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Defining the Transnational Corporation in the Era of Globalization

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With the exception of the nation-state, the transnational corporation (TNC) generates more controversy and attention in international political economy than any other single actor. While Rhys Jenkins in the previous chapter explores the multiple perspectives on the TNC, highlighting its controversial nature, C. Roe Goddard focuses on defining the TNC, assessing its role as the primary instrument of globalization and tracing the changing motivations and patterns of foreign direct investment (FDI) in the post–World War II era. Goddard takes us inside the TNC to examine the complex and diverse mix of factors that motivate corporations to invest outside their home country and how these factors have changed over time. In addition to debunking common misperceptions about the motivations behind FDI, he examines FDI flows, emphasizing the role of the advanced industrialized countries as historically both providers and recipients of FDI, as well as the recent, increasing flow of investment into a limited number of developing countries.

As key agents in international political economy, transnational corporations (TNCs) are controversial and frequently misunderstood. Widely held beliefs about the nature of TNCs' activities, their motivations for investing outside the home country, and the patterns of international investments are often misinformed or too simplistic.

The reasons for this are several. First, the emotion and conflicting viewpoints surrounding the globalization debate often overshadow and inhibit a close examination of both globalization and TNCs. Both are highly politicized subjects, such that their mention elicits a barrage of often vehement responses from all sides of the political spectrum. It is under the "antiglobalization" umbrella that a disparate group composed of environmentalists, labor activists, human rights organizations, communists, as well as right-wing nationalists have found common cause or at least a common enemy.

Second, globalization and TNCs as concepts defy clarity. The multiple levels of aggregation at which we can speak about globalization (international, country, industry, firm) and the tremendous variability among TNCs make defining these concepts problematic (Govindarajan and Gupta, 2001).[1]

And third, traditional distinctions among academic disciplines and the artificial segmentation of scholarly investigation complicate obtaining a fully formed and complete understanding of TNCs. While scholars in international political economy tend to focus on the effects of TNCs and the political and distributional implications of their activities en masse, researchers from the management discipline emphasize the internal management or strategic issues of individual firms. Scholars of international political economy are often rightly accused of glaring generalizations regarding the motivations of TNCs in expanding internationally; equally so, their management colleagues fall victim to tunnel vision and the failure to recognize the fundamental conflict of interest between states and TNCs.

The primary objective of this chapter is to overcome these shortcomings, by bridging the disciplines of international political economy and management, and closely examine the TNC. To that end, the first section explores some of the controversy surrounding the TNC. At the root of the unease about TNCs is a fundamental incongruence between the interests of TNCs and those of the nation-state. This is further complicated by the proliferation of strategic alliances and the attendant, increasingly obscure boundaries of firm interests. The concentration of economic power among TNCs, long-term dispute over transfer pricing, and recent highly visible disclosures of excessive executive compensation and legally questionable accounting practices have fueled distrust in TNCs and undermined their standing in society.

With the controversies surrounding the TNC explored, the second section shifts to the challenging task of defining them. A one-size-fits-all definition of TNCs is problematic; they are quite diverse entities and belie simple definitions or classification schemes. Nevertheless, a number of important dimensions by which TNCs can be distinguished are highlighted and explained.

The third section searches for a theory of why firms invest outside their home country. Researchers focusing on corporate strategy and decision-making have not yet discovered a single elegant theory of why firms invest internationally; however, decades of research have produced several useful theories and frameworks. In particular, product life cycle theory and the ownership-locational-internalization (OLI) framework are highlighted as useful tools for understanding why firms invest abroad.

Finally, attention shifts to exploring the changing patterns of foreign direct investment (FDI) flows in the post–World War II era. The focus is on which countries' firms are investing in what other countries. Particular attention is paid to the role of the developed and developing world in providing and receiving foreign direct investment flows. The intent is to provide a global picture of investment flows, both inward and outward.

Controversial Nature of Transnational Corporations

Just as globalization has spurred its share of critics and controversy, it naturally follows that the TNC, the major vehicle for the globalization of international production, has generated opponents as well. When TNCs first became visible to the public and academic community in the 1960s and 1970s, there was uproar over the dangers they were perceived to pose to national sovereignty and labor around the world. As globalization has deepened and as the presence and activities of TNCs have grown, voices expressing concern have grown louder. Specific concerns regarding the TNC are the incongruence between the geographically dispersed activities and interests of the TNC and the geographically defined nation-state, most clearly illustrated by the transfer pricing issue; and the concentration of economic power in a limited number of TNCs.

Tensions in the System: TNCs and the Nation-State

At the root of the controversies surrounding the TNC are fundamental incompatibilities and inevitable tensions between TNCs and nation-states. At issue is the disconnect between an international economy dominated by TNCs, with their own set of distinct motivations and financial interests—largely determined by their geographically dispersed stockholders—and a global political system composed of geographically defined nation-states. Whereas the TNC's primary motivation is to maximize the profitability of the firm, the nation-state focuses on the nature and relative level of economic activity that occurs within its geographical space. At odds are two distinctive regimes, each with their own set of constituents and potentially incompatible objectives. Heightening the tension, the objectives of both TNCs and nation-states are widely perceived to be legitimate and constructive (Vernon, 1998: 28).

