Multinational Corporations and Sovereignty

- **Preliminary observations**
  - MNCs are important players in int'l economic affairs. Largest MNCs have worldwide operations and revenues greater than the GDP of all but about 20 nations (Table 1)
  - MNCs are also very important in int'l trade. About 1/3 of world trade is between subsidiaries of MNCs located in different countries - "intrafirm" trade.
  - <u>Sovereignty issue</u>: sheer size of MNCs creates potential problems for national governments on a range of issues – location of production, jobs, technology and managerial expertise.
  - Tension arises because goals of MNCs may conflict with the goals of governments.

Definitions and Trends

- **Definitions**
  - Foreign direct investment (FDI) is 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).
  - A multinational corporation (MNC) is a firm that owns and manages productive facilities in 3 or more countries. MNCs engage in FDI.
- **Trends**
  - America's leading firms are deeply involved in FDI. The largest U.S. companies are MNCs.
  - The U.S. is by far the largest home country of MNCs as well as the largest host country to foreign MNCs (Figure 1)

Economics of FDI

- **Why do MNCs exist?**
  - Answer is not obvious since there are alternative ways to enter foreign markets (<u>export</u> goods from home or <u>license</u> production to a local firm) that are seemingly more efficient than FDI.
  - Many factors involved - FDI theory is amorphous.
  - Discuss 4 "levels":

1. Product Level (Raymond Vernon)

- Product Cycle Theory

2. Firm Level (Richard Caves)

- MNCs just a special case of the <u>theory of the firm</u>
- Some firms possess <u>intangible assets</u> that have the characteristics of public goods. Such valuable but difficult-to-price intangibles include brand names, managerial skills, and production techniques.

Economics of FDI (cont.)

2. Firm Level (cont.)

- Intangible assets are like public goods because once available, they can be had by anyone at no cost (nonexcluable). MNCs exist to control intangible assets that give them an edge over local producers.
- MNCs may also exist to limit the possibility of opportunism. Firms that are very 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).
- Firm-level arguments useful in explaining why firms don't license but not why they don't export.

Economics of FDI (cont.)

3. Home country level

- resource endowments
- tax policy
- transfer pricing: prices paid for goods exchanged between affiliates of an MNC. MNCs manipulate transfer prices to transfer profits out of high tax countries to low tax countries and thereby avoid taxes. Manipulation is possible because intangible assets don't have a market price.

