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Contents

Foreign direct investment and local input linkages in Malaysia

Nigel Driffield and Abd Halim Mohd Noor*

This article examines variations in local input linkages in foreign transnational corporations in Malaysia. The extent to which transnational corporations foster such linkages, particularly in a developing host economy, has become an important issue for policy makers and others concerned with the long-term benefits associated with foreign direct investment. This article employs a unique data set, covering inward investors in the electrical and electronics industry, and analyzes in detail the determinants of variations in local input uses. The article develops a model of local input linkages, based on a transaction-cost framework using firm-specific factors, such as nationality of ownership, the age of the plant and its technology, and the extent to which firms employ locally recruited managers and engineers. In addition, the impacts of various policy measures on local input levels are discussed, and also the importance of the original motivation for investing in Malaysia. The article demonstrates that policy initiatives that target particular outcomes, such as stimulating exports or technology transfer, will result in a greater beneficial impact on the host country economy than more generic subsidies.

Introduction

The question of whether transnational corporations (TNCs) are more or less committed to a particular country or region is one that has been examined on numerous occasions and in numerous ways, following John Stewart (1976), Patrick O'Farrell and Brian

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O'Loughlin (1981), Philip McDermott (1979) and Dermot McAleese and Michael Counahan (1979). This issue has become particularly pertinent to the economies of South-East Asia, given the recent economic downturn throughout the region. This article examines this issue with respect to local input linkages in the Malaysian electronics and electrical industry, using detailed firm-specific information on inward investors. The article will begin with a discussion of inward investment into the electrical and electronics industry of Malaysia, while the next section discusses issues concerning TNC-host linkages. Then the article describes and analyzes the data used. The following two sections develop an econometric model of local input usage, and present the results, while the last section includes conclusions and policy implications.

On initial inspection, there are several reasons for believing that inward investors in Malaysia may foster only weak local linkages. Low labour costs and a range of investment incentives (such as generous export subsidies and tax and re-investment allowances) have in general motivated inward investment in Malaysia. This suggests that foreign direct investment (FDI) is motivated by ownership advantages generated at home, and location advantages in the form of subsidies. Shigie Makino and Andrew Delios (1996) show that, in such cases, linkages with host country firms will be weak. This is similar to the result reported by Stewart (1976).

The concept of studying linkages to examine the stability of inward investment, and also its contribution to local development, has been understood for some time, following Albert Hirschman (1958). The greater the linkage between inward investors and local firms, the greater the gain to the local sector, through the transfer of technology and other knowledge. Equally important, however, such linkages provide evidence that TNCs have incurred significant sunk costs associated with an investment. Such linkages are therefore indicative of TNCs being less likely to be merely short-term investors. From this perspective, it is then important to understand the determinants of the strength of local linkages, in order to evaluate the likely future evolution of the foreign affiliates, and also of host country industry. Ivan Turok (1993), for example, described a process in which TNCs seek to avoid local linkages in order to minimize costs. Within this framework, the essential concern for host countries

is that TNCs and their affiliates become embedded in the local economy to maximize the gains for the host countries concerned.

Inward investment into the electrical and electronics industry of Malaysia

The electrical and electronics industry[1] is the main manufacturing industry in Malaysia, in terms of output, export earnings and employment. In 1995, the industry employed 345,000 people, or 16.8 per cent of total manufacturing employment. In 1996, electrical and electronics exports contributed 56.0 per cent of the nation's total exports (Malaysia, Ministry of Finance, 1996, p. 140). Output growth in this industry was 32.6 per cent for 1993, and 16.9 per cent for 1992.

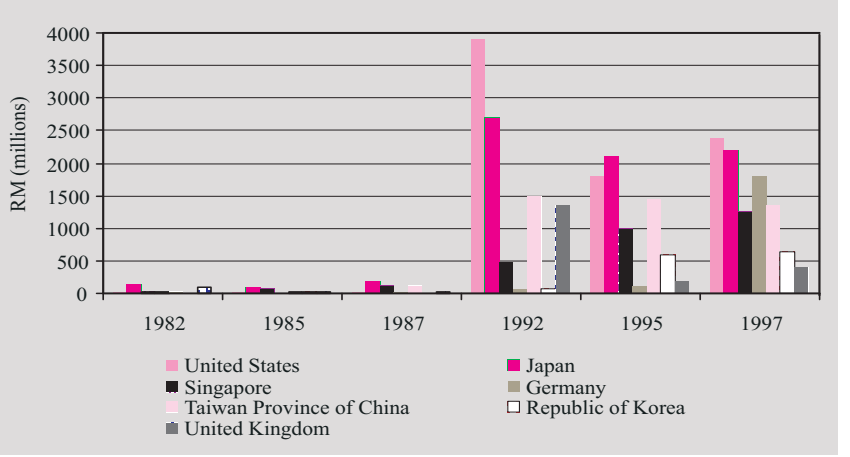
The beginning of the electrical industry in Malaysia can be traced to the 1960s, with the introduction of policies designed to stimulate import substitution. The electronics industry developed in the early 1970s when the emphasis shifted to export oriented industries. Wires, cables and household appliances accounted for more than 80 per cent of the electrical output (Malaysia, MITI, 1996, p. 52), while semiconductors and other components were the important activities in electronics.

