REVIEW ARTICLE

Interdependence and integration of the world economy: the role of States and firms

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Interdependence and *integration* are commonly used expressions in the discussion of world economic issues emanating from both the academic community and international organizations. An important issue in these discussions is the role of States and firms in shaping world economic relations. For example, a recently published book entitled *Rival States, Rival Firms: Competition for World Market Shares*, authored by John Stopford, professor of international business at the London Business School, and Susan Strange, professor of international relations at the European University Institute (with John S. Henley), states that "Growing interdependence now means that the rivalry between States and the rivalry between firms for a secure place in the world has become fiercer. As a result, governments have come to recognize their increased dependence on the scarce resources controlled by firms." (Stopford and Strange, 1991, p. 1). The first sentence of a recent publication by the Transnational Corporations and Management Division (TCMD) of the United Nations Department of Economic and Social Development (the successor to the United Nations Centre on Transnational Corporations), entitled *World Investment Report 1992: Transnational Corporations as Engines of Growth* reads: "Transnational corporations have become central organizers of economic activities in an increasingly integrated world economy" (TCMD, 1992, p. 1). The present article reviews these two publications.

It is useful to begin by drawing a few conceptual distinctions. International *interdependence* should be distinguished from *integration*, and from international *relations*, none of which, in turn, is the same as *common* or *mutual interests*. Integration implies behaviour on the part of separate countries and their citizens as if they were a single country. Integration can be defined without value premises. If it is so defined and if the omitted value premise is that all members of the integrated area should be treated as equals with respect to achievements, as well as opportunities (that is, they should

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not only have equal access to the law, as well as to trade, capital flows and migration, but should also be subject to a system of progressive taxation and enjoy social services and other benefits of the modern welfare state), the world was more integrated in the nineteenth century than it is today. By imposing fewer objectives on government policy and by accepting what later, in retrospect, appeared to be irrational constraints (such as the gold standard, fixed exchange rates and balanced budgets), different countries were, unwittingly, integrated into a single world economy, dominated by a single power. Domestic policies were constrained by the need to adhere to fixed exchange rates. The main function of the Government was to maintain law and order, including the enforcement of contracts. Later, numerous objectives were added to the government agenda: the encouragement of some industries, full employment, economic growth, income distribution, price stability, regional balance and protection of the natural environment, among others. These additional objectives and the rejection of the old constraints on policy, such as fixed exchange rates and limits on the discretion of fiscal and monetary policy, led to a greater integration of national economies, but at the same time to the disintegration of the international economy.

Simultaneously, there has been an opposite force at work. As Stopford and Strange show in their masterly book, the emergence of a transnational business civilization — what Osvaldo Sunkel called the "transnational kernel" (Sunkel, 1973) — in which the social and political elites world-wide accept the same values, mores, customs and taboos, has led to partial international integration and with it to national disintegration. An egalitarian incomes policy becomes impossible if excessive emigration of professionals is to be avoided. Indigenous values are threatened by the propagation of cultural influences from the global elite.

The international disintegration that results from national integration mentioned above is, however, entirely consistent with a high and growing degree of interdependence. Interdependence exists when one country by unilateral action can inflict substantial harm on another country, and this other country, in turn, can inflict harm on the first country. Arms races, competitive protectionism, competitive devaluations to maintain exports and domestic employment, competitive deflations to correct balance-of-payment deficits, the international spread of inflation, technology and investment wars, or global pollution of the air and oceans are such examples. A nuclear war would be the ultimate form of international interdependence resulting from international disintegration.

Interdependence is measured by the costs of severing a relationship. The higher the costs to one partner, the greater the degree of dependence of that partner. If a small country benefits more from the international division of labour, and would lose more from its cessation, its dependence is greater. If high costs were to be incurred by both partners to a transaction, there would be interdependence. Stopford and Strange quite rightly dismiss the concept of *dependency* as unhelpful in explaining the situation in developing countries.

It is quite possible to have intensive and rapidly growing international *relations* without a high degree of interdependence, if the relations can be abandoned at low costs. The benefits from trade, for example, should be measured not by the volume or value of trade or their rate of growth (as they commonly are), but by the producers' and consumers' surpluses. Most trade is conducted in slightly differentiated consumer goods, which could easily be replaced by domestic production at not greatly increased costs without great loss to consumers.[1] On the other hand, a small and slowly growing volume or value of trade can be of great importance, and can lead to substantial losses if cut out. Manganese, tin and chromium imports into the United States would be such examples.

