THE UNITED NATIONS LIBRARY ON TRANSNATIONAL CORPORATIONS

VOLUME 1

The Theory of Transnational Corporations

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Note

The Transnational Corporations and Management Division (formerly the United Nations Centre on Transnational Corporations) of the United Nations Department of Economic and Social Development serves as the focal point within the United Nations Secretariat for all matters related to transnational corporations and acts as secretariat to the Commission on Transnational Corporations, an intergovernmental subsidiary body of the United Nations Economic and Social Council. The objectives of the work programme are to further the understanding of the nature of transnational corporations and of their economic, legal, social and political effects on home and host countries and in international relations, particularly between developed and developing countries; to secure effective international arrangements aimed at enhancing the contribution of transnational corporations to national development goals and world economic growth; and to strengthen the negotiating capacity of host countries, in particular the developing countries, in their dealings with transnational corporations.

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Foreword

The activities of transnational corporations are one of the most important and intriguing facets of the modern world economy. Transnational corporations now probably account for one third of the privately generated gross output of market economies. For most of the post-war period, and especially since the 1980s, foreign direct investment has grown at a much faster pace than either world trade or world production. Annual flows of foreign direct investment amounted to around $225 billion in 1990, with the stock of this investment having reached some $1.7 trillion. The number of firms that own or control assets in more than one country through equity arrangements is about 30,000, and those firms own or control more than 150,000 foreign affiliates.

By their very nature, transnational corporations integrate production at the international level and, in this manner, play a central role in economic growth. Most importantly, these firms are the principal actors in the development and dissemination of technology which is assuming greater importance as a determinant of international competitiveness and the growth of nations. But transnational corporations also contribute to capital formation, provide training and play an important role in trade. In brief, transnational corporations play a pivotal role in the organization of international economic activities and considerably affect the social and economic welfare of both host and home countries.

Host countries look towards transnational corporations as an additional source of investment, technology, innovation, employment, the upgrading of labour and management skills, increases in national competitive strength, greater integration in the world economy, new export markets and tax receipts. By contributing to these objectives, transnational corporations can play a valuable developmental role in host countries. On the other hand, they may also stifle indigenous development through a variety of business practices that may adversely affect local enterprises.

Policy-making in recent years has generally taken a favourable view of the impact of transnational corporations on economic development. Most governments have reduced or eliminated restrictions on inward direct investment and have introduced new fiscal and other incentives to attract it. It needs to be stressed, however, that transnational corporations have their own long-term objectives in undertaking crossborder business operations. Before investing in a certain country, they consider the size and growth of the local or regional market, other alternative locations, the costs of production and the general investment climate. Transnational corporations establish their operations in locations that are perceived to advance best their business objectives. In practice, 80 per cent of foreign direct investment is now directed to developed countries. Developing host countries, therefore, face a policy challenge in increasing their attractiveness as locations for foreign direct investment, and ensuring that such investment contributes to their national development objectives.

The objective of the *United Nations Library on Transnational Corporations* is to offer balanced insights into the major economic, management, organizational and legal issues of transborder business activities. The literature on transnational corporations and the various aspects of their activities has swollen in the past twenty years to such an extent that it is difficult for scholars, government officials, corporate executives and others to obtain a state-of-the-art overview of the emergence, growth, operation, impact and likely evolution of transnational corporations. Accordingly, the United Nations Centre on Transnational Corporations initiated the preparation of this *United Nations Library on Transnational Corporations*, an endeavour brought to fruition by the Transnational Corporations and Management Division of the Department of Economic and Social Development of the United Nations. It is meant to contribute to a better understanding of the role of transnational corporations in the world economy, and especially their impact on developing countries.

