

Outline: Multinational Corporations

- Economic and political importance of MNCs
 - Number and size
 - Conflict with National Sovereignty?
- Why do MNCs exist?
 - Locational Advantages
 - Market Imperfections
- Politics of MNCs
 - Developing countries
 - Developed countries
- Explaining regulations on MNCs
 - “Obsolescing Bargain” argument
- Hot issue: “Offshoring” of service sector jobs

Importance of MNCs

- In 2000, world's largest 500 MNCs had sales of \$13.7 trillion--nearly half the value of all goods and services produced in the world
- Largest MNCs have revenues greater than the GDP of all but about 20 nations
- MNCs are also important in int'l trade
 - About 1/3 of all world trade is between branches of MNCs located in different countries; this is known as “intrafirm” trade.

Economic Size (assets to GDP)

1	United States	\$10,171.4	27	Norway	\$165.5
2	Japan	\$4,245.2	<u>28</u>	<u>Ford</u>	<u>\$164.2</u>
3	Germany	\$1,873.9	29	Denmark	\$162.8
4	United Kingdom	\$1,406.3	<u>30</u>	<u>Daimler Chrysler</u>	<u>\$157.1</u>
5	France	\$1,302.8	31	Turkey	\$147.6
6	China	\$1,159.0	32	Indonesia	\$145.3
7	Italy	\$1,090.9	<u>33</u>	<u>Toyota</u>	<u>\$135.8</u>
8	Canada	\$677.2	<u>34</u>	<u>General Electric</u>	<u>\$134.2</u>
9	Mexico	\$617.8	<u>35</u>	<u>Royal Dutch Shell</u>	<u>\$133.5</u>
10	Spain	\$577.5	<u>36</u>	<u>Total</u>	<u>\$131.6</u>
11	Brazil	\$502.5	37	Venezuela, RB	\$124.9
12	India	\$477.6	38	Finland	\$122.0
13	Korea, Rep.	\$422.2	39	Iran, Islamic Rep.	\$118.9
14	Netherlands	\$375.0	40	Greece	\$116.3
15	Australia	\$368.6	41	Thailand	\$114.8
16	Russian Federation	\$310.0	42	South Africa	\$113.3
17	Argentina	\$268.8	<u>43</u>	<u>Mitsubishi</u>	<u>\$112.7</u>
<u>18</u>	<u>Wal-Mart</u>	<u>\$256.3</u>	<u>44</u>	<u>Mitsui</u>	<u>\$112.0</u>
19	Switzerland	\$247.4	<u>45</u>	<u>Chevron Texaco</u>	<u>\$112.9</u>
<u>20</u>	<u>British Petroleum</u>	<u>\$232.5</u>	46	Portugal	\$108.5
21	Belgium	\$227.6	47	Ireland	\$101.2
<u>22</u>	<u>Exxon-Mobil</u>	<u>\$222.8</u>	48	Egypt, Arab Rep.	\$97.5
23	Sweden	\$210.1	<u>49</u>	<u>Allianz</u>	<u>\$97.1</u>
<u>24</u>	<u>General Motors</u>	<u>\$185.5</u>			
25	Austria	\$188.7			
26	Poland	\$174.6			

MNCs and National Sovereignty

- Sheer size of MNCs creates potential problems for national governments on a range of issues:
 - location of production, jobs, technology, managerial expertise
- Tension arises because goals of MNCs may conflict with the goals of governments

