiency of markets but because the firm is a superior institution from the point of view of the development and utilization of knowledge.

This approach - in conjunction with some of Dunning’s elements - was further developed in Cantwell (1989) where the firm is seen as an active generator of ownership advantages particularly via research and innovation. Cantwell also sees a strong interaction between ownership and locational advantages. Successful innovators tend to invest in innovation activities in several centers/countries; as they do so, their investment generates spillover effects to the location and the industry thus encouraging more investment and innovative activities by other firms. Each innovating firm brings external benefits to the locality in which it invests. Conversely, the investors benefit from the favorable technological environment that develops in the locality. Agglomeration scale economies – that is those economies of scale arising from the geographical proximity of several related businesses - are generated and they further strengthen the centers and the position of the firms operating in them. Thus – according to Cantwell - locational advantages should be seen as largely endogenous – that is generated from within the system itself and from the interaction between companies and countries – and not as exogenous – that is arising from outside the production system and linked to a country’s resources endowments. His approach leads Cantwell to conclude that in innovation there is a hierarchy of companies though not necessarily a hierarchy of countries: this is one of the elements on which he criticizes Vernon’s theory of the international product life cycle.

4f. The Scandinavian School

Vernon’s and the evolutionary theories are the ones that exhibit the strongest elements of dynamism: situations change and firms adapt to changes as well as generating them. Dynamism is at the centre of another theory developed by various Scandinavian economists and marketing experts on the basis of applied case studies.

Drawing on the works of Penrose (1959), of Cyert and March (1963) and of Aharoni (1966), a group of Swedish academics explored the dynamics of internationalization in their attempt to explain what motivates firms to move from
domestic only production and sales to foreign sales (Johanson and Wiedersheim-Paul 1975; Johanson and Vahlne 1977 and 1990). The authors study the organization of sales and marketing in one or more foreign countries and come up with the idea of stages in the internationalization process. Two patterns of internationalization need explaining. The first pattern is designed to explain the increase in business involvement in a specific foreign market/country. This develops according to an establishment chain characterized by the following sequence: exports via independent representatives (agents); sales subsidiaries; and, finally, production subsidiaries. The authors bring in various theoretical and applied elements to explain how and why the sequence evolves. The second pattern relates to involvement into several foreign countries. This proceeds in a time sequence related linearly to the psychic distance from the home country. The psychic distance is defined as:

“…the sum of factors preventing the flow of information from and to the market. Examples are differences in language, education, business practices, culture and industrial development.” (Johanson and Vahlne 1977, 24).

Psychic and spatial distances tend to be very closely related. Firms start by operating in closer foreign countries and later use their knowledge of internationalization to branch out into locations that are psychically and spatially more distant.

In both types of patterns – within a single foreign country and across many – we see internationalization as a result of a series of incremental decisions. It proceeds dynamically and linearly: from one stage to the next; from small to large resources commitment; from a single foreign country to several.

4g. Key elements in the theories: the role of the nation-state

The different theories presented here and indeed others not discussed are developed by emphasizing one or more of the following elements: (a) Different modalities of operations and stages within them (as in the Scandinavian School); (b) Different aspects of market imperfections: structural (Hymer, Vernon) versus transactional (internalization); and (c) Strategy versus efficiency as a general approach to companies’ objectives.

I would now like to probe a little further into the third element and discuss the strategic versus efficiency approach to explanations of TNCs’ behavior and activities. Most theorists accept that firms’ behavior is motivated by the desire to increase/maximize profits; however, in reality it is not easy to define what maximizing behavior means – for example over what time period does the firm maximize. In practice some theories emphasize the efficient use of resources as the main route to profits; others see the firm as led by strategic objectives such as eliminating rivals or defending from rivals’ aggressive behavior.

The internalization and the evolutionary theories I see as dominated by efficiency criteria: efficiency in dealing with transaction costs and/or in using and developing knowledge. This approach has been further developed in the so-called ‘New Trade’ theories of the multinational companies.17
Strategic approaches usually deal with strategies towards rival firms; elements of this can be found in the theories of Hymer, Vernon, Dunning. However, firms and particular TNCs can improve their position and profits performance by developing also strategies towards other players in the economic systems and specifically towards labor and governments. The reason why TNCs are in the best position to develop these wider ranging strategies is related to the fact that they operate across national frontiers. To understand this point we must look at the role of nation-states vis-à-vis TNCs.