The United Nations Centre on Transnational Corporations was established in 1974 as the Secretariat of the United Nations Commission on Transnational Corporations, a subsidiary body of the Economic and Social Council. At the beginning of 1992, as part of the reorganization of the economic sector of the United Nations, the Centre became part of the Transnational Corporations and Management Division of the Department of Economic and Social Development. The Division serves as the focal point within the United Nations system for all matters related to transnational corporations and foreign direct investment. More specifically, the objectives of the Division include: to advance the understanding of transnational corporations, to secure effective international agreements relating to their activities and to strengthen the negotiating capacity of host countries, particularly developing countries.

The volumes in the *United Nations Library on Transnational Corporations* are edited by leading international experts from the specific fields that the volumes address. The editors were asked to select for their topics the best articles or parts of books that had previously been published, i.e., that had passed the 'test of time'. In addition, each editor was asked to prepare an introductory essay on the relevant subject to provide a state-of-the-art overview of the field and to assess what the principal issues are in it today and what some of the future issues are likely to be.

The *United Nations Library on Transnational Corporations* is prepared under the distinguished general editorship of John H. Dunning, Professor of International Business at the University of Reading, United Kingdom, and Rutgers University, Newark, New Jersey. Special thanks go to Karl P. Sauvant, who worked with John H. Dunning on this project, and Azizul Islam and Miroslav N. Jovanović, who assisted in its implementation.

It is my hope and belief that the *United Nations Library on Transnational Corporations* will prove useful to government officials, scholars, business executives and students throughout the world in broadening and deepening their understanding of the role of transnational corporations in today's world economy.

Hamdan BenAissa
Director

Transnational Corporations and
Management Division
New York, May 1992

Preface

The importance of transnational corporations and the globalization of production are now well recognized. Transnational corporations have become central actors of the world economy and, in linking foreign direct investment, trade, technology and finance, they are a driving force of economic growth. Their impact on the economic and social welfare of developed and developing countries is both widespread and critical.

It is one of the functions of the Transnational Corporations and Management Division (formerly the United Nations Centre on Transnational Corporations) – the focal point in the United Nations for all issues relating to transnational corporations – to undertake and promote research on transnational corporations to contribute to a better understanding of those firms and their impact. Over the past 30 years, research on this phenomenon has mushroomed, and hundreds of books and reports, as well as thousands of papers, have been published. It is the principal purpose of this 20-volume *United Nations Library of Transnational Corporations* to distil, summarize and comment on some of the more influential of those writings on the role of transnational corporations in the world economy. In particular, the contributions in the *United Nations Library* deal with four main issues: the determinants of the global activities of transnational corporations, their organizational structures and strategies, their interactions with the economies and legal systems of the countries in which they operate and the policies that Governments pursue towards those corporations. The 20 volumes are intended to cover a wide range of topics that embrace economic, organizational and legal issues.

To accomplish that task, the Centre assembled a distinguished group of editors, who were commissioned to select the seminal contributions to their subject areas published over the past 20 to 30 years. They were also asked to prepare comprehensive bibliographies of writings on their subjects for inclusion in the volumes, and state-of-the-art introductions that summarize the development of their subjects, review the most important current issues and speculate about future work. We hope that the result in each case is a volume that provides a succinct, yet comprehensive, overview of the subject to which it is devoted.

The first volume, prepared by John H. Dunning, Professor of International Business at the University of Reading, United Kingdom, and Rutgers University, New Jersey, sets out some of the leading contributions on the theory of the determinants of TNC activity: Why does it occur? Where does it take place? What particular advantages do transnational corporations possess over other firms in the territories in which they produce? Why do firms prefer to engage in foreign direct investment rather than trade or to conclude cross-border licensing agreements and strategic alliances?

Since the early 1960s, many scholars from a wide range of disciplines have grappled with those questions. The present volume traces the evolution of the thoughts and writings of economists and business analysts since Stephen Hymer's classic contributions in the 1960s to Mark Casson's incisive speculations in the early 1990s on the future of the theory of international business. In particular, the contributions depict both the many different strands of intellectual heritage that help explain the contemporary transnational corporation and its global activities and, more particularly, the recognition of the need for a multidisciplinary approach to the subject.