Foreign firms from the United States, Japan, Western Europe, Taiwan Province of China, Singapore, Hong Kong (China) and the Republic of Korea dominate this industry. Virtually all of these firms are either located in export processing zones or have a licensed manufacturing warehouse (LMW) status.[2] Traditionally, such establishments have been characterised by high import propensities, in both inputs and capital goods, and also by high export propensities.

[1] The Malaysian electrical and electronics industry essentially consists of two related industries. The e*lectronics* industry is defined as the production of "equipment whose functioning is based on the manipulation of electrical signals/ impulses and/or components of such equipment". The e*lectrical* industry produces equipment which "generates, stores and transmits electrical power or transform electrical energy into other forms of energy" (UNDP, 1990, p. 1).

[2] LMW firms are located outside export processing zones but enjoy the same benefits as firms located in the zones. LMW facilities were set up basically to encourage the dispersion of firms to other areas.

Figure 1. FDI in Malaysian electrical and electronics industry
(1978 Prices)



Source: Mohd Noor, 1999.

Figure 1 illustrates the dramatic increase in inward investment in the industry in recent years, from other newly industrializing countries as well as from more traditional investors such as Japan, the United States and United Kingdom. Essentially this increase is ascribed to the incentives that have been made available for inward investment, particularly where exports will be generated (Phongpaichit, 1990; Narayanan and Rasiah, 1989; Mohd Noor, 1999). More recently, however, there has been a large increase in the number of small and medium-sized foreign enterprises, especially from Japan, Taiwan Province of China and the Republic of Korea. Many of these firms are subcontractors to large TNCs in their home economies. It is likely that such export-oriented TNCs would have weak linkages with local firms, and that most inputs are imported from the home economy. Given this, a major concern of the Government of Malaysia, and other policy makers, is the likely longevity of such investment and its impact on local producers.

Local linkages

After employment creation, possibly the major reason for developing (and more developed) countries to attract FDI is that it is

assumed that TNCs will develop links with the domestic economy. Such links are then presumed to be indicative of technology transfer, the transfer of skills to the local workforce and greater investment and employment multipliers from FDI. Previous studies in Malaysia have however produced conflicting results. For example, a survey undertaken by the Japanese External Trade Organization reported a significant increase in local sourcing by Japanese TNCs in Malaysia. In 1988 and 1989, Japanese affiliates reported an increase in local procurement of 77 per cent and 60 per cent, respectively; the value of locally procured goods amounted to 23.7 per cent of total non-labour inputs of Japanese TNCs in 1989 (Aoki, 1992). This, however, can be misleading, as Takeshi Aoki also reports that locally owned firms supplied only half of these inputs by value, the rest being supplied by foreign subcontractors. A survey undertaken by the Malaysia American Electronics Industry (MAEI) reported a much lower usage of locally sourced inputs: in 1994, the MAEI member firms reported that their local sourcing was only 9 per cent of total value of output produced (Malaysian-American Electronics Industry, 1995, pp. 5-6).

Premachandra Athukorala and Javant Menon (1996), and M. Hobday (1996) attributed the low level of local linkages to the incapacity of local firms to meet appropriate quality standards, and to compete with global components prices. Lynne Guyton (1995) reported that the lack of local linkages was due to TNCs' sourcing practices that gave preference to home country firms. This suggests that local suppliers face a transaction cost disadvantage when contracting to inward investors, based on accumulated knowledge and long run vertical relations. Within this framework, other phenomena may be important here, such as the impact of government policy and the various reasons why firms chose initially to set up in Malaysia.

The data and background to the analysis

This article employs data obtained from a survey of foreign firms drawn from the 1993 Malaysia Industrial Development Authority (MIDA) directory of electronics and electrical firms. The survey was conducted from December 1996 to March 1997. The first

section of the questionnaire was devoted to understanding the type of technology used by TNCs, the level of automation and the age of the technology. Information was also obtained on the important factors that determine the type of technology employed. These included the volume of output, the types of products generated and the take-up of government incentives used to attract new technology to Malaysia. The second section was concerned with the extent to which local conditions influenced the level of technology employed. This provided evidence on the perceived competence of local labour to operate and maintain the plants' capital equipment.

The third section was concerned directly with linkages between the foreign and domestic sectors. Information was obtained on, not only the number of suppliers and their activities, but also the perceived constraints in expanding the use of local inputs. This section also obtained details of the types of agreements that were undertaken between TNCs and host industry. This covered issues such as technical assistance to be given to local firms (and if so what type), licensing of technology and whether the arrangements were simply subcontracting.