Given the incompatibility between these two regimes, achieving reconciliation and reducing the unease about TNCs will be difficult. Short of a retreat into isolationism and extreme nationalism, with the attendant devolution of TNCs into solely national firms, perhaps the best hope for restoring equilibrium is an enlargement of political society to a new level of organization capable of bringing TNCs under jurisdictional control. The unavoidable reality is that virtually all nation-states are now too small to control their own economic fate. No nation's jurisdiction comes close to matching the worldwide scope of most TNCs. Multilateral organizations, international agreements, and supranational governing bodies for regional economic pacts may be effective vehicles for reasserting some degree of control over TNCs. However, to date they have not replaced the functions of the traditional nation-state, and while possessing regional reach, they still lack the global reach of many TNCs. Calls for an amalgamation of political society may seem farfetched, but until a new equilibrium is obtained between the level of political organization and the nature of international production, the inevitable frictions will continue.

Strategic alliances: Blurring the boundaries. Adding to the unease about TNCs, recent changes in the nature of international production and the activities of TNCs in response to competitive challenges in the marketplace have further undermined the efficacy of the nation-state. The rising number of interfirm "strategic alliances" has blurred the boundaries of the interests of the enterprises involved, making their regulation or control more difficult and their activities more suspect. Observing the TNC from the perspective of a national government, environmental group, or a labor union, the formation of strategic alliances has made it more difficult to confidently assess the interests and influence of TNCs.

Strategic alliances, whether for technology-sharing purposes or to construct a manufacturing plant, have considerable variation in their range and depth. This contrasts to earlier and more traditional TNCs where their boundaries and interests were very discernible. These TNCs were composed of a parent company and subsidiaries, all operating under strict control with a clear line of separation between the company and outside interests. With the proliferation of strategic alliances, it is now much more difficult to define discrete boundaries between the interests of firms (Vernon, 1998: 26).

The Enduring Controversy over Transfer Pricing

While the obscure nature of strategic alliances complicates distinguishing between TNC and nation-state interests, nowhere is the fundamental incongruence more pointed and publicly visible than in the issue of taxation.

Determining taxable income is particularly difficult when the output of a particular subsidiary is part of a much larger production process incorporating other subsidiaries operating in other countries. Confounding host-state tax authorities is the task of assigning global profits to a specific geographic locale, when you consider that at issue is not just the transfer of goods and services between them but also the sharing of research gains, patents, trademarks, and copyrights among the firm's affiliates. Neither will this issue disappear. In fact, given the percentage of international trade flows that are associated with intrafirm trade, now estimated to be one-third of total aggregate global trade flows and growing, the issue of transfer pricing is likely to become even more salient in disputes between TNCs and their host-state regulators (Vernon, 1998: 39).

Transfer pricing defined. Central to tensions over determining tax liability is the transfer-pricing issue. Specifically at issue is the assignment of price and value to products that are traded within the firm. Given the tax differentials among different nation-states, it is in the TNCs' interests to transfer income from the high-tax country to the low-tax country to lower the tax liability of the parent corporation at large. This can be done by manipulating the price charged to individual affiliates for products or services traded among them. If country A's subsidiary operates in a tax locale that has a higher tax rate than country B where another subsidiary is located, and if products and services are traded among these two subsidiaries, all other things being equal, it is in the interest of the parent firm to minimize its tax exposure in the country with the higher tax rate, in this case country A. To do this the subsidiary in country A would decrease the internal price charged to country B's subsidiaries for products or services it provided, or conversely, the subsidiary in country A would agree to pay a higher price for the products and services it purchases from country B's subsidiary. In the end, country A's subsidiary's earnings are deflated, lessening taxable income, and country B's subsidiary's earnings are inflated, raising taxable income but at a lower tax rate than in country A.

The challenge is for the host-state tax authorities to garner their fair share of taxes. To achieve that and to stop what they perceive as an illegitimate exploitation of international reach by the TNC, the host state must determine a credible arm's-length price for the individual transactions. However, resolving the transfer-pricing controversy and determining an arm's-length price is no easy task. Despite being the subject of numerous congressional hearings, close examination by multilateral bodies, and the efforts of motivated armies of corporate comptrollers, tax accountants, and regulatory officials asserting their respective interests, setting an international standard or even achieving consistency in practice on transfer pricing and taxation remain out of reach. To this day it is arguably the most contentious issue in TNC–host-state relations, pointedly illustrating the fundamental incongruence between the interests of TNCs and nation-states (Vernon, 1998: 40).

The Concentration of Economic Power

Clearly adding to the unease over TNCs is the concentration of economic power they represent. By 2000, international production by TNCs spanned virtually all countries and economic activities. However, it is the concentration of economic power in a limited number of TNCs from a narrow range of countries that creates the most discomfort.

Annual sales for the largest TNCs exceed the gross national product of many of the countries in which they operate. It is estimated that a mere 1 percent of TNCs own half the total of all existing foreign assets. For the largest 1 percent of TNCs, in 1998 the $2 trillion in assets of their foreign affiliates accounted for one-eighth of the total assets of all foreign affiliates worldwide.

Adding to concerns over the concentration of economic power, while TNC activities may be dispersed throughout most of the countries in the world, they originate and are headquartered in a very limited number of advanced industrial countries. The world's top one hundred nonfinancial firms are disproportionately headquartered in the advanced industrialized countries of the United States, Britain, Germany, France, and Japan (*World Investment Report*, 2000: xv).