New York, May 1992

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Introduction: The Nature of Transnational Corporations and their Activities

John H. Dunning

Basic Concepts

The theory of the transnational corporation (TNC) seeks to explain the existence and growth of transnational corporations. The theory of the activities of TNCs aims to identify and evaluate the determinants of the foreign-owned production of such corporations. Though the two subject areas are similar to each other, the former is more micro-oriented and concentrates on the reasons for the transnationality of firms, while the latter is more interested in explaining the factors influencing the ability and willingness of groups of firms or countries to engage in foreign value-added activities.

Transnational corporations are enterprises which own or control value-added activities in two or more countries. The usual mode of ownership and control is by foreign direct investment (FDI),[1] but TNCs may also engage in foreign production by means of cooperative alliances with foreign firms. Most of the literature on the determinants of TNCs and TNC activity, until recently at any rate, has been concerned with explaining foreign-owned production, i.e., production financed by FDI, and most of the readings in this volume reflect this direction of interest.

There are two near relations of the TNC: the international trading company and the multiplant domestic firm. Like international trading companies, they undertake cross-border transactions; but unlike them, they own and control foreign production facilities. Like multiplant domestic firms, TNCs operate two or more production units, and internalize the transactions between these units. But, unlike them, at least one of these production units is located in a foreign country and the markets internalized are transnational rather than domestic.

Location and Ownership of Production

Any explanation of TNCs is then concerned with the location of value-adding activities and the ownership and organization of these activities. As such, it needs to draw upon and integrate two strands of economic theory. The first is the theory of international resource allocation based upon the spatial distribution of factor endowments. This theory chiefly addresses itself to the location of production. The second is the theory of economic organization, which is essentially concerned with the ownership of that production and ways in which firms manage the transactions relating to that production (including those that may impinge on its location). To the extent that firms may react differently to any given set of locational and organizational variables, a subset of the theory of organization, *viz.*, theory of strategic management, may also be required.

In traditional, i.e., classical or neoclassical models of trade, which were the dominant paradigms in international economics until the 1950s, only the first issue, that is, the "where" of production, was addressed. Questions relating to the ownership and organization of economic activity were largely ignored. This was because the market was considered to be a perfect mechanism of exchange and to involve zero transaction costs. Resources were presumed to be immobile across national boundaries but mobile within national boundaries. Firms were assumed to engage in only a single value-added activity. Entrepreneurs were predicated to be profit maximizers. Managerial strategy was assumed to be confined to identifying the optimum level of output and minimizing the costs of producing that output.

However, once one allows for imperfections in goods or factor markets, the possibility of alternative patterns of the ownership of firms and/or organizing production and transactions arises. For example, in place of one firm selling its product through the market to another firm, which then adds value to it, the same firm may coordinate both sets of activity, and in so doing replace the market as a mechanism for transacting the intermediate product. Where at least one of these activities spans national boundaries, foreign production occurs. The factors influencing the modality of organizing cross-border activities are therefore at the heart of the theory of foreign-owned production; indeed, some writers go as far as to assert that it is the only question of interest.

Taking a different starting point, it might equally be asked why, given the ownership of firms and the way in which they organize production and transactions, they should choose to locate at least some of their value-added activities in a foreign country. In this case, the spatial distribution of factor endowments may be as relevant as it is in explaining some kinds of trade. Or, put another way, the introduction of market imperfections and the TNC not only opens up the possibility of foreign production; it may require a complete reappraisal of the theory of trade. Indeed, some types of international transactions, e.g., intra-industry trade, can be explained only by use of the theory of economic organization.

From the above, it should be evident that any attempt to theorize about TNCs or the extent and pattern of TNC activity crucially depends on the type of question one wishes to answer. Is it primarily "why do firms own foreign production facilities"; or "why do firms locate their activities in one country rather than another"; or "why does the participation of foreign, relative to indigenous firms, differ between countries and sectors"; or "under what condition will firms finance their foreign activities in the currencies of their home country rather than in those of another (i.e., engage in foreign direct investment)"? Even a cursory review of the literature on international production[2] suggests that, very often, researchers address themselves to related, but rather different questions.