The fourth section was concerned with the education and training of the local workforce, and the positions held by Malaysian nationals, compared with expatriates. This section also examined the extent to which TNCs employ local workers in management and engineering positions, possibly an important phenomenon when explaining local linkages.

The final two sections were concerned with the general company profile, its size, age, activities and degree of foreign ownership. This provided a distinction between assembly and manufacturing, and the proportion of sales that were exported. These are also important issues in the linkages literature (e.g. McAleese and McDonald, 1978). These sections also provided detailed information on the factors that attracted the firms to Malaysia. They concerned specific policies, general inward investment incentives and more general location advantages, such as low wages, local market conditions and the availability of local materials or components.

This questionnaire (see also table 1) therefore provided detailed information on not only the extent of the links between TNCs and local firms, but also the likely determinants of these links.

Table 1. Characteristics of the survey of foreign firms in Malaysian electronics and electrical industry, December 1996 to March 1997

Industry	Number of firms in the population	Number of firms responded	Percentage of respondents in the population
Electronics:	101	37	36.63
Electronics products	66	25	
Electronic components	25	8	
Computers	4	2	
Electronic supporting services	6	2	
Electrical:			
Electrical products	20	8	40.00
Total	121	45	37.19

Some descriptive statistics

With one exception, firms in the sample entered Malaysia between 1973 and 1991, with an average plant age of only 12 years. As such, reliable data were collected on the reasons why firms were initially attracted to Malaysia. Only one third of firms stated that they were attracted to Malaysia because of a desire to enter the local market, and only 40 per cent of firms were attracted by the desire to obtain access to local inputs. Conversely, nearly all the firms listed export incentives, low local wages and tax and investment incentives as being important motivating factors in their decisions to operate in Malaysia. Given the lack of location advantages beyond subsidies and low wages, or the desire for TNCs to access local markets, it is perhaps not surprising that over 90 per cent of all output generated by these firms is exported. Indeed, more than half of the firms in the sample export their total output. There is however evidence that value added is genuinely being created in Malaysia by TNCs, as few firms can be said to be merely assembly operations, particularly in semi-conductors. There is evidence, however, that much of the output is in

the form of components to be exported and assembled elsewhere, the final destination being the European Union (EU) or the North American Free Trade Argeement (NAFTA) Area.

Table 2. Descriptive statistics

Variable	Mean	Standard deviation	Number of positives
LOCAL CONTENT (%)	26.36	20.02	43
SALES (Million RM)	367638	697742	
AGE (Years)	11.89	8.41	
TECHAGE (Years)	8.96	5.23	
LOCAL MANAGEMENT (%)	15.4	17.19	38
LOCAL ENGINEERS (%)	62.27	98.48	38
JV			5
ENTER LOCAL			14
SUPPLY LOCAL			18
LOCAL COMPONENTS			20
EXISTING INVOLVEMENT			16
IMPORT RESTRICT			18
PIONEER			35
EXPORT SUBSIDY			34
INVESTMENT TAX ALL.			37
TRAINING INCENTIVE			23
R&D INCENTIVE			28
IND ADJUSTMENT			24
MODIFY			38
ASSEMBLY			10
JAPAN			23
US			7
KOREA			3
TAIWAN			5
EU			4

The above table presents some descriptive statistics derived from the sample. The average age of the foreign plants is less than 12 years, and it is clear that a high proportion of the firms have been in receipt of various subsidies or incentives that are available for inward investors. This does raise the concern that such firms will only remain in Malaysia as long as the subsidies and low wages last, rather than

seeking to develop strong local linkages. However 14 firms were set up in Malaysia before 1980 (the earliest being 1960), and there is evidence that over two thirds of firms gave either the desire to enter local markets, or the desire to obtain local inputs as a major factor in their decision to invest in Malaysia. As such, one would expect such firms to develop significant local roots and invest for the long term. Also, export incentives have been important in attracting FDI. This incentive requires firms to maintain a certain level of local content in their inputs. In addition, there is clear evidence that, while managerial posts are still largely filled with source country nationals, nearly two thirds of all engineering posts are filled from the local workforce, although there is a good deal of inter-firm variation in this.

Types of linkages

Ivan Turok (1993, 1997) and Philip McCann (1997) suggested a common framework for the evaluation of linkages between inward investors and local firms. The relationship is seen as either "dependent" or "developmental", based on the extent to which the local sector productive efficiency increases as a result of inward investment. There is significant evidence of direct linkages between TNCs and domestic firms in Malaysia. For example, there are several firms where non-labour local inputs exceed 50 per cent of total inputs. In terms of labour-inputs, more than 95 per cent of the firms stated that all of their operatives were recruited locally, and over 50 per cent employ solely local labour for maintenance operations. This suggests that training does occur in these functions, and that these firms have incurred significant sunk costs. Importantly, there is also evidence that local inputs are used in the manufacturing process. This also suggests that knowledge is transferred from foreign firms to the local population. The amount and quality of such knowledge will be dependent on the nature of the manufacturing operations concerned.