Recent Events and the Standing of the Transnational Corporation in Society

Recent events and activities of TNCs have added new fodder to the litany of complaints and undermined the standing of the corporation in society. Given the high visibility of TNCs, they are often the subject of public investigation and disclosure of their practices. While traditionally, TNCs have been accused of exploiting natural resources, using their international mobility to pit labor against labor, and intervening in local politics, recent activities have drawn attention to issues of compensation and ethics.

Particularly tarnishing the corporation's image have been recent public disclosures of the exorbitant salaries paid to upper management. In June 2001, *Fortune* magazine's cover story, by Geoffrey Colvin, titled "The Great CEO Pay Heist," chronicled the astronomical rise in compensation packages of U.S. CEOs (*Fortune*, 2001). The number-one earners in each of the past five years received packages averaging $274 million each. (*Fortune*, 2001: 66). Neither have the exorbitant salaries and the resulting public dismay been limited to cases involving American CEOs. Percy Barnevik, founder and former chairman of Asea Brown Boveri (ABB) and once the darling of the international corporate world, and Goran Lindahl, a former chief executive of ABB, were forced to return more than half of the controversial pension and severance benefits (estimated at $140 million between them) they received on leaving the company. The ABB debacle and the issue of executive compensation are particularly sensitive in egalitarian-minded Sweden.

Adding fuel to the flame, at a time when downsizing is rampant and the notion of cradle-to-grave employment in exchange for loyalty and commitment are dim recollections from a distant past, these disclosures seem particularly disconcerting. Recent corporate emphasis on providing employees with "portable skills," at the same time of these massive payouts, seems shallow and self-serving. In addition to soaring executive compensation, the Enron debacle and the collapse of Arthur Andersen amidst charges of corruption and obstruction of justice, as well as rogue traders have further undermined the position of TNCs within society. Over the long term, these events are likely to be more consequential than executive salaries in influencing regulatorial control over TNCs.

Defining the Transnational Corporation

Because of their tremendous diversity, TNCs resist definition and a simple classification scheme. A textbook definition of a TNC is an organization that has its productive activities in two or more countries. As a base definition this might serve a purpose, but it provides little insight into the rich variability among them. The TNC is simply a more disparate entity than a single definition can capture. Nevertheless, identifying the central and more consequential dimensions on which they differ will provide insight into the diverse universe of the TNC. Critical dimensions on which they differ are the nature of the TNCs' industry, segmentation of the value-chain, range and scope of product lines, and the varied relationships with subsidiaries.

Adding difficulty to defining the TNC is the ambiguity surrounding the issue of control. The varied equity stakes that parent companies have in their subsidiaries and the recent growth in more loosely knit alliances compounds efforts at determining the boundaries of the firm's interests.

Nature of the Industry

An important difference among TNCs is in the nature of the products they produce or services they provide. There is considerable breadth in the nature of activities in which TNCs are engaged. TNCs can be producers of finished, intermediate, capital, or consumer goods, extractors of natural resources, or providers of a service. Within a particular product or service line, TNCs may produce either a segment of the value-chain of the product or produce it in its entirety. Nike is an excellent illustration of the former; it focuses almost exclusively on the marketing and sale of the product—sport shoes in this instance—and subcontracts all of the manufacturing to firms mostly in East Asia. While it is surprising and seems somewhat deceptive that Nike does not manufacture any of its own shoes, involving itself with only a small segment of sport shoes' value-chain, the segmentation of functions is highly common and spans virtually all manufacturing and service sectors.

Driving the increased outsourcing of segment functions and the narrowing of the range of firm activity is intensifying competition. Since the 1970s, firms have increasingly shed stages of the value-chain in the production of goods in order to focus more exclusively on a particular stage of the production process. This focus on "core competence" is such now that the extensive division of the value-chain among firms is more the norm than the exception. If a simple, relatively low-technology product like sports shoes has multiple segments and suppliers in its value-chain, one can imagine the large number of suppliers and subdivisions of the production process that occurs in the more technology-intensive automotive, telecommunications, information technology, and aerospace industries.

Outsourcing has extended beyond hard components within the value-chain. It is also becoming commonplace for TNCs to outsource administrative functions such as billing, training, and even entire human resource functions. As firms have shed these various production and administrative functions, building collaborative and closer-knit relationships with suppliers and customers has taken on added importance for firm profitability. Changes in the organization of production, occurring to various degrees among most TNCs, have made the universe of TNCs even more diverse and have complicated attempts to define them.

Relationship Among Subsidiaries

Another dimension along which we can examine TNCs is the relationship among subsidiaries and the related range of products each affiliate produces. One mechanism for differentiating among TNCs categorizes them as being either horizontally integrated, vertically integrated, or diversified firms. Horizontally integrated firms produce broadly the same line of goods from their affiliates in each of its geographical markets. These subsidiaries operate as relatively self-contained entities, producing similar products that are consumed in the same location as they were produced. Thus, in the horizontally integrated firm there is minimal interaction among the subsidiaries.

In contrast, vertically integrated firms produce outputs in some of their plants that serve as inputs to activities in other plants. The subsidiaries are tightly coordinated in an attempt to achieve a seamless manufacturing process, benefit from economies of scale, and minimize duplication of effort. A third type of TNC in this scheme is the diversified firm that is neither vertically nor horizontally integrated. Subsidiary products are neither components for other subsidiaries nor are they similar in nature (Caves, 1996: 2). This particular firm type is noted for the unrelated and diverse nature of the products it produces.