Definitions

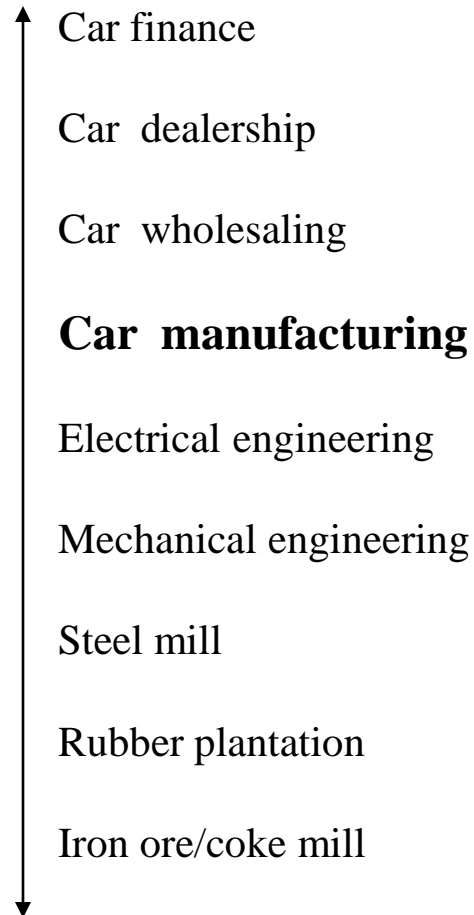
- Multinational corporation (MNC): firm that owns and manages productive facilities in 2 or more countries
- Foreign direct investment (FDI): ownership of productive assets by foreign residents for purposes of controlling uses of those assets.
 - Control distinguishes FDI from “portfolio investment” (bank loans or bond lending).
- Summary: MNCs engage in FDI

Two Types of FDI

- Horizontal FDI: when a MNC produces the same product in multiple countries
 - Example: Coca Cola is made in over 200 countries; 70% of its revenues are overseas
- Vertical FDI: when a MNC owns and controls different stages of a worldwide production process
 - E.g. oil company that owns everything from crude oil field wells, to transportation pipelines, to refining firms, to storage and distribution facilities, to retail gasoline stations.

Vertical Integration of a Multinational Car Company

Forward integration



Backward integration

Economics of FDI

- Why do MNCs exist? Answer is not obvious since there are alternative ways to enter foreign markets:
 - export from home
 - license production to a local firm
- Suppose you are firm owner. Which would you choose: export, license, or FDI?
 - To choose FDI, there must be both a “locational advantage” and a “market imperfection.”

Locational Advantages

- Natural Resource Investments
 - Raw materials are spread unevenly around the world. MNCs may need to locate abroad to obtain them
- Market Oriented Investments
 - Nations with large consumer markets are attractive to MNCs
- Efficiency Oriented Investments
 - MNCs “outsource” portions of the production process to different nations based on different factor prices (e.g, low labor costs)
- But Locational Advantages are not enough to explain FDI! (firms could license)

Market Imperfections

- Market imperfections exist when the price mechanism fails to yield mutually beneficial transactions
- One type of imperfection involves “Intangible Assets” (“knowledge” assets that are difficult to price)
 - e.g managerial skills, knowledge about production processes, reputation
 - intangible assets are quite valuable but hard for firms to protect: once out there, they can be had by any competitor at no cost

Intangible Assets

- Why MNCs? MNCs exist to control and protect the intangible assets that give them a competitive edge.
 - MNCs engage in FDI to maintain intangible assets within the firm, where they can control them
- Very common in auto production, where FDI is explained by the combination of:
 - intangible assets (knowledge about production process)
 - locational advantages (large markets or access to low cost labor)

Specific Assets

- A second market imperfection involves “specific assets”
- Specific assets are physical and human investments that are specialized and unique to a task
 - e.g, the production of a certain component may require investment in specialized equipment, or the distribution of a certain product may necessitate unique physical facilities
- In short, specific assets are investments that are dedicated to a particular use

Specific Assets (cont)

- Specific assets create incentives for vertical integration because it is difficult to write and enforce long term contracts because of the “hold-up” problem.
 - Firms that are dependent on a single supplier for an input worry that the supplier could try to “hold-up” the firm. To avoid this possibility, the firm simply buys up the supplier and “internalizes” the transaction within the firm. (e.g., GM-Fisher Body).
- Vertical FDI occurs when specific assets combine with locational advantages (e.g. oil industry)

Politics of FDI in Developing Countries

- Historically, LDCs have been more concerned with MNCs than developed countries
 - but that is now changing due to offshoring
- Legacy of Colonialism makes them wary
 - Concern about foreign domination
- Development strategies (ISI) created tensions with MNCs (over use of profits, investments, technology, hiring of locals, etc)
- Result was greater degree of regulation

