Transnational Corporations and Foreign Direct Investment

In Chapter 7 we discuss firms and how they are organized. We mention the growing importance of what are called *transnational corporations*—firms that have a physical presence in more than one country. Why is the growing number of such firms relevant in the modern economy, and how are they related to the international flows of knowledge and capital?

What Are TNCs?

Over the past half century the concept of a *national* economy has become less precise as firms have produced what they require in more than one country. Such firms used to be called *multinational corporations,* but the United Nations now officially calls them *transnational corporations* (TNCs). TNCs encourage global competition as well as the transfer of technological know-how among countries. Their number has been increasing steadily over the years. Although large firms still dominate the TNC scene, the role of medium-size and small TNCs is significant and growing.

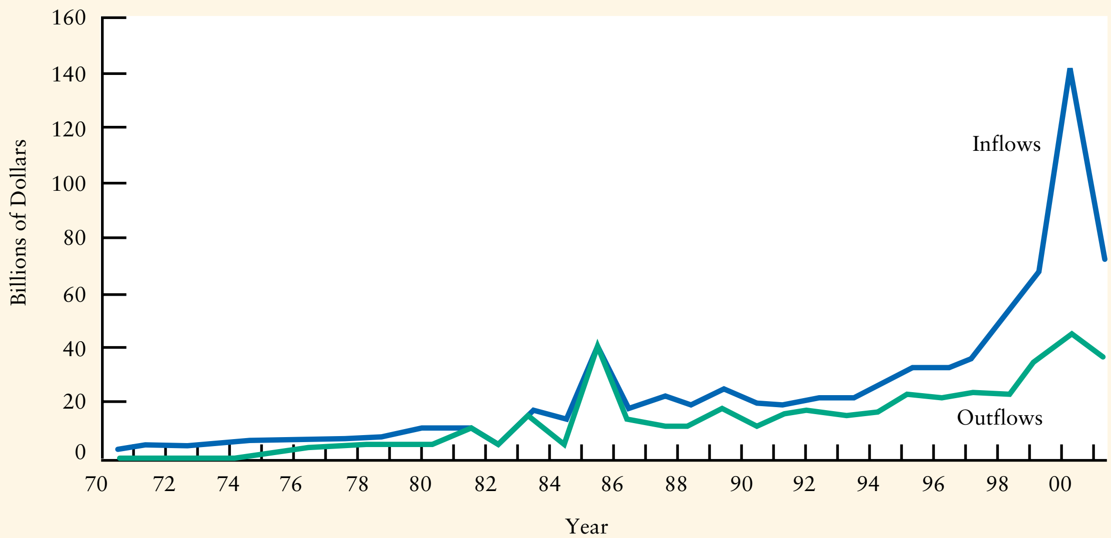
At the beginning of the 1990s there were about 37 000 TNCs in the world and they controlled about 170 000 foreign affiliates. Ninety percent of these TNCs are headquartered in developed countries; the five major home countries being France, Germany, Japan, the United Kingdom, and the United States. About 60 percent of all parent TNCs are in manufacturing, 37 percent are in services, and 3 percent are in primary production such as forestry and mining. Some of the largest TNCs with names you surely recognize include Wal-Mart, General Motors, Exxon, Royal Dutch Shell, Toyota, Mitsubishi, and General Electric.

TNCs and Foreign Direct Investment

The main way in which firms used to develop foreign operations was foreign direct investment (FDI), which means acquiring the controlling interest in foreign production facilities either by purchasing existing facilities or by building new ones. More recently, however, other methods have become more common. The most important of these are joint ventures with domestic firms located in countries where the TNCs wish to develop an interest, and licensing arrangements whereby a domestic firm produces a TNC's product locally.

Figure 1 shows the flows of FDI into and out of Canada from 1970 to 2001. For the first twenty years of that period, inflows and outflows grew gradually, from a few billion dollars in 1970 to about $20 billion in 1990. But then, partly due to the increased integration of the North American economies brought about by the Canada–U.S. Free-Trade Agreement (FTA) in 1989 and the North American Free-Trade Agreement (NAFTA) in 1994, Canadian FDI flows grew dramatically. By 2001, inflows of FDI to Canada exceeded $80 billion and Canadian outward FDI was just under $40 billion.

FIGURE 1 Canadian Inward and Outward Flows of Foreign Direct Investment



Canadian FDI has grown substantially over the past three decades. The data shown here are the annual gross inward flow of foreign direct investment (foreigners' investment in Canada) and the annual gross outward flow of foreign direct investment from Canada (Canadians' investment abroad). After the early 1990s, both flows increased dramatically.

(*Source:* Adapted from Statistics Canada, CANSIM database. Inflows: series D58979; outflows: series D58982.)

Why Do Firms Become TNCs?

There are many reasons for a company to transfer some of its production beyond its home base (thus becoming a TNC) rather than producing everything at home and then exporting the output. First, products become more sophisticated and differentiated; locating production in large local markets allows more flexible responses to local needs than can be achieved through centralized production back home. Second, trade barriers make location in large foreign markets, such as the United States and the European Union, less risky than sending exports from the home base. Third, many TNCs are in the rapidly developing service industries such as advertising, marketing, public management, accounting, law, and financial services, where a physical presence is needed to produce a service in any country. Fourth, the computer and communications revolutions have allowed production to be "disintegrated" on a global basis. Components of any one product are often manufactured in many countries, each component being made where its production is cheapest.

Problems with TNCs?

Other reasons for a transnational corporation to locate production away from its home base have led some observers to be critical of TNCs. First, the TNC's internal accounting practices may allow it to report most of its revenues in low-tax countries and most of its costs in high-tax countries, thereby reducing the total tax it pays and avoiding altogether the paying of tax in some countries. Second, the TNC may threaten to remove its production away from its home base in an attempt to secure "friendly" tax policies from the government of that country. Third, the TNC may relocate its production in order to produce in countries with less stringent environmental or labour standards.

On balance, however, most economists believe that the globalization of production—much of which has occurred through the spread of TNCs—has brought benefits to most countries. This includes developing countries, which have gained increasing employment at wages that are low by world standards but high by their own. TNCs now account for a large proportion of the foreign trade of many developed countries. As the United Nations puts it, "This dynamic aspect of the growth of TNCs is one of the major channels by which economic change is spread throughout the world."