Foreign Direct Investment and the Issue of Control

Adding to the challenge of defining the TNC is the difficulty of determining what constitutes the minimum amount of a firm's overseas activity for it to be considered multinational, and the uncertainty surrounding the parent firm's control over its affiliates. According to Richard Caves, the minimum "plant" abroad needed to make an enterprise multinational is a matter of judgment. The transition from being purely a foreign sales subsidiary or a technology licensee to a producing subsidiary is not always a clearly identifiable shift in function or status.

Compounding the challenge of establishing functional minimums for plants overseas to qualify as multinational, what constitutes control over a foreign establishment is another judgmental issue. Many foreign affiliates of TNCs are not wholly foreign-owned enterprises (WFOE). In fact, the TNC may own only a small equity stake in the production facility and be one of several partners in a joint venture relationship. For accounting and tax purposes, countries differ with regard to the minimum percentage of equity that is required to engender control and therefore represent FDI and not portfolio investment. Without a universally accepted minimum, the deciding factor in qualifying as FDI is whether the investor is engaged in an ongoing manner in the long-term management of the enterprise. To qualify as FDI, the intent of the investor must be to control significant strategic and operational decisions (Caves, 1996: 1). Examples of FDI would be Caterpillar investing in a plant to manufacture diesel engines in Shanghai, Toyota investing in an assembly plant in Poland, or Morgan Stanley setting up a branch office in São Paolo, Brazil.

Determinants of Foreign Direct Investment

There is no single elegant theory that can by itself capture and explain why firms invest outside their home country. This is not for lack of research; a vast literature base has sought to explain the motivations behind foreign direct investment.

We do know that the nature of competition among TNCs is one of movement and activity. This means that TNCs are constantly engaged in a range of activities to identify rivals and weaken them, penetrate new markets, access higher quality and less-expensive sources of supply, or develop new products and services. A decision to invest outside the home country can be the outcome of one or a combination of these activities (Vernon, 1998: 22). The diversity of these activities highlight the breadth of objectives that can occupy the TNCs' energies and the plausibility of achieving a single theory on why firms invest. Despite the lack of a single succinct explanation for why firms invest abroad and the multitude of potential motivations, decades of research have provided useful concepts and a framework for examining the driving forces behind foreign direct investment.

Product Life Cycle Theory

One of the more classic and enduring explanations of why firms invest abroad is Raymond Vernon's classic product life cycle theory (Vernon, 1966).[2] Notions of the product life cycle have been used to explain the evolution of demand for single products as well as the motivations for corporations to expand internationally. The basic idea of the product life cycle theory is that following the introduction of a new technology—whether a product, manufacturing process, or business technique—the high profit margins obtained will attract new entrants into the market. This undermines the "monopoly windfall for the early starter" (Vernon, 1966). With the initial expansion in demand, production becomes more standardized, which lessens uncertainty for competitors entering the market, imitators appear, and initial monopoly profits begin to disappear as price competition intensifies. With profit margins lessening, the firm is motivated to expand the sale or use of the technology into new markets where similar products or processes have not yet materialized.

According to Vernon, the firm attempts to capitalize on its own experience and knowledge by introducing the technology in its home market, where it has already proven itself by past profits, and seeks out markets with a similar economic profile in which to duplicate that experience. Given that the preponderance of new technologies originate in developed countries where most of the world's TNCs reside, the firm seeks to export the technology to similar high-income and high labor cost countries. Whereas introduction of the technology into the home market was relatively easy, with a lengthy introductory period during which profit margins were high, introducing this technology into a foreign market is more challenging for a number of reasons. Whether because of increased costs of transporting the product to the foreign market, a slower market-penetration rate due to peculiar consumer tastes and preferences, less familiarity with the vagaries of operating in the foreign market, or the lack of adequate patent or trademark protection for the firm's process or products, indigenous producers quickly threaten the technology's margins as they develop similar products.

Should the firm be committed to establishing a presence for this technology in the new market, it is at a major decision point that ultimately may require committing significant financial capital to enter the market. In many ways, this decision point is commonplace and is confronted by all firms in the evolutionary process of expanding internationally. The decision is, in the face of rising indigenous competition, whether the firm sould continue simply to export the product from the home market or increase its commitment and establish a more permanent manufacturing presence in the foreign market.

In lieu of the significant commitment of financial capital required to build a plant is the option of licensing the technology to a local producer. Establishing a relationship with a local manufacturer, licensing the technology to the firm, and allowing them to use the firm's technology in exchange for a royalty on all sales or goods produced by that technology does create a local ally interested in the technology's success. However, for most firms this is a second-best option given the loss of control over the technology, product quality concerns, and the sharing of profits with the local licensee. Consequently, finding the licensing option less desirable and convinced that for a variety of reasons the firm should be present in this market, the firm commits significant capital by either building or acquiring a manufacturing capability in the target country.

According to product life cycle theory, the firm's expansion into developing countries occurs after the technology has been introduced into the high-margin and high-labor-cost market. Less-developed countries become involved in the international production of goods by two routes. First, as imitators enter the high-income and high labor cost market, profit margins are squeezed, and the firm begins seeking ways to lower production costs. To do this, the production process of the good is segmented into component parts. As stages in the value-chain are identified, low-cost producers of individual components are sought out. Whereas the developing country might lack both the market for the finished good and the ability to manage the entire production process, it could produce select, individual component parts that would then be transported to the target market for final assembly. Or conversely, the developing country could perform the minimal value-added final assembly of the good, and the production of critical technology-intensive components would remain in the more industrially advanced target market.

