Transnational corporations (TNCs) and economic development

Introduction
Transnational corporations are companies that operate in at least two nations and have at least 10% equity in the foreign operation. TNCs are not a new form of economic relation between center and periphery. In fact, TNCs date back to colonialism with two well-known examples being the Dutch East Indies Company or British East India Company.

Only after the second industrial revolution, occurring the late 19th century, did the giant vertically integrated corporation emerge. With this change, TNCs begin to expand sources of revenues from trade, particularly from monopolistic control of trade routes and select commodities to production abroad, albeit mostly of primary commodities.

While the existence of their presence is not debated whether TNCs are agents of development is. However, before going there let’s set the stage with some information about these large organizations. In 1990, foreign affiliates of TNCs accounted for just over one trillion dollars of value-added activities. 20 years later, the number grew significantly from just under 5% of world GDP to over 10% at more than seven trillion dollars. If we consider home production of the TNCs, they account for about 25% of world output and are responsible for about 33% of world trade.

However, because of the way we defined TNCs, we have dramatically understated the extent of their presence. Utilizing a web of offshore networks, TNCs are able to take advantage of subcontracting often in free trade zones, to operate without accountability. Tracking the activities of TNCs is only becoming more difficult with the rising role of tax havens which obscure the magnitude of international financial flows.

The table here shows data by region for inflows and outflows of FDI. Very often analysts will focus on the benefits of incoming FDI flows to developing nations, totaling more than 600 billion in 2010. However, about 1/3rd of this inflow does not lead to capital formation, but rather is spent on acquisition and mergers of existing firms. Moreover, notice that developing nations also provide a source of funds with FDI outflows totaling about 400 billion in 2010. The so called “third -world transnational corporations”, like Cemex from Mexico who is the largest producer of cement in the US, have saturated domestic markets and accumulated significant capital that they have now setup foreign subsidiaries, mimicking the path of South Korea decades ago.

For developing nations, for every $100 flowing in, $65 flows right back out. This interesting result has a rather simple explanation. Giving the globalized world we live in, it is easier for a firm to cross borders than to cross into another area of production.
Import substitution industrialization and the TNCs

The colonial era, the industrial revolution, and the end of WWII mark the three distinct rounds of transnational activity. ISI has been adopted as a development strategy by many nations. ISI uses protectionist policies to develop domestic industry. TNC from the core countries found themselves behind the wall and unable to export. However, undeterred, TNCs simply jumped over the wall and setup “stand alone” operations in the less-developed nations.

Post WWII, there was a wave of nationalizations as developing nations sought to reclaim control from the TNCs. Primarily directed at foreign investments that had been setup during the colonial era in resources and raw materials; moreover, not only were the nationalizations concentrated in industry, but they were also concentrated across time and space. ¾ths of the nationalization occurred from 1966-76 and 2/3rds were accounted for by just 28 regimes.

The parallel rise in ISI and TNCs setting up foreign branch plants was not coincidental. Following WWII, the US needed an outlet for the massive increase in its industrial capacity. There was also a very strong desire by industrialists and policy makers alike to avoid the fractious global dynamics that erupted prior to the Great Depression. Part of the US ascendancy following WWII arose from its championing of ISI strategies and procurement of preferential treatment for US based TNCs in the developing nations. As TNCs who focused on resource extraction were being nationalized, US manufacturing TNCs were blazing the trail into a new territory.

Protected markets from ISI policy made it profitable for smaller operations without the need for economies of scale. In the table, you can see that even though the US saw its role decline slightly in the 80’s, it has successfully maintained its dominant position as the leading source of FDI.

The globally integrated production system

Beginning in the late 60’s and continuing into the 21st century, the emergence of global factories began to shape the fourth form of transnational economic activity. It was not the domestic market nor abundance of natural resources, rather, it was availability of cheap labor and the lack of environmental regulations that animated the growth of global factories. Perhaps, not so shocking was that this new period of transnational economic activity coincided with a shift in policy-making circles of the center to push for export-led industrialization and away from ISI.

The era of globally integrated production began in the 1970s with the revolution in communication, transportation, and information processing technologies. The global shift has been, according to some scholars, been driven by the changes in technology which has allowed a deskilling of the labor force. A core group of technicians and managers reside in the core countries, while production is outsourced to less-skilled workers in the less-developed nations.