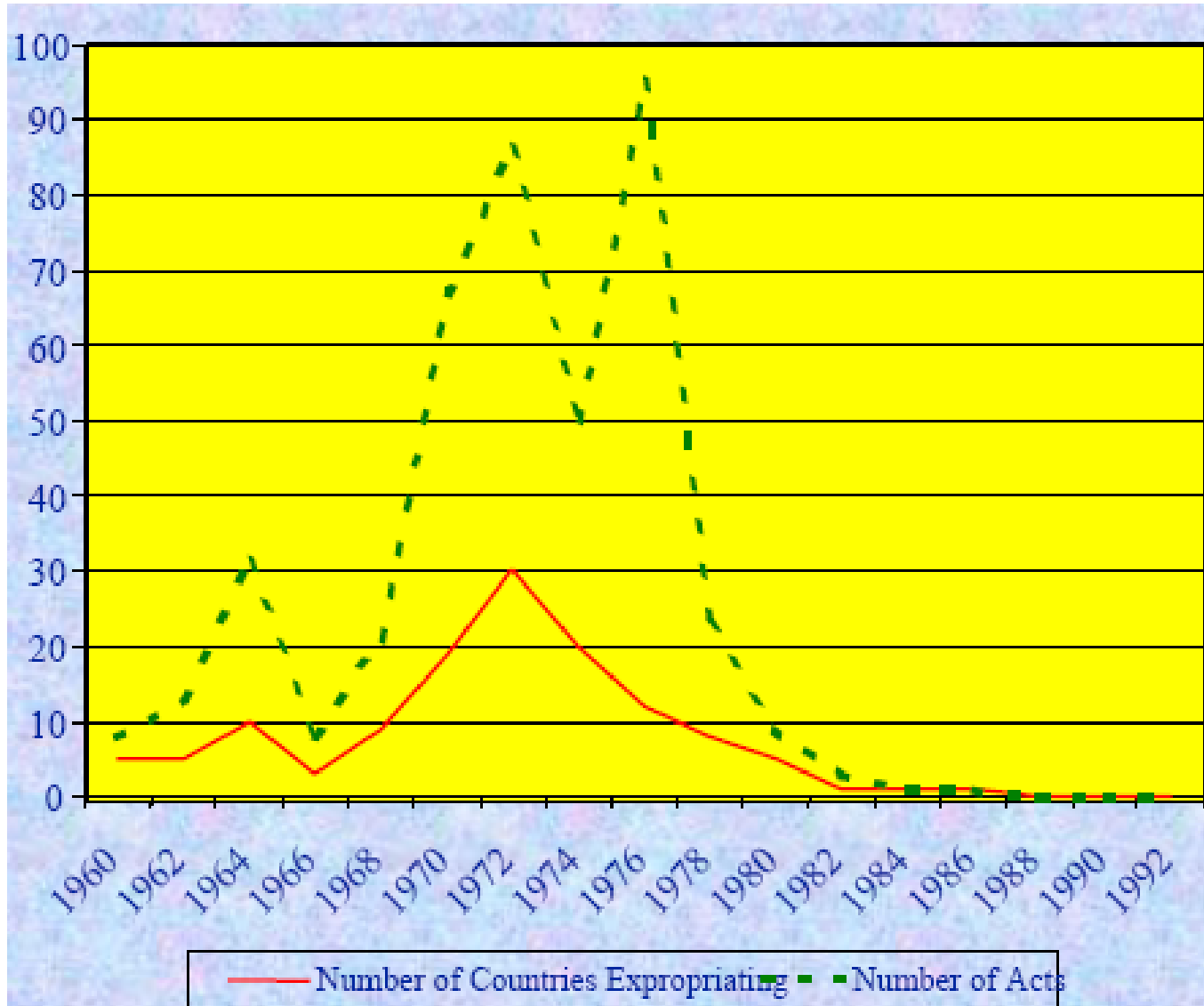
Types of Regulations on MNCs

- export performance requirements
- restrictions on profit repatriation
- technology transfer requirements
- employment requirements
 - MNC must hire certain number of locals
- local content requirements
 - MNCs required to buy inputs from local firms
- ownership restrictions (foreigners allowed to own only so much—e.g. 49%)
- In the limit, expropriation