At first, it is likely the parent firm will simply seek out local suppliers in the less-developed countries. But as time progresses and demand for the product or similar products grows, it is commonplace for firms to internalize the production of that good either by acquiring critical suppliers in the developing country or by investing in a manufacturing plant for the component that is independent and in competition with their traditional suppliers.

Vernon and product life cycle theorists identify a second route by which firms expand into developing country markets. This explanation is more central to the fundamental idea of the "product" in product life cycle theory itself. As markets in the high-margin and high labor cost countries become increasingly competitive with new entrants, and as profit margins lessen and new products offer incremental but worthwhile improvements over the original product, the monopoly position of the original producer disappears. Unable to achieve the high margins of the earlier stage in the product's life cycle, the original producer seeks new markets where the product can be introduced and thus reproduce the gains associated with being a unique or differentiated product or process. In an overall sense, the whole thrust of expansion into new markets also allows firms to further dilute their fixed costs over a larger number of products sold and to recoup their initial investment in research and development. All of these variables, in total, provide further motivation for the firm to expand into new markets.

The OLI Framework

To this day Vernon's product life cycle theory continues to be one of the most widely accepted explanations for why TNCs invest internationally. In the wake of Vernon's seminal work, considerable research has been conducted on motivations behind FDI. With the additional research, a framework has emerged that organizes the determinants of FDI in terms of firms seeking to exploit ownership (O), locational (L), and internalization (I) advantages (Dunning, 1993: 53).[3]

Firm-specific or ownership determinants of FDI. While there is no final agreement among scholars on which of the three determinants is most important in investment decisions, the most frequently cited explanation for why firms invest is that the firm possesses some firm-specific or ownership competitive advantage that will allow it to prevail in competition in foreign markets. Given the added difficulties and cost of doing business outside the firm's home market where it has knowledge and experience, this advantage must not be possessed by others, and in particular by firms operating in the target market. Indigenous firms within the target market are perceived to have certain home-court advantages, including established contacts, intimate knowledge of the customers, and brand recognition, all of which could place the foreign investor in an inferior position without possession of some unique product or process knowledge. If the potential investor has some knowledge or experience in the market through previous exports to that market, or if it has past licensing agreements, operates a sales office, or has enlisted a local marketing representative, these can lessen the home-court advantage of the indigenous firm. Not to be overlooked, transaction and transportation costs, accruing to the foreign investor and not the indigenous firm, make having some exploitable, firm-specific advantage even more critical.

The specific ownership advantages that propel firms to invest internationally are numerous, the most important one being size. Typically, a firm considering investing internationally is a major player in the home marketplace and has achieved considerable success and size. There are many advantages to being a large firm. First, the firm possesses by definition a large capital base and has access to additional financial capital should it be needed for expansion. Given the firm's success and established track record in borrowing capital, its cost of borrowing will be lower. In addition, given that most foreign investors have originated in the advanced industrialized countries, capital is more accessible because of the higher levels of disposable income and therefore savings, established equity and bond markets, and the country's ability to attract global capital.

Second, although in the early twenty-first and late twentieth century we have witnessed a proliferation of small and medium-sized firms investing internationally, most foreign investors historically have been large established corporations with preexisting multiple investments internationally. Therefore, they already possess the added advantage of experience in manufacturing or marketing products outside their home countries.

Third, it is highly probable that large corporations are industry leaders in their particular product or production process. Sharpened by experience in the intensely competitive markets of the advanced industrialized countries, they most likely possess the latest technology and have achieved some brand recognition. Thus there are many firm-specific competitive advantages inducing firms to invest outside of their home market.

The ownership advantages of size, possession of technology, and access to capital do not necessarily induce a firm to invest internationally. It could still exploit these advantages by continuing to export from the home country and not take the costly and risky step of investing in an overseas manufacturing or service facility. Or the firm could hedge its costs and risks by entering into a joint venture relationship or licensing agreement, as described earlier.

Although these varied relationships have increased in number recently, TNCs generally find these options less attractive than entering the market alone as a wholly foreign-owned enterprise (WFOE). Furthermore, once the TNC has entered a foreign market as a WFOE, evidence suggests that the linkages between it and the WFOE will be stronger than had the subsidiary been a joint venture or a licensee. The subsidiary will be more tightly linked with the parent firm's global strategy, resulting in higher levels of sourcing, increased technology transfer, and additional investment (Moran, 2001: 5).

The reasons for this preference for WFOEs are simple. In joint venture relationships, licensing agreements, and other partnering forms, the firm loses total control over the quality of goods produced and important strategic decisions, such as the timeliness of production, the selling price of its output, the assigned market for that output, and the price at which it is invoiced to the parent in vertically integrated production processes. All of these must now be negotiated with partners whose interests may differ from the home-country firm (Vernon, 1998: 23).

Research confirms the numerous conflicts of interest and disappointing performance that seem to plague these partnering relationships. There is a Chinese expression used to describe the difficulty of sharing management decisions in joint ventures: "Same bed, different dreams." Thus the desire to keep ownership advantages in-house, commonly referred to as internalizing the firm-specific advantages, is a major motivation for entering a market through a WFOE and not through a partnering relationship.

Locational determinants of FDI. Ownership advantages provide an explanation for why firms invest, but they not explain satisfactorily why firms invest in one country and not another. Such advantages provide the push element in push-pull explanations for FDI but not the pull. Specific attractors of FDI, the pull, are found in locational advantages present in the target market.