Sometimes the concept *interdependence* is used in a different sense, according to which dependence means only "influenced by", without great benefits from maintaining, or costs from severing, the relationship. In this attenuated sense, there can be interdependence, even though the costs of severing it are low or even negative. But this is not the sense in which the concept is used here.

Occasionally *mutual interests* are confused with interdependence. Yet, mutual interests can exist without any interdependence. Two countries may be wholly autarkic in their trade policies and, therefore, completely independent of one another, yet it may be in their mutual interest to engage in foreign trade or capital flows with each other. While interests can refer to potential relations, interdependence is always actual.

Mutual interests are sometimes confused with *common interests*. Mutual interests imply that actions on the part of one agent are reciprocated by different actions on the part of the other agent. An example is barter or money trade. Common interests refer to shared areas of interest, such as the

[1] There may even be an excess of international trade beyond the optimum indicated by trade theory because of cross-hauling at prices below total unit costs for foreign sales. Automobiles would be an example.

preservation of the stock of fish in the sea, trees in the forests, clean air, a stable monetary system, free access to markets, or peace. Mutual interests apply to transactions in private goods; common interests to public goods.

The cross fertilization between the theories of industrial organization, international trade and global political economy have yielded fruitful and illuminating results. Such cross fertilization bore its early fruits in the work of Stephen Hymer (1976), when two branches of economics, namely, industrial organization and international trade, were married and produced for the first time a convincing rationale for transnational investment in manufacturing industries. Stopford and Strange carry this cross fertilization forward and marry politics and economics. Their book deals with the complex network of interdependence among and between companies and States. They bring the logical standards of economics to politics and international relations and the political and historical standards of empirical investigation to economics. The book is pioneering, undogmatic and full of important insights and common sense, useful to both firms and Governments. There are no major generalizations but, by disaggregating, the authors throw new light on many problems. By lowering the level of generality, they raise the level of realistic analysis. The policies of three very different host Governments are explored in depth: Brazil, Malaysia and Kenya. The following paragraph conveys the spirit of the book:

> "Why bargaining theory helps so little should be clear enough from our evidence. A state has objectives that are multiple, often conflicting, always shifting. It cannot in reality be a rational actor in the game-theory sense of having a fixed order of priorities in its policy goals. It always wants incompatible, conflicting values. It wants to be efficient and competitive *and* to preserve social peace and the cohesion of the state with society. It wants autonomy and the freedom to choose its own path to economic development *and* access to advanced technology and overseas markets. It is playing a trade-off game in which the variables are never constant" (p. 135).

Among the premises advanced, two impinge directly on the role of States and firms. The first is that the primary influences on the behaviour of firms and States are found in the international political economy. They have limited the independent options of States. The second is that there are growing interactions between national strategies designed to achieve social and economic objectives and global strategies of firms.

The first premise, which amounts to saying that interdependence has grown, can be subdivided along the lines indicated by R. N. Cooper into five distinct effects: the trampoline effect, the ricochet effect, the erosion of policies, the transformation of policies and the interdependence of government policies (Cooper, 1986). The trampoline effect derives from the analogy that a major impact in one place has a consequential, though smaller, impact on other places. The ricochet or boomerang effect means that intended targets of policies are not hit, and the initiator is frustrated. Restrictions of United States grain sales to the former Soviet Union led the latter to substitute purchases of grain from Argentina. Chile, Italy, Japan, Peru and Spain, no longer able to buy from Argentina, shifted their purchases to the United States.

The erosion of policies means that instruments of economic control, such as fiscal and monetary policies, are much less effective because the results spill over into foreign countries; monetary restrictions have little effect if transnational corporations (TNCs) can readily draw on capital from abroad. The transformation of policies means that the consequences have changed: higher interest rates in the United States no longer mean that mainly domestic investment in housing is reduced, but they attract an inflow of capital and cause an appreciation of the dollar and higher unemployment because of reduced exports. And the interdependence of policies means that the channels of interdependence have changed from the multiplier effects to induced changes in government policies. The important economies have to keep more or less in step. When the United States raises its interest rates, others, wishing to avoid capital outflows, have to follow suit sooner or later and vice versa.