Research Strands

Similarly, scholars differ in their choice of the unit of analysis, i.e., the variable to be explained. Some authors have essentially taken a macroeconomic perspective and concerned themselves with why countries engage in foreign direct investment. These economists – e.g., K. Kojima (1973, 1978, 1982) – usually take as their starting point neo-classical type trade models and extend them to explain the extent and pattern of foreign production. Not surprisingly, they tend to focus on location-specific variables and why firms of a particular nationality may have different propensities to engage in trade and production than others. More recently, however, strategic trade economists have fully acknowledged the need to incorporate market imperfections into any explanation of cross-border transactions.[3]

Others, more interested in the behaviour of the individual enterprise, 2 draw upon the theory of the domestic firm (which seeks to answer very different questions than that of international trade) to explain both the existence and the growth of the TNC. This school of thought, of which P. Buckley and M. Casson (1976, 1985), Casson (1987), J. Hennart (1982, 1986), A. Rugman (1986), and D. Teece (1981, 1985) are leading exponents, looks upon the TNC as a hierarchy that internalizes the market for cross-border intermediate products, and derives its methodology and approach from both the founder of modern transaction cost economics, Ronald Coase (1937, 1960), and that of such organization theorists as A. Alchian and H. Demsetz (1972), Herbert Simon (1947, 1955) and O. Williamson (1975, 1985, 1986).

A third group of economists, more closely allied in background to the 3 second than the first, addresses the question of why firms of one nationality are better able to penetrate foreign markets than indigenous firms located in those markets, and why they wish to control value-added activities outside their national boundaries. Stephen Hymer (1960, 1968, 1976) was the progenitor of this type of explanation of foreign production, which he argued could not occur without the investing firms possessing some kind of monopolistic advantage over and above that possessed by their indigenous competitors. In his explanation, he drew not so much on the theory of the firm, but on the theory of industrial organization and market structures, which a few years earlier had been developed to explain the pattern and ownership of United States domestic industry by J. Bain (1956).

In reviewing the literature on the determinants on international production, it is important to distinguish between these approaches, for what may be an exogenous variable in one theory may be endogenous in another. It follows, then, that there is no one correct explanation of international production, only a correct answer to particular questions, each of which may help us to complete a jigsaw of understanding about the pattern of ownership and location of firms outside their national boundaries.

An Historical Perspective

The theory of the TNC and TNC-related activity is of comparatively recent origin. Indeed, the terms "multinational enterprise" and "transnational corporation" (which are now used interchangeably with each other by most writers) were only coined in the middle 1960s and early 1970s.[4] Prior to that time, firms that had established value-adding activities outside their national boundaries were referred to as multi-territorial firms (Bye, 1958) or more usually firms which engaged in foreign direct investment (Hymer 1960, Vernon 1966).

The reason for this state of affairs was that, for the most part, explanations of international production, such as they were, were dominated by international economists, who had little interest in the firm as an institutional or organizational unit;[5] but only with alternative forms of international involvement, noticeably trade and capital movements. At the same time, economic theorists interested in industrial economics and the theory of the firm not only confined their attention to the domestic operations of firms, but, for the most part, to situations devoid of the characteristics necessary for the very existence of TNCs.[6]

Though the origins of the theory of TNCs and international production can be traced back to some early insights of Thomas Mun (a director of one of the earliest known TNCs, The East India Company), Adam Smith, David Ricardo, E.G. Wakefield, Alfred Marshall, Karl Marx, J.R. Commons and R. Hilferding,[7] it was not until 1960 that anything approaching a separate theory of foreign direct investment was formulated. From the 1930s onwards, several empirical and largely country-specific studies addressed the factors influencing the location of foreign direct