The determinants of local linkages

It is important not only to examine differences in local inputs, but also to examine the determinants of the variation in local input levels in order to evaluate the strength of these local linkages. This

article then turns to an econometric examination of these linkages, in terms of the determinants of linkages outlined above.

Most studies of local linkages base their analysis on the proportion of (typically non-labour) inputs that are purchased locally. Previous papers concerned with local linkages (e.g. O'Farrell and O'Loughlin, 1981; Stewart, 1976; Turok, 1993, 1997; McCann, 1997; and, to a lesser extent, McAleese and McDonald, 1978; Barkley and McNamara, 1994) base their analysis on the extent to which TNCs want to develop linkages with the domestic sector. Turok (1993, 1997), in particular, argued that firms do not seek to develop local linkages to the detriment of the host country.

It is not clear however, that such an approach is particularly useful. Markus Nordburg, et al. (1996) demonstrated that TNCs do not seek to exclude any particular group. They merely select suppliers on the basis of quality and formulate their contractual relations with the aim of minimising transaction costs. For illustration purposes, if a firm's technology is represented by:

$$Q = AK^{\alpha_1}L^{\alpha_2}M_L^{\alpha_3}M_F^{\alpha_4} \qquad \text{…..(1)}$$

where K and L are capital and labour, M_L represents local material inputs, and M_F represents foreign inputs; total costs are given by:

$$C = wL + rK + \mu_L M_L + \mu_F M_F \qquad \text{….(2)}$$

then it is trivial to show that a profit maximising firm will use local and foreign inputs at the rate given by:

$$\frac{M_L}{M_F} = \frac{\mu_F}{\mu_L}\,\frac{\alpha_3}{\alpha_4} \qquad \text{…(3)}$$

where μ_F = cost of foreign input; and
μ_L = cost of local input.

The likely determinants of local input linkages can therefore be divided into those that will impact directly on μ_F/μ_L, or those that impact on α_3/α_4. However, while it is likely that these costs vary between firms, there is no reason to suppose that TNCs will

deliberately under utilize local suppliers. An analysis of differences in local input ratios must therefore be seen in terms of three phenomena:

- differences in the foreign / local price ratio for inputs;
- differences in the relative productivity of domestic/foreign inputs; and
- differences in transaction costs between engaging foreign/ domestic suppliers.

Previous studies attempting to explain variations in embeddedness have included the size of the plant and a set of industry dummy variables. Clearly, an advantage of this study is that it is more appropriate to have a set of firms within the same industry, such that industrial or trade policy will impact on input prices uniformly.

Factors likely to impact on relative input prices

Clearly, external factors can affect the ratio of local to foreign inputs. Firstly, host country governments can influence input prices with subsidies, taxes or tariffs. Equally, one may expect that large TNCs may influence μ_L through monopsony power or μ_F through transfer pricing. A TNC may perceive variations in transaction costs between suppliers. In particular, the costs of contract specification and quality control may be higher in dealing with local firms, rather than established firms in the home country. Modern manufacturing methods, such as just-in-time, and others, which seek to limit inventories to a minimum for example, would encourage local sourcing, as would high transport costs. Equally, firms from particular countries have access to particular inputs at different price that will in turn impact on M_L. As such, therefore, country of ownership may be important, along with whether the plant is a joint venture with a local source of capital.

Factors likely to impact on relative factor productivity

Possibly the most important indicator of this is why a firm was initially attracted to the host country. For example, if a firm was set up with the specific intention of gaining access to local materials, then clearly α_3 is greater than average, and so one would expect the

proportion of local inputs to be larger. The survey on which this article is based provided information on the eight main reasons why a firm chose to produce in Malaysia, and also details on the importance of the seven main inward investment incentives that were available. It is expected, for example, that firms that were attracted by the promise of export subsidies will have stronger links to local producers than those attracted by tax holidays. Finally, the nature of an operation may be an important factor. Plants that are assembly rather than manufacturing may be less integrated into the local economy, due to the extensive investment in export processing zones in Malaysia. Data are available on the importance of the seven main incentive schemes for attracting individual firms, which are expected to impact on relative productivity variations of respective inputs. The data relating to these incentive schemes are discussed below.

Factors likely to impact on transaction costs differentials

Nick Phelps (1993) showed that branch plants have lower levels of local linkages than do more autonomous production units. The most likely explanation of this is that the transaction costs between affiliated branch plants are lower than for transactions between TNCs and host-country firms. Again, it may