The second premise can be summed up by saying that interactions between firms and States (like those within the family) are in the nature of cooperative conflict, or conflictual cooperation.

> "There is complementarity of interest when the state can secure the location and the firm can establish the control. There is conflict when the firm decides that it prefers another location (and can overcome the exit barriers) or when the state seeks to restrict how the firm exercises its control" (p. 212).

The authors are quite critical of Michael E. Porter's much-acclaimed *The Competitive Advantage of Nations* (Porter, 1990). "Michael Porter's analysis provides only a point of departure for many of the lines of argument advanced here" (p. 8); one might add to their several criticisms of Porter's book (including the complaint that it neglects entrepreneurship and investment and that it fails to examine the interaction of competitiveness of local firms and government policy and the influences of global production on Governments, crucial for many developing countries) that it does not analyse why competitive advantage takes the form of foreign direct investment (FDI), rather than other forms, such as exporting or licensing.

There is a useful list of advice to firms and to Governments. One would have liked to see an additional section of advice to multilateral and bilateral development agencies. Technical assistance in negotiating contracts and training local officials in negotiating skills can be given only by multilateral organizations, for bilateral agencies consider TNCs as their citizens. The Commonwealth Secretariat, the World Bank and the United Nations have been doing a little of this. Another unexplored area is the design of hybrid organizations, such as the British Commonwealth Development Corporation, that combine the initiative and enterprise of the private sector with public accountability and a concern for maximizing development rather than profits, although they must cover their costs.

The authors mention, but do not discuss in any detail, the role of the civil society — churches, trade unions, political parties, professional organizations, action groups, women's organizations — that can exercise pressure on both Governments and firms. This has both national and international dimensions. Finally, there is the familial society — the family, the clan, the tribe — particularly important in some low-income countries, that can be both an aid (as a source of capital in Chinese culture) and an obstacle (as a drain on earnings in some African countries) to the growth of local firms.

The authors favour outward-looking government policies. But there are problems with this concept. Much development is concerned (as the Kenyan flower industry example in the book) with replacing imported inputs by domestic inputs for products that are re-exported. This can be regarded as outward-looking, because the value added in exports is increased. But it can also be regarded as inward-looking, because import-substitution has increased. Sometimes the same industry begins with being an import-substituter for the domestic market (often under protection) and ends up being a highly successful exporter, like Volkswagen Brazil. Another difficulty with outward-looking is that it is too aggregative. In a world that shows signs of splitting into blocs and in which different markets grow at different rates, the direction of the orientation is very important. There are also other difficulties with that concept and it may, indeed, be better to abandon it. Of course, if outward-looking is defined, as it sometimes is, as "market-friendly" and inward-looking as "market-hostile", nobody can quarrel with the recommendation.

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The Transnational Corporations and Management Division has published its second annual report, the *World Investment Report 1992: Transnational Corporations as Engines of Growth* (TCMD, 1992).[2] It provides a wealth of material, a survey of the state of knowledge in this area and some useful analysis of interactions between policies adopted by States and activities of these firms.

The *Report* consists of three parts. Part One, on recent trends. presents global, regional and national trends in FDI, a chapter on the importance of TNCs in the world economy and in host countries and a chapter on recent developments in policy. Part Two is headed "Transnational corporations and growth in developing countries". After setting out an analytical framework based on growth accounting, it discusses the contribution of TNCs to capital formation, technology, human resource development, international trade and environmental quality. The final chapter in this part contains a particularly interesting discussion of the newly emerging global system of production. Part Three is about the implications for policy and ends with "A look to the future". The annex contains a list of tables.

The emphasis of the *Report* is on the role of TNCs in the economic growth of developing countries. Although developing countries receive less than one fifth of total investment flows, they depend heavily on TNCs for investment, technologies (including environmentally sound ones), training and human resource development, market access and other stimuli to growth. It is the combination of these contributions that often constitutes the specific merit of these firms.