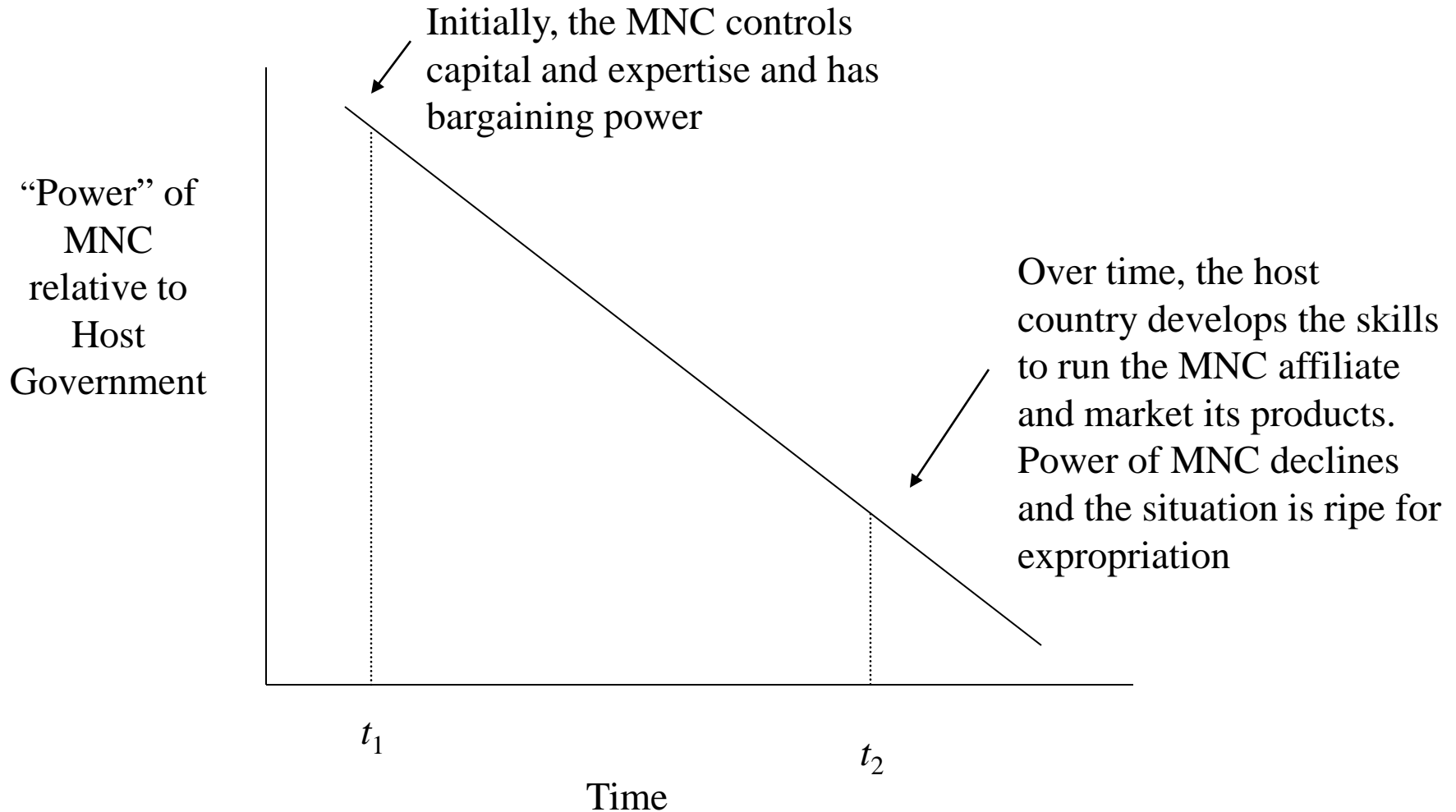
Expropriations by Host Governments

- Expropriations peaked in the mid-1970s.
 - Extractive and raw materials industries (e.g. oil, minerals) were the most vulnerable.
- Since then, problem has almost disappeared.
- Why? “Obsolescing Bargain” posits a negative relationship between MNC “power” over host governments and time
- Recent MNC investment is in manufacturing and services, is not as vulnerable to the “obsolescing bargain.” Hence expropriation unlikely in these industries