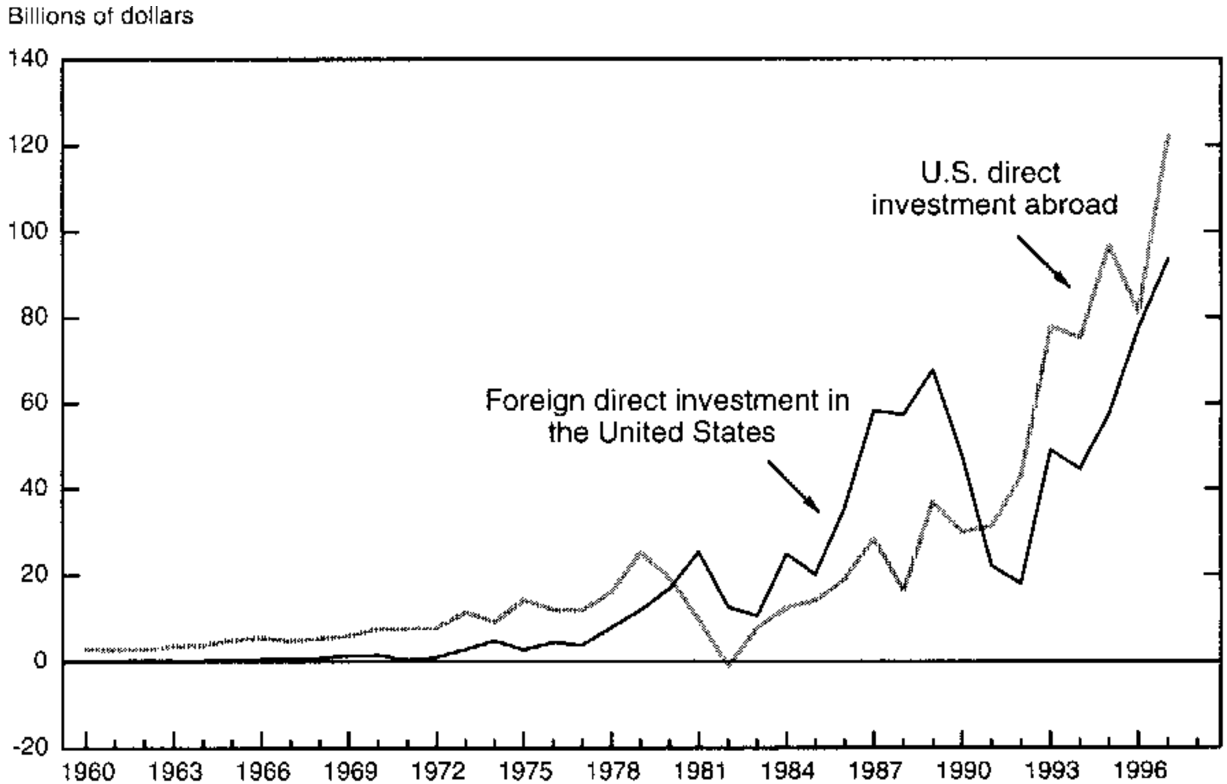
4. **Host country level**

- Tariffs and trade barriers
- Government investment policies
- Exchange rate policy

Table 1: Largest Countries (ranked by GDP) and Largest MNCs (ranked by sales)

1	UNITED STATES	$4,847,310
2	JAPAN	2,843,710
3	GERMANY, FED. REP.	1,201,820
4	FRANCE	949,440
5	ITALY	828,850
6	UNITED KINGDOM	702,370
7	CANADA	435,860
8	CHINA	372,320
9	SPAIN	340,320
10	BRAZIL	323,610
11	AUSTRALIA	245,950
12	INDIA	237,930
13	NETHERLANDS	228,280
14	SWITZERLAND	184,830
15	MEXICO	176,700
16	KOREA, REP. OF	171,310
17	SWEDEN	159,880
18	BELGIUM	153,810
19	AUSTRIA	127,200
20	**GENERAL MOTORS**	**121,085**
21	**FORD MOTORS**	**92,445**
22	FINLAND	91,690
23	NORWAY	91,050
24	DENMARK	90,530
25	INDONESIA	83,220
26	**EXXON**	**79,557**
27	ARGENTINA	79,440
28	SOUTH AFRICA	78,970
29	**ROYAL DUTCH SHELL GROUP**	**78,381**
30	SAUDI ARABIA	72,620
31	TURKEY	64,360
32	VENEZUELA	63,750
33	YUGOSLAVIA	61,710
34	**INT. BUSINESS MACHINE**	**$59,681**
35	THAILAND	57,950
36	ALGERIA	51,900
37	**TOYOTA MOTORS**	**50,789**
38	**GENERAL ELECTRIC**	**49,414**
39	**MOBIL**	**48,198**
40	**BRITISH PETROLEUM**	**46,174**
41	**IRI**	**45,521**
42	ISRAEL	44,960
43	HONG KONG	44,830
44	**DAIMLER-BENZ**	**41,817**
45	PORTUGAL	41,700
46	**HITACHI**	**41,330**
47	GREECE	40,900
48	NEW ZEALAND	39,800
49	PHILIPPINES	39,210
50	COLUMBIA	39,070
51	**CHRYSLER**	**35,472**
52	MALAYSIA	34,680
53	EGYPT ARAB REP.	34,330
54	**SIEMENS**	**34,129**
55	PAKISTAN	34,050
56	**FIAT**	**34,039**
57	**MATSUSHITA ELECTRIC IND.**	**33,922**
58	**VOLKSWAGEN**	**33,696**
59	**TEXACO**	**33,544**
60	**E.I. DUPONT DE NEMOURS**	**32,514**
61	UNILEVER	30,488
62	NIGERIA	29,370
63	**NISSAN MOTORS**	**29,097**
64	PHILIP'S	28,370

Figure 3: FDI Inflows and Outflows, 1960-1997



Source: Department of Commerce (Bureau of Economic Analysis).

FDI involves the <u>control</u> of businesses or property across national borders.

Figure 1: Vertical Integration of a Multinational Car Company

Forward integration

Car finance

Car dealership

Car wholesaling

Car manufacturing

Electrical engineering

Mechanical engineering

Steel mill

Rubber plantation

Iron ore/coke mill

Backward integration

Figure 2: Transaction Costs and the Choice between Exporting, Licensing, and FDI