Paradoxically, when analyzed closely most theories of the TNCs have very few elements that can be seen as really inter-national; what I mean is that very few theories have elements specific to nation-states and what differentiates them from each other. In order to introduce such elements let us start by identifying three dimensions of operation across nation-states: a spatial/geographical dimension; a cultural linguistic dimension and a regulatory regimes dimension. Regarding the latter, the following elements of nation-states regulatory regimes can be identified: (1) currency regimes; (2) fiscal regimes; and (3) social security regimes and, in particular, rules and regulations related to labor and its organization.

Let us now assume that companies behave strategically and that strategies can be developed not only towards rival firms but also towards labor and governments. The existence of regulatory regimes gives companies the opportunity to develop strategies towards labor and/or governments with a view to maximize profits and gain stronger market position.

The company could develop a location strategy designed to take advantage of the first two types of regulatory regimes. In particular, different fiscal regimes in different countries coupled with the existence of intra-firm trade gives the company scope to manipulate transfer prices thus cutting their overall tax liabilities: an issue which will be explained in the next section.

Different regulatory regimes for labor mean that the labor employed by the same TNC in the various countries in which it operates is subject to different regulations and finds it more difficult to organize and resist the company management. This gives the company a stronger negotiating position towards labor compared to a situation in which all labor were employed by the same company in one country only. The differences in labor regulatory regimes generate scope for specific locational strategies.

The conclusion we can draw from this approach is that the existence of different nation-states with different regulatory regimes enables the TNC to develop locational strategies that enhance its profits and puts it in a stronger position towards rival firms.

5. Effects of TNCs’ activities

There are many effects arising from the activities of TNCs on their country of origin as well as on the host countries. There are also indirect effects on third countries, that is on countries that are neither home nor host to the investment of a particular TNC; this happens, for example, if the third country’s trade is affected by the investment decision of the TNC. This section will, however, concentrate on the effects on home and host countries. There are effects on the macro economy as well as on the industry of which the TNC is part and on the company’s performance. What general type of effects can we identify regarding the countries and macroeconomies? There are effects on innovation
and capacity creation; effects on employment and labor in general and there are effects on trade and the balance of payments.

Most TNCs being large companies well endowed with resources tend to be at the forefront of innovation and technology and to spread innovative practices in the countries in which they operate in terms of both organizational and technological innovation. Moreover, there is evidence that their internal networks of operations with affiliates in many countries aids the accumulation and spread of innovation and technology\(^{21}\): they learn from the diverse environments in which they operate and their activities spill over innovation effects on the localities in which they are involved. This means that the total effect is more than the sum of the parts.

Does FDI generate productive capacity in the host country and, if so, under what circumstances? Foreign direct investment of the greenfield type will increase capacity in the host country; this is not necessarily at the expense of capacity in the home country: it all depends on the specific circumstances of the industry and the home country. However, FDI generated by the merger and acquisition variety does not create extra capacity: all that happens is that existing capacity in the host country changes ownership as a domestic firm is bought by a foreign firm. Sometimes capacity may indeed be reduced if plants are closed under rationalization programs following the merger; there is, however, also the possibility that following short term restructuring the foreign company will invest in new capacity and new technologies in the long run.

Similar effects are possible also with regard to employment; whether FDI generates employment in the host country much depends on whether it is of the greenfield or M&A variety; in the latter case employment may be reduced if the post-merger rationalization programs lead to redundancies as they often do. The greenfield type of FDI does generate extra employment in the host country. Affiliates of TNCs world wide employ directly some 72.6m people\(^{22}\), which is not a very large number. This is due to several reasons including the following. Many TNCs - being technologically advanced - tend to use labor-saving techniques; moreover, since the 1980s many companies have been outsourcing large part of their activities and production processes. It is not the case that the employment effects on home country are always the opposite of those in host countries: outward FDI may or may not reduce employment in the home country; much depends on the conditions in the latter. There are also indirect employment effects on both the host and home countries.

The activities of TNCs have wider effects on labor over and above any direct and indirect effects on employment. There are effects on productivity, on skills acquisitions and on labor relations. In 4g above I mentioned the fact that labor working for the same company in several countries is in a weaker position vis-à-vis the company’s management in term of its bargaining power. This is due to the fact that labor employed is fragmented and its trade unions are weaker because they are organized and operate on a country by country basis while facing companies that are truly trans-national in their strategic behavior.