In the 1950s, 1960s, and into the late 1970s, traditional locational advantages that attracted FDI were the presence of desired natural resources, abundant and low-cost, unskilled or semiskilled labor, and proximity to markets for finished goods. During this time, most of the firms investing outside of Western Europe and the United States were either natural-resource-exploiting firms (petroleum, chemicals, minerals) or those producing low-technology manufactured goods such as textiles and some consumer electronics. The United States and Western Europe, possessing sizeable markets and economies-of-scale advantages, attracted a much wider range of foreign investment to include more advanced technology producers.

Beginning in the later 1970s and continuing to the present, the nature of the locational advantages for foreign investors changed. On the broadest level, world events have had a significant impact on where and why firms invest internationally. As markets in the advanced, industrialized West were becoming saturated with overcapacity, new markets in China, the former Soviet Union, and the formerly centrally planned economies of central Europe became accessible. Simultaneously, advances in technologies of communication, information, and transportation made distance-related transaction costs less consequential (Dunning, 2000: 27).

Regional economic agreements such as the European Union (EU) and the North American Free Trade Agreement (NAFTA) have also impacted locational advantages. They have influenced investment decisions in two respects. First, they have decreased transaction costs among the participating countries by lowering barriers to the flow of goods, services, capital, and labor. The resulting merging of consumer bases provides economies-of-scale and -scope benefits. And second, these agreements have lowered perceptions of risk to foreign investors by incorporating additional protections for both investment and trade, thereby stimulating investment.

Research and development capacity as a locational advantage. Historically, prior to the late 1970s, there was very little research and development (R&D) activity by TNCs outside of their home country. When outside R&D was conducted, it tended to be of a particular kind. Rarely was it fundamental research and development, seeking innovations in products and processes; more often it was simply to adapt and modify home-based R&D and create products and processes more suited to the particular marketplace (Dunning, 2000: 28). It was more modification than innovation. Walter Kuemmerle refers to this as "home base exploiting R and D" (Kuemmerle, 1996: 9).

Since the latter 1970s, the nature of research and development conducted outside the home country has changed. This has contributed to the aggregate flow of FDI. There has been a sharp increase in the amount and kind of R&D, and increasingly, such activity in host states focuses less on adaptation and modification of products and processes and more on truly innovatory activity (Dunning, 2000: 28). Advances in communications technology, rising living standards in the newly industrializing countries of East and Southeast Asia, and the development of a cadre of highly trained, often Western-educated engineers and scientists in countries such as India, China, Taiwan, South Korea, Malaysia, Indonesia, Thailand, Mexico, and Brazil have brought these countries in certain sectors technologically on a par with the United States, Europe, and Japan. This has accelerated foreign investment flows for R&D purposes into these regions.

This does not mean that research-and-development-seeking FDI has not flowed into the United States, Europe, and Japan where specific capabilities were present; these countries have also experienced an increase in R&D investment. It simply highlights that whereas locational advantages were once limited to possession of natural resources or low-cost labor, countries with a highly skilled workforce capable of conducting innovatory research and development can now attract additional foreign investment for that purpose. John Dunning and others refer to this type of FDI as technology- or knowledge-seeking investment.

The increasing prominence of the overseas affiliate in the TNCs' research and development effort reflects larger changes in the competitive environment as a whole. As global competition intensified in the late 1970s through the 1980s and 1990s, the nature of competitive advantage has changed. Prior to the latter 1970s, under less-intense competition than in the 1980s, overseas affiliates operated autonomously, with much duplication of business functions among them. They were generally stand-alone enterprises with little involvement in a globally integrated production process. TNCs could be successful and achieve adequate market share simply by transplanting their operations in kind from the home country to their affiliate subsidiaries.

The hypercompetitive marketplace that appeared in the 1980s changed everything. Competitive pressures caused by the declining dominance of U.S. TNCs and the rise of European and Japanese competitors, coupled with a quickening pace of innovation, have forced firms to become more efficient in all aspects of their production processes. Driven to achieve competitive scale and efficiencies, overseas affiliates have become tightly integrated into the worldwide operations of the parent firm.

Another critical change in the nature of the firm's competitive advantage is the elevation of multinationality as an ownership advantage. According to Dunning, the degree to which a firm is truly multinational, and not the country of origin, has become much more important. Critical for competitiveness are the manner in which the assets and skills of the firm are linked and managed with the capabilities of other allied firms and the way these combined assets interact with the specific endowments of the locations where they are operating. Given the hypercompetitive environment, rapid pace of innovation, and significant scale required to compete successfully, many firms are struggling to go it alone and are driven to establish strategic alliances (Dunning, 2000: 26).

This is particularly true in the rapidly changing technology sectors. Firms are driven to seek out those potential partners and the location-specific attributes that add the most to their value-added activities. Firms that are truly multinational, in the sense that they seek out the best practices and technology on a global basis, are in a better position to innovate, learn, and disseminate knowledge more rapidly among their affiliates than competitors with a more limited geographical reach (Dunning, 2000: 27).

The recent clustering of TNC investment in specific locations is concrete evidence of the competitive desire of companies to wed value-adding alliances with location-specific attributes. Clustering, whether of the information technology industry in Silicon Valley, software providers in Bangalore, or the pharmaceutical industry in New Jersey, provides several location-specific advantages for firms. It allows them to benefit from a common infrastructure. More specifically, clustering enhances learning by placing firms in more immediate contact with innovatory structures such as universities and science centers, competitors, and local producer associations, and it provides a highly trained labor pool and increases contacts between firms and their suppliers (Frost, 2001: 102).