Growth is the ratio of investment to national income divided by the incremental capital-output ratio. In the past, more attention has been paid to the former, but more recently the emphasis has shifted to the latter. Even

[2] The first report, *World Investment Report 1991: The Triad in Foreign Direct Investment*, published by the United Nations Centre on Transnational Corporations (UNCTC, 1991), documented the highly uneven distribution of FDI in the world. Three fourths of global investment flows occur between industrial countries and are concentrated in the Triad, comprising the United States, the European Community and Japan. Investment flows to developing countries are also highly concentrated.

more recently, models have been proposed that focus on the interdependence of the two ratios. New capital equipment has lower capital-output ratios and therefore higher investment accelerates growth both directly and indirectly, by lowering capital-output ratios. According to the *Report*, TNCs make a contribution to the investment ratio, but more important are the numerous ways in which they reduce the capital-output ratio, often through new types of capital goods (including improved and new products and foreign trade). The discussion of these ways, their linkages and the emphasis on technology and government policies, is very good. There is also an interesting chapter on the relationship between growth and the environment, showing compatibilities and conflicts.

Since the 1980s, FDI has grown rapidly, faster than world trade and world output. There are now about 35,000 TNCs with about 150,000 foreign affiliates. New developments include the greater role of the private sector and greater reliance on market forces; rapidly changing technologies and new technological breakthroughs that are transforming the nature of production and the location of firms; the globalization of firms and industries, with activities transcending national frontiers; higher awareness of the environmental impact of these activities; the growing importance of services, which have become the largest sector in the world economy; the growth of TNCs from developing countries; the tensions between trends towards the regionalization of markets and those towards their globalization; and dramatic changes in regimes and policies.

The technological revolutions in information, communications, transport and travel, with the correspondingly rapid growth of the flow across frontiers of goods, services and capital and, to a lesser extent, people, have shrunk the world and have (partially) integrated markets. Some have put much hope in the resulting growing efficiency of markets, others have expressed fears about the prospects of indigenous enterprises, the growing vulnerability and exposure to uncontrollable outside forces, or the increasing difficulty of national integration.

There is, however, an important difference between the past, in which the developing countries served the metropolitan powers, and the present. Raw materials and minerals, largely the result of physical endowments that yielded rents to a small group, used to play a much more important part than they do today, when acquired human skills and ingenuity and government policies are decisive. Comparative advantage can be destroyed and created and is no longer God-given. And, as the *Report* shows, TNCs make an important contribution to this creative destruction. The *Report* is, of course, aware that TNCs "can also transmit growth-inhibiting factors. For example, TNCs can act monopolistically within host economies, and production techniques introduced by TNCs can have negative environmental impacts" (p. 99). But the emphasis is on TNCs as engines of sustainable growth.

Much of the heat has gone out of the storm over TNCs. All developing countries now welcome FDI, even the most delinked ones, such as Albania and Myanmar. Relations between Governments of host countries and TNCs have moved from ideological heat to pragmatic light. In spite of Barlow Clowes, Blue Arrow, Guinness, Bank of Credit and Commerce International (BCCI) and Maxwell, we hear nowadays much less about the great scandals of TNCs. There used to be indignation over the illegal contributions to political parties, such as those of Gulf Oil in the Republic of Korea; over bribes to local officials, such as those of United Brands to General Oswaldo Lopez Arellano, the Chief of State in Honduras to reduce the banana export tax; over ITT's meddling in the Chilean election that attempted to prevent Allende's coming to power; over Lockheed's bribery of Prince Bernhard of the Netherlands that suggested that not only the poor accept bribes; over Nestlé's behaviour in the sale of baby formula, that led to the campaign "Nestlé kills babies", and over many others. The condemnation of the devil incorporate has been replaced by a feeling that, if what is good for General Motors may not be automatically good for humanity, at least the Ford Motor Company is the next best thing to the Ford Foundation. Transnational corporations are considered by many observers and by host countries today as wholly benign agents. Expropriation acts have dropped from a peak of 83 in 1975 to 1 in 1985; since then barely any nationalizations have taken place (p. 287).

There are, however, still critics. David C. Korten, for example, writes:

> "Today the most intense competition in the globally integrated market is not between gargantuan oligopolistic transnational corporations. It is between governments that find themselves competing with one another for investors by offering the cheapest and most compliant labour; the weakest environmental, health, and safety standards; the lowest taxes; and the most fully developed infrastructure. Often Governments must borrow to finance the social and physical infrastructure needed to attract private investors. Having pushed almost the entire social and environmental costs of production onto the community, many firms are able to turn a handsome profit. Having bargained away their tax base and

> accepted low wages for their labour, many communities reap relatively few benefits from the foreign investment, however, and are left with no evident way to repay the loans contracted on the firms' behalf" (Korten, 1991).