FDI, outsourcing, and trade are distinct categories. Outsourcing is the least embedded in the developing nations production structure. Often outsourcing occurs in free trade zones or export processing zones, a topic we will return to later.

The global production system relies on just in time inventory controls and total quality management techniques. These new techniques under the emerging globally integrated production system requires a network of sophisticated suppliers. The complex and quickly adjustable production systems required
under this system is becoming increasingly provided by other TNCs. Many less-developed nations are being further marginalized as a select few of the first movers of the newly industrialized countries can adopt these techniques. The just in time and total quality management reinforce the tendency toward cumulative causation and backwash effects.

A lot of recent research finds that as integrated production systems expand, the role of local supplier declines as foreign owned supplier steps in to service the high value-added needs of the TNCs. The Mexican auto sector is the perfect example of this trend.

Transnationals are found in most less-developed nations. Their presence primarily occurring in the four categories listed on this slide.

**Foreign direct investment**

Foreign direct investment entails the ownership of productive assets by a parent corporation in another nation. Such ownership should be distinguished from the purchase of foreign stock or the lending of funds to foreign companies and governments. These latter forms of investment are known as portfolio investments.

The flow of investment to developing nations is heavily concentrated. In the 1980’s, the top 10 nations received over 70% of capital flows to the less-developed world. While there was variation in which nations constituted the top 10, over the same period 18 countries received 80% of all investment. On top of this, the flows tend to shy away from the poorest countries: international investment flows to countries where growth is already taking place.

While the US maintained dominance as a source of international investment, it has become increasingly diversified. The diversification of FDI sources provides a critical opportunity for the host country to reap benefits from TNC investment.

**Who in the less-developed countries gains from FDI?**

In the neoclassical development theory, developing nations lack capital and thus FDI can only have a positive effect on growth. However, FDI is relatively insignificant in the total share of investment. Not only are these flows highly concentrated, but TNCs often target existing capital equipment rather than formation of new capital. Rather than increase the productive capacity, FDI often reduces domestic ownership of existing capital: FDI often results in denationalization.

Even when FDI is used for the formation of new capital, it often crowds out domestic investors. FDI does not completely complement local investment, but rather acts partly as a substitute. These effects can be mitigated as they were in Asia who was much more selective in liberalizing access to domestic markets.

FDI is not the panacea it is often portrayed as. FDI does not necessarily add to the growth generating capabilities of a nation; as an example, construction of fancy hotels and shopping centers are considered FDI if financed from abroad. Another reason FDI might not generate the promised results is that retained earnings from TNCs are considered FDI and often these earnings are directed towards financial markets in the host nation which almost certainly means it will not be used to finance capital formation.
Collateral effects of TNCs: the modernization perspective

TNCs bring with them the potential for new capital, new products and process technologies, and organizational innovation— they bring with them the potential for modernization.

However, it is important to distinguish the linkages between FDI flows and portfolio investment, private loans, and bilateral and multilateral aid. The more business friendly a nation is, the greater the rate of these additional capital inflows.

The table here shows the distribution of capital and other financial flows. The share of FDI to total flows rises steadily throughout the 90’s. It peaked at nearly 80% before a dramatic increase in the other flows began to reduce FDIs share. The table demonstrates the importance of private sector flows, particularly those from TNCs. However, the poorest nations received very little FDI. At the turn of the century, the poorest 49 nations received less than 0.5% of total FDI.

Economically motivated migration has soared as development policy has failed in many nations. The final row in the table shows remittances which rises dramatically to about 2/3rd of FDI.

Capital formation

Capital formation resulting from TNCs is relatively small, the qualitative difference can be much greater. These investments are typically directed to a narrow range of industries that are important for economic growth; the concentration of investment in manufacturing and services is associated with significant gains in productivity and production.

Moreover, aggregate data may obscure non-equity arrangements within the host nation which can have a substantial impact on productivity and output. These arrangements include franchising, licensing, subcontracting, etc. The arrangement represents production linkages which provide an avenue for diffusion of technology, skills, R&D, etc.