While clustering usually refers to a spontaneous occurrence primarily driven by market forces, governmental entities also have sought to create and nurture location-specific advantages in order to attract investment. The proliferation of export-processing zones, free trade zones, and industrial parks attest to government attempts to attract similar investments and create locationally specific synergies. These various schemes to induce clustering have met with mixed success.

Changing Patterns of Foreign Direct Investment in the Post–World War II Era

Who is investing where and why? How has this changed over time? As previously discussed, the nature of international production has changed dramatically over the post–World War II period. FDI flows immediately following World War II were not driven by the same set of corporate interests and environmental variables that later drove investment flows in the 1980s and 1990s. Moreover, the sectors of the world economy involved in FDI flows were not the same in the earlier and later periods.

In the immediate postwar period, U.S.-headquartered TNCs dominated FDI, but by the latter 1970s, they were increasingly challenged by firms originating in Europe and Japan. These are just a few of the changes that have characterized FDI flows in the postwar era.

Throughout the late 1940s and into the 1960s, FDI flows were limited in several ways. First, most of the firms engaging in FDI originated in the United States. With the decimation of the German, French, and Japanese economies in World War II, these countries' firms were in no position to meet all of their own domestic needs for products and resources, let alone invest and compete internationally. U.S. firms, many of them emboldened by demand for their products in the prosecution of the war effort, dominated FDI flows, reaching a peak in 1967 with 76 percent of global aggregate FDI.

A second respect in which FDI flows were constrained in the immediate post–World War II era was in the investment sectors. Most FDI in the two decades following World War II was concentrated in the extractive and natural resource sector. Firms such as Royal Dutch Shell, Anaconda, British Petroleum, and Exxon had significant investments internationally. During this period, flows in the manufacturing sectors paled in comparison to the natural resource sectors.

In the latter 1960s and 1970s, significant changes occurred in the pattern of FDI flows. Beginning in the late 1960s, U.S. firms placed significant amounts of manufacturing production in Europe. This was largely in response to the rebuilding of Western Europe and the growing competitiveness of firms originating in Europe. Competitive pressures to lower transportation costs and gain a more intimate, insider's knowledge of the growing European market were prime motivators. The shift of production by U.S. manufacturers out of the United States and into other countries, at this time European, was a preview of the nature of investment flows in the 1980s and 1990s.

A century earlier, foreign investment had reached a scale proportionally commensurate with the FDI flows now occurring, but it was portfolio investment and not FDI. For the first time in world history, at the end of the Cold War, firms began to place a significant percentage of their manufacturing outside the geographical confines of their home countries. The end of communism and the embrace of capitalism and protections for private property, opened up many new opportunities for foreign investors that had been previously closed or too risky.

In addition to new opportunities for investment created by liberalization in the former Soviet Union and China, the West was privatizing sectors that in the past had been previously restricted to public ownership. Furthermore, European and Japanese firms began shifting some of their production to the United States due to fear of rising protectionist sentiment. Foreign firms began investing in the United States and establishing production facilities there as a means to preempt anticipated trade restrictions. Simultaneously, U.S. firms expanded into Asia, concentrating their investments in Singapore, Taiwan, Hong Kong, Malaysia, Indonesia, and China.

To date, some countries' firms have in excess of 50 percent of their production outside their home country; the United States and Britain, representing intermediate cases, have an estimated 20 percent or more of their production abroad. While manufacturing since the 1960s accounts for the largest share of FDI flows, the newest and fastest growing wave of FDI flows is in the services sector. Firms such as Nomura Securities, Citibank, and Credit Suisse Boston are but a few of the service-sector enterprises setting up operations internationally (Grunberg, 2001: 348).

Foreign Direct Investment and the Developed Countries

A more focused examination of recent FDI flows reveals significant characteristics and patterns not visible in a broad decade-by-decade analysis. The distribution of international production across countries is highly skewed, with FDI flows from and into the developed countries clearly dominant. Contrary to popular perceptions, a relatively small amount of total global FDI flows into the developing countries. And only a fraction of that is motivated by the desire to exploit inexpensive and unskilled labor.

The United Nations Conference on Trade and Development, the world's foremost monitor of the activities of TNCs, estimates that for much of the post–World War II period developed economies both received most of the FDI flows (over 80 percent) and contributed most of the outflows (over 95 percent). Since 1985, almost 70 percent of total outward FDI and 57 percent of inward FDI came from and was received by only five developed nations: the United States, UK, Germany, France, and Japan. In 1999 alone, ten countries received 74 percent of global FDI flows. Of the total FDI of $636 billion in 1999, approximately 75 percent went to the developed countries. U.S. inflows, driven by large mergers and acquisitions, received a record $276 billion, totaling nearly 33 percent of the world's total. In that same year, developing countries as a whole received approximately 25 percent less FDI than the United States alone, totaling only $208 billion (*World Investment Report*, 2000: xvi).