The TNCs have wide effects on international trade that is on imports and exports of goods and services world wide. Over 80 percent of world trade originates with the TNCs. Moreover, some of this trade is internal to the company itself though external to the country: this is the so-called \textit{intra-firm trade (IFT)}. It is estimated that IFT amounts to over a third of all world trade. Intra-firm trade originates through the setting up of
international vertically integrated production systems. These systems imply that the corporation decides to locate different components of the final product - and therefore different stages of the production process - in different countries in order to take advantage of different skills availability and different labour costs: the whole strategy is designed to minimize the cost of production of the product as a whole. This means that the various components have to be transferred from country to country for further processing: such transfers are internal to the company – from affiliate to affiliate or between parent and affiliate – though they cross national boundaries.

Intra-firm trade is significant for various reasons: because it highlights the relevance of strategy and planning across countries, i.e. trans-national operations, within the company; because it affects the utilization of resources and particularly labor and the development of labor skills or lack of it – for the various countries involved, both the home and the host countries. Lastly because it gives scope for the so-called manipulation of transfer prices; before we deal with them let us look at another type of effect which is also relevant in their context.

Trade generates balance of payment effects as currency moves in opposite direction to goods and services to pay for them. Balance of payments effects are also generated by currency movements due to investment: the funding of investment – be it greenfield or M&As type – is likely to require currency movements usually from the home to the host country. However, this is not always the case because some FDI is funded from the accumulation of past profits or by raising funds directly in the host country. However, this is not always the case because some FDI is funded from the accumulation of past profits or by raising funds directly in the host country.

Balance of payments effects are also generated by the movement of profits and dividends that follow the investment in the host country: the currency movements of profits and dividends go in opposite direction to that of the investment; moreover, an initial investment may give rise to profits for many years in the future. This provides countries with a long history of outward FDI with a large and steady flow of inward profits.

One specific effect of intra-firm trade is due to the so called transfer prices or rather to the manipulation of transfer prices by companies. They are prices charged by one part of the company (parent or one of the affiliates) to another part (any of the affiliates or the parent) for the internal transfer of goods and services. We are talking about the prices charged on invoices for internal transfers within the same company. The word manipulation refers to the fact that the prices charged for internal transfers are set at different levels from actual or potential market prices. The scope for manipulation of transfer prices can be quite wide in the case of transfers that though internal to the company are external to countries as in the case of intra-firm trade. Why might TNCs manipulate transfer prices? The main reasons are given in box 3.

**Box 3**

**Possible reasons for the manipulation of transfer prices.**

- To minimize tax liabilities for the company as a whole.
- To circumvent restrictions to the transfer of profits from those host country(ies) which pose strict ceilings and constraints to such transfers.
- To take advantages of expected appreciation or depreciation of currencies.
• To record low costs of components in a country/market that the company wants to penetrate through low prices. This is essentially a strategy designed to gain competitive advantages over rivals.
• To record relatively low profits in countries where it is feared labor and its trade unions might demand wage increases if high profits were disclosed.

The most common – and best known - reason for the manipulation of transfer prices is the minimization of the overall tax liability of the company. A company faced with tax liabilities in many countries is likely to be faced also with different tax rates in different countries – as part of what in 4g was referred to as different fiscal regimes. If the company manages to declare most of its profits in the country with the lowest tax rate, it will avoid the charge of higher tax rates on some of its profits thus minimizing its overall tax liability. This aim can partly be achieved by a strategy of transfer prices manipulation that leads to the recording of higher profits in the country with the lowest tax rate and very low profits in countries with high tax rates. The direction of possible transfer of profits depends on the tax rate of the countries not on whether they are host or homes or whether they are developed or developing countries. The practice of manipulation of transfer prices is illegal but difficult to detect because for many of the components being transferred internally there are no market prices; in fact, many transfers relate to services from one part of the company to another.

6. TNCs and globalization

Cross border transactions are nothing new in the history of mankind, can we say that the present globalization is something special and if so why? The present process is special in terms of both quantitative and qualitative elements. Regarding quantitative elements all types of cross border transactions have been increasing: from trade to FDI to portfolio investment to collaborative agreements to movements of people. As regards the qualitative aspects, the current process is underpinned and enhanced by: the political and social environment; the breath of change which involves most aspect of modern life from culture to production processes to consumption to the military (Held et al. 1999); the technological basis and specifically the ICTs; and the role of TNCs in the process.

The transnational corporations are involved in - or fully responsible for - all types of international transactions and therefore all quantitative aspects of the globalization process; they also drive most of the qualitative elements. Our decades can, indeed, be seen as a new phase of capitalist development in which the TNCs are the ‘dominant cause’ of the globalization process (Ietto-Gillies 2002, ch. 9).