What some consider market-friendly others regard not necessarily as people-friendly.

Turning trade-related investment measures (TRIMs) on their head, the authors of the *Report* have an interesting discussion of investment-related trade measures (IRTMs).

> "The most obvious trade measure — one that has received considerable attention by researchers — is the imposition of *tariffs* or *quantitative restrictions on imports*. Both of those measures affect the volume of trade. If the market of the country imposing that trade restriction is considered to be of significant interest to foreign firms, they might seek to engage in foreign direct investment in order to maintain their participation in that market. Foreign direct investment in this case, known as tariff-jumping investment, is therefore a response to restrictions on trade" (p. 269).

It is frequently assumed that protection induces FDI instead of exports. But protection is neither a necessary nor a sufficient condition for FDI. It is not necessary, for foreign firms with a special advantage over local firms (goodwill attached to a brand name, proprietary knowledge resulting from research and development, patents, economies of scale or scope, legal monopoly or natural monopolistic access to inputs, ability to spread risks, reduced imperfections in the markets for intermediate goods etc.) will tend to invest in the absence of protection, if this seems better than exporting; and it is not sufficient, for unless a firm has an advantage, it will not invest, however tight the restrictions. Protection may, however, be a facilitating condition, determining, for example, the location of the investment, if the special advantage is present. The same argument applies to some of the other measures discussed under the heading IRTMs.

One could differ with the authors on the discussion of the taxation of TNCs.

> "If a Government abuses the use of taxes as a means of rent-snatching, it could induce TNCs to relocate their operations elsewhere. It is clear

> also that a Government cannot offer subsidies (incentives), on the one hand, and simultaneously try to capture a net rent via taxation, on the other" (pp. 278-279).

First, since rent is defined as the earnings to factors of production in excess of the minimum sum necessary to keep them in their existing use and location and prevent them moving to other uses or places, relocation could (by definition) not occur. It could be the case that while total supply is fixed, the supply to any particular country is highly elastic, so that the tax would fall on opportunity costs, and supply to the country would be reduced. The answer to relocation elsewhere is treaties with rival countries not to reduce taxes on factors in fixed total supply. Second, it is perfectly sensible for a Government to tax (genuine) rent, while simultaneously subsidizing (for example, some inputs or some outputs) that would lead to an expansion of the investment.

The authors of the *Report* see a great future for TNCs. "Transnational corporations may increasingly be viewed as networks, in which intra-firm flows of capital, goods, services, training and technology play an important role, and whose major value-adding function is the integration, organization and management of those international flows" (p. 301). The problem, however, is that this integrating function is only partial. Capital, technology and management are highly mobile internationally. Their elasticity of supply with respect to any given location is high, but the total elasticity of supply is low. Being in scarce total supply, they earn high rents. On the other hand, there is the "ground personnel", the large and rapidly growing unskilled and semi-skilled labour forces of the low-income countries. They are in highly elastic supply locally, but fairly immobile across frontiers. Their earnings are low. Global integration leaves them out in the cold. Many are bound to remain unemployed or underemployed. Having little else to assert, they become prone to assert their cultural autonomy and, in protest against modern technology, turn to religious fundamentalism. Unless globalized production finds ways of engaging these masses of poor people in productive and remunerative work, the outlook for global peace and prosperity is dim.

One challenge is to explore ways in which the large TNCs can be used to encourage efficient, labour-intensive sub-contractors, makers of spare parts, components and providers of ancillary services, which would mobilize the large human potential in the developing world; or in which smaller TNCs adapted to the needs of development can be used to activate the labour surpluses.

Another challenge is how to democratize the large TNCs. While the world has found unworkable and has rejected the centralized process of decision-making that the formerly centrally planned economies had adopted, this very same process still governs the relations between management and labour force within both capitalist and former socialist firms. Although there is now widespread agreement that economies do not work well if run from the top, a corporation is presumed to run best if it is. It is a challenge to people of all political convictions to find ways to harness the enterprise and initiative of the workers at the workplace. Experiments have been made with self-management, work enrichment, teamwork, participation, scaling-down, politicization of the workplace, self-supervision and the introduction of the free market into the plant. It is time to apply the lessons of these experiments. ■

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