Lack of foreign exchange can create a bottleneck for developing nations, curbing development potential unless foreign markets can be penetrated. Entering foreign markets widens the market and facilitates benefits from economies of scale. If TNCs transmit export skills to domestic producers, another potential benefit from TNCs emerges.

The table on this slide shows reflects the increasing emphasis of global production and, particularly, the success of some Asian nations in constructing complex production facilities. While many nations have successfully transitioned away from dependence on primary commodity exports, many remain stuck, unable to escape. You should notice the dramatic rise in medium and high-skill production; the obvious exceptions in the table are petroleum and apparel, a primary commodity and low-skill labor intensive industry, respectively. In the areas not typically associated with developing nations, the TNC integrated production process is generating significant gains in the share of world exports. The biggest caveat is that many developing nations remain a source of cheap labor for the globally integrated process. Exceptions have been achieved but required strategic direction from the state in pursuing embedded industrial policy.
Are there spillover effects from FDI?
The existence of spillover effects is greatly debated.

Backward linkages can be developed by imposing local content requirements. If the TNC is vertically integrated, then the possibility of developing the linkages is greatly diminished. The possibility remains that through employment of the domestic workforce, skill diffusion can occur.

Understanding spillover effects has been confounded by studies combining advanced and developing nations in the sample. However, one interesting result has emerged: when the parent company sets up operations aimed at the domestic market rather than for export, the formation of backward linkages is much greater. Conversely, when a nation hosts high tech operations, *ceteris paribus*, they should expect very few spillover effects. A major problem with many of these studies is that they use productivity of domestic firms as a proxy for spillover and if any correlation is discovered it is assumed that the greater productivity was caused by FDI. However, correlation is not causation. Case studies are needed to support the assumed conclusion.

So do externalities and spillover effects from FDI exist? Well...we do not know, but evidence is building that FDI has a negative impact on domestic productivity. Private property, like technology, provides revenue to TNCs. Allowing it to spill over would diminish the opportunity for profit. However, if allowing others access to the proprietary knowledge reduces costs or raises profits without undermining their dominance a TNC may be expected to allow spillover effects. The TNC has a spectrum of capacities, they will share knowledge but generally only at the lowest level on the spectrum of capacities. If the developing nation has strategically created the capacity to absorb higher levels and the TNC finds it advantageous, significant spillover effects may occur.

Potential costs of TNC to a host country.

We have considered potential benefits from TNCs, now we turn to the costs. How might TNCs and FDI deepen underdevelopment or facilitate a process of biased economic growth wherein the bulk of the economic benefits are retained by the TNCs. Three of the potential costs we will consider are achieved through transfer pricing, income transfers, and increasing industrial concentration.

Regarding transfer pricing: TNCs often buy input and sell output to other branches or affiliates of the same TNC operating in different countries. These intra-firm transactions are of a significant magnitude. Transfer prices allow firms to track costs, productivity, and profitability across its operations. However, these prices can be manipulated to avoid taxes or restrictions on repatriated profits or even to disguise profits in attempt to avoid repercussions like labor tensions or nationalization.

Regarding income transfers via TNCs: TNCs can generate resource inflows to a developing nation, they can also generate outflows. The outflows often come in the form of a loan repayment to the parent company or repatriated profits. If the subsidiary is not earning foreign exchange though imports or saving foreign exchange by engaging in ISI, the outflows can act as a net drain, reducing financial capital available for investment.

The presence of TNCs is associated with increasing industrial concentration. This type of economic concentration tilts the income distribution towards those at the top. The resulting inequality acts as a barrier that divorces growth from human development.
Weak linkages, thin globalization
The data shows that developing nations are making great strides in productive efficiency, facilitating a surge in exports. However, these changes are happening within a global production system financed by TNCs.

Perhaps the best indicator of skill and technology transfers relates to the linkages formed between the TNCs and the host economy.

Mexico has consistently been a top recipient of FDI, yet its national industrial base has failed to develop; rather, Mexico’s economy appears to disarticulated with a dynamic export sector controlled by TNCs and largely unlinked to the domestic economy. The maquiladora sector serves as a great example of this thin globalization. Foreign capital has moved across the border into Mexico, but the export sector stands alone disconnected from the rest of Mexico.