It is often argued that the globalization process leads to economic, social and cultural if not political integration. It is certainly the case that consumption patterns are becoming more homogenous; markets – particularly financial market – more global; and that concerns over far away parts of the worlds are increasing. However, there is also an additional meaning that can be attached to the concept of integration: a meaning related to production and production processes and their organization.

Transnational corporations are increasingly planning production on a multi countries – and on occasions global – basis. The planning takes account not only of the location of markets but also of the required productive resources: where the materials and
labor needed for production are located. Not only, but the production process can be adapted to fit the availability and cost of resources in various locations. The production process can be split into various parts in which different components are so designed as to require different skills intensity; this allows the location of their production in different countries according to the levels of skills required. The overall result is that low skills components will be located in labor abundant countries, usually developing countries with low labor costs; components requiring high levels of skills will be located in developed countries. Several firms may be involved in the process with some working as sub-contractors to the large ones. The overall cost of the product will be minimized in this process known as international vertical integration of production. It is precisely this type of strategy that leads to increase in intra-firm trade.

This process leads to greater integration of countries and companies; the large TNCs develop not only internal networks across borders but also networks with several external enterprises. However, it can also be claimed that the same process leads also to the disintegration of the production process as no single country becomes responsible for the whole process and product. Moreover, there is a process of fragmentation of the labor force employed in the overall production process: different groups of laborers work on different components in different countries under the overall strategy from the centre of the TNC. The organization of labor through their trade unions becomes more and more difficult in such a fragmented structure particularly because workers’ solidarity tends to be weaker across borders. The problem arises from the fact that a truly trans-national organization – the TNC with its ability to control, manage and devise strategies across countries – confronts organizations that are unable – or have been unable so far – to organize themselves trans-nationally. Whether this asymmetry and unbalance in the power of social forces will continue in the future remains to be seen; regional integration processes across many area of the world may change the situation. The social, economic and political consequences of this fragmentation are issues that merit discussion and research well beyond the scope of this chapter.

Further reading


**References**


---

1 See in particular their annual *World Investment Report* and their quarterly academic journal *Transnational Corporations*.

2 In practice the term greenfield is used comprehensively to include both brownfield and strictly greenfield investment.

3 FDI flow and stock data for each country are given in the UNCTAD *World Investment Report* where further details on definitions can also be found. See also letto-Gillies (2005, Part I) for further analysis of the contents of sections 1 and 2 in this chapter.


5 On this see evidence in (letto-Gillies 2002, Part II).

6 More on these in letto-Gillies (2005, ch. 2).

7 A wider treatment of this is in letto-Gillies (1997).

8 An oligopolistic structure is one in which the market is dominated by a few large firms each striving to get ahead of its rivals.
See among others the single issues on the following journals: *Contributions to Political Economy* 2002, 21, and *International Business Review* 2006, 15, 2. Hymer’s theory is further analysed in Ietto-Gillies (2005, ch. 5).

See Ietto-Gillies (2005, ch. 6) for more on the theory and critiques.

A summary of Williamson’s contribution is in Ietto-Gillies (2005, ch. 9, sec. 2).

Various criticisms and appreciations of this theory are developed in Ietto-Gillies (2005, ch. 9).

For a clear and critical exposition of the evolutionary theory see Forsgren (2007, ch. 4).

See Cantwell (1995) for the whole critique and Ietto-Gillies (2005, ch. 6, sec 5 and ch. 12, sec. 2) for selective points.

See Ietto-Gillies (2005, ch. 11) for a summary of these and other points related to this theory.

Forsgren (2007) presents several theories with emphasis on different aspects of the TNC. See, in particular, his discussion of the ‘Networking Multinational in ch. 6.

Many authors have contributed to this approach in the last 20 years. A clear exposition of these theories is in Barba Navaretti and Venables (2004, chs. 3-6); see also Ietto-Gillies (2005, ch. 13) for a summary and critique.

The strategic approach is very pronounced in Knickerbocker (1973) as well as in Cowling and Sugden (1987). Their theories are considered in Ietto-Gillies (2005) respectively ch. 7 and 14.

For a full development of the points made in this section, cf. Ietto-Gillies (2005, ch.15).

See Ietto-Gillies (2005, part IV) for a longer discussion of the theoretical frameworks and of methodological issues in the assessment of effects; Barba Navaretti and Venables (2004, chs 7-9) analyse the empirical results of several studies.

Cantwell 1989; Castellani and Zanfei (2006); Frenz and Ietto-Gillies (2007).

See UNCTAD (2007, Table 1.4 p.9).

Ietto-Gillies (2000).