Within the developed world, foreign investors from the EU nations were particularly active, and within those, TNCs from the UK, France, and Germany accounted for the largest share of the EU's outward flows. In 1999, EU firms invested $510 billion abroad, approximately 65 percent of the world's total outflows. Even though it is a major outward investor, with significant foreign operations in the United States, Europe, and East and Southeast Asia, Japan does not receive significant inward flows from TNCs based in Europe, the United States, or elsewhere. The perceived impenetrability of the Japanese market, reflected in the minimal amount of foreign investment there, is often a source of tension in Japan's economic relations with the outside world. Foreign-owned firms account for less than 1 percent of total sales in Japan. Although FDI flows to Japan quadrupled in 1999, reaching a record $13 billion, most of these inflows came through a small number of mergers and acquisitions (*World Investment Report*, 2000: xvi).

Foreign Direct Investment and the Developing Countries

Of the FDI flowing to the developing world, the concentration in a limited number of countries was equally dramatic. By 2000, ten developing countries received 80 percent of the total FDI in the developing countries. Major recipients include China (including Hong Kong), Malaysia, Indonesia, Singapore, Brazil, and Mexico.

These countries offer two attractions for foreign direct investors. They either possess large and growing internal markets and/or they have developed a sophisticated infrastructure (e.g., banks, port facilities, a highly educated population). Africa, plagued by the AIDS epidemic and political turmoil, has largely been bypassed, attracting less than 1 percent of aggregate FDI.

Within the developing world, recent FDI flows continue to reflect the interest of foreign investors in a limited number of high-potential countries. Mexico continues to receive significant FDI flows following its recovery from the 1994–1995 peso crisis. Its early repayment of funds borrowed from the International Monetary Fund and the United States, its conservative monetary and fiscal policies, and a vibrant U.S. economy have made Mexico the prime destination for FDI flows into Latin America. After a two-year lull following the Asian financial crisis, in which virtually all of the region's countries experienced a significant drop-off in FDI, foreign investment flows into select East and Southeast Asian countries returned to nearly their precrisis levels, reaching $93 billion in 1999, an increase of 11 percent over 1998. This increase in FDI centered on the newly industrializing countries (NICs) of Hong Kong, Singapore, Taiwan, and South Korea (*World Investment Report*, 2000: xvii).

Among the Asian NICs, South Korea, once perceived as nationalistic and hostile to foreign firms and investors, experienced an unprecedented inflow of $10 billion (*World Investment Report*, 2000: xvii). Following the dramatic devaluation of its currency in 1997 and faced with a severe foreign-exchange crisis, South Korea borrowed from the International Monetary Fund to meet its international obligations.

Under IMF tutelage, South Korea was forced to lessen its restrictions on FDI and take other steps to rationalize and interject efficiencies into what had become a highly protected economy. Paving the way for a wave of foreign investment, the stranglehold of the *chaebols* (huge conglomerates) over the Korean economy was weakened as they were forced to divest major business segments. Both the liberalization of laws regarding FDI and the new investment opportunities presented with the divestiture of the chaebols provided many opportunities for foreign firms to expand into Korea.

Conclusion

Much has been written on the role of the TNC within international political economy. The TNC has been the subject of research by scholars from a broad range of disciplines including geography, economics, political science, and management, among others. This chapter was not an attempt to add new knowledge to the literature base on TNCs nor to survey the contributions of each of the relevant disciplines. Its purpose was, by drawing primarily on disciplinary sources in international political economy and management, to correct some of the misinformation and clarify some of the definitional confusion surrounding the TNC.

Defining the TNC poses a challenge. Given the considerable variation along multiple dimensions in the nature of TNCs, it is difficult to speak of them as a single entity. TNCs have significant differences in terms of the degree of multinationality, the nature of their products or services, and the relationships among their subsidiaries.

The desire to increase earnings is a motivation for expanding domestically or internationally common to all firms, but it provides few explanations. Closer analysis of individual investment decisions reveals a range both of ownership variables internal to the firm and locational variables exogenous to the firm, which influence investment flows. Perhaps more interesting is that the relative influence of firm-specific versus locational variables in influencing foreign direct investment decisions has changed over time.

In the analysis of the changing patterns of FDI flows, the post–World War II era provided a rich laboratory for examining the evolving geographical nature of TNCs' international activities. A decade-by-decade account captured the extent to which both the providers and the recipients of FDI flows have changed. It also highlighted the evolving nature of the motivations behind international production. While foreign direct investment in the early postwar era was resource-seeking, market- and knowledge-seeking motivations became more important in the 1970s and beyond.

Definitional clarity is a first and critical step to understanding the TNC; however, it is only the first step. As previously stated, much has already been written on globalization and the TNC, two of the most controversial topics within the international political economy. Further research will certainly inform and deepen the continuing analysis on the role and merits of the TNC in international society.

Notes

[1] The literature both supportive and opposed to globalization is vast. Globalization is defined as the process of integration of the financial, currency, and product markets on a worldwide scale. For a succinct overview on recent changes in the nature of international finance, trade, and production that define "economic globalization," see Gilpin (2001: 5–12). Addressing the tension between globalization and domestic social arrangements, see Dani Rodrik, *Has Globalization Gone Too Far?* (Washington, DC: 1997). For a perceptive and entertaining read on these same tensions, see Thomas L. Friedman, *The Lexus and the Olive Tree* (New York: Random House, 2000). A critique of globalization can be found in Richard Falk, *Predatory Globalization* (Oxford: Polity Press, 1999). The notion that the current level of globalization is not unique in history and is not unprecedented is addressed by Cable (1995).

[2] See also Vernon (1971).

[3] The author would like to recognize the voluminous writings of John Dunning. His contribution to the study of TNCs is unmatched, elucidating the concepts and dynamics that have come to inform most discussions of the TNC and its activities.

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