The qualifier thin allows an understanding of how the globally integrated production system has drawn countries into the system without developing linkages to the local economy. The superficial integration allows the TNC to retain the value-added activities within its own structure, keeping the benefits for themselves: the virtuous circle that emerges from investment is prevented from ever starting.

Even when linkages are formed, the domestic suppliers to the TNCs are increasingly foreign owned. The more promising scenario, which occurred in East Asia, arises when the state actively works to integrate the TNCs within the domestic economy. The developmental state encourages six key processes listed on the slide.

The passive hosting of TNCs results in thin globalization: a disarticulated dual economy. Exports may rise, but value added does not and the nation may even experience deindustrialization as the local industrial base fades away.

Export promotion and the fallacy of composition
The strategy of promoting FDI and expanding exports cannot be employed a one time in many nations. If many countries engaged in this strategy at the same time, it would create declining terms of trade for the labor intensive, low technology manufactured goods. Gaining market share requires participation in a race to the bottom. This in fact is what has been happening; data from the IMF shows declining terms of trade for manufactured goods originating from less-developed nations. Declining terms of trade not only affects primary commodities, but also affects manufactured goods.

Long-term costs of TNCs: the potential for environmental degradation
TNCs generally have leverage over a host nation which allows them to engage in environmentally unsound activities. From the perspective of cost minimization, TNCs have an incentive to act as environmental predators. Stopping this assault on the environment requires at the first level, consciousness of environmental degradation in the developing world and then to develop the ability to monitor the behavior of TNCs.
Export processing zones

TNCs operating in EPZs do not have to play by the same rules. Products entering and leaving EPZs usually do so exempt from taxes. Firms operating in EPZs have many fees waived. Unions do not exist in EPZs and often, nor do labor laws like minimum wages.

The industrial parks within the EPZs are subsidized as are the provision of infrastructure, utilities, waste removal, and labor training and housing.

The incentives for host nation are the receipt of foreign exchange and the creation of jobs; although, the receipt of foreign exchange is normally restricted to the value-added from the wage income of labor engaged in production.

EPZs tend not to create linkages to the domestic economy. The focus on exports prevents forward linkages, while thin globalization prevents the formation of backward linkages.

For an EPZ to function as an engine of growth, they must be embedded in the production structure through the formation of linkages. South Korean and Taiwan are two examples of TNCs operating in EPZs creating the virtuous circle.

One of the key manners in which the circle was initiated was the increasing requirement of locally sourced inputs as a condition of remining in the EPZ.

Failure to develop linkages contributes to a disarticulated economy; the EPZ provides cheap labor and an attractive investment climate for the export platform.

Vertically integrated TNCs and development prospects

The image shows an EPZ circuit of capital.

The production process is initiated outside the country in which the export subsidiary is located. Money capital ($M$) is used to purchase produced means of production and raw materials ($MP$) and labor ($L$), for the first stage of production ($P_1$). From this comes a partially transformed output or new means of production ($C'$) with a value as yet unsold or “unrealized” greater than the initial outlay, $M$. With the completion of the first stage of production, $C'$ is shipped by the TNC to its export subsidiary in the small, export-platform economy. There the semi-processed product is combined in the local production process ($P_2$) with unskilled, cheap labor. Now, the subsidiary of the TNC produces final or partially assembled commodities, $C''$, which are then re-exported. Their value is realized, and the profit from production is accumulated not in the country where the EPZ is located, but elsewhere within the international structure of the TNC. Production ($P = P_1 + P_2$) and realization take place only on an international scale, in which many individual subsidiaries of a TNC in widely scattered locations ultimately may participate. $C'' > C' > C$ and $M' > M$, where the difference $M' - M = S$, is the level of gross profit.

This process can create the illusion of development and/or industrialization. Production $P_2$ will almost always raise the host nations GDP. However, the production process is not location specific and can be easily moved to a different nation with a more attractive environment.
Bargaining with the TNCs

Economic progress can be achieved through a selective and constructive interaction with TNCs. Leverage to negotiate with TNCs is enhanced if the nation has a strong domestic market; moreover, the dispersion of power resulting from the decline in US TNC dominance has facilitated some nations achieving better terms of engagement.

Conclusion

The ability to capture gains from FDI and through interaction with TNCs requires active engagement and dynamic policies from a developmental state.

References