Expropriation Acts by Year, 1960-1992



The Obsolescing Bargain



Politics in Developed Countries

- Rich countries are less worried about FDI
 - Not as dependent on FDI, so less concern with sovereignty
 - Less vulnerable to foreign domination
- Policy stance is “neutrality” (regulations should not be biased in favor or against FDI)
 - Neutrality is obtained by way of two principles:
 - right of establishment
 - national treatment
 - An important exception is national security...

National security regulation of FDI

- United States:
 - Committee on Foreign Investment in the United States (CFIUS, 1975)
 - The Fairchild-Fujitsu Example (1987)
 - Obvious xenophobia
 - Exon-Florio amendment (1988)
- Decline of Japanese FDI in the US has left Exon-Florio a dead letter

Developed Countries *encourage* inward FDI

- To encourage FDI, rich countries (as well as states and localities within countries) offer MNCs generous incentives:
 - subsidies, tax breaks, infrastructure, land purchases etc.
 - U.S. States have engaged in bidding wars to court foreign investors
 - Mercedes in Alabama, BMW in S. Carolina

Off Shoring of Services

- Until recently, off shoring involved sending manufacturing jobs overseas, to take advantage of lower labor costs
- Now, information and communications technology (internet, video conferencing, etc) has made it possible to deliver a wide array of services from afar:
 - low-skilled services like call centers, transcription and telemarketing.
 - high-skilled services such as programming, accounting, radiology, architecture, and engineering

Off Shoring of Services

- Entry of 1.5 billion “new” workers into the world economy (China, India, Russia) means that there are plenty of people willing to provide services from afar...and not all are low skilled!
 - Even a small fraction of 1.5 billion is a big number, if you are an American working in the service sector
- Phone call centers in Bangalore already serve millions of customers in the United States
- Medical x-rays are now transmitted digitally from hospitals in the U.S. to be analyzed by radiology labs in Bombay
- There is deep anxiety in the U.S. about all this job loss

Politics of Off Shoring

- In 2006, polls showed deep concern for globalization – 80% said offshoring hurts American workers
- Conversely, most economists would say that U.S. economy is enriched by offshoring
 - Greg Mankiw (Council of Economic Advisors): offshoring “is just the new way of doing international trade” which makes it a “good thing.”
- But some economists (e.g Alan Blinder) have expressed concern about the distributional implications of offshoring

Winners and Losers from OffShoring

- Winners in the U.S. are capital owners who substitute cheaper foreign labor in the service sector for domestic labor. U.S. consumers gain from the decline in prices
- Losers are U.S. workers who experience falling wages and increasing job insecurity due to export of jobs overseas
 - Even high-skilled white collar jobs are threatened
- Evidence: workers in industries exposed to higher levels of offshoring are far more likely to feel job insecurity and to favor restrictions on offshoring

What can be done about it?

- Recall that 19th century globalization sowed the seeds of its own destruction due to a political and policy backlash (Williamson)
- Outsourcing of white collar jobs has the potential for creating such a backlash today
 - With 30-40 million US jobs potentially offshorable, the political reaction could be fierce (Blinder, 2007)
 - Law, medicine, accounting--which have never been exposed to much global competition--now face outsourcing. With powerful lobbies, they could initiate a backlash.

What can be done about it?

- Trade protection won't work
 - can't stop bits of data from flowing in/out of the country
- US should reemphasize training in comparatively advantage skills:
 - more science and engineering
 - more spending on R&D
 - keeping capital markets vibrant as a source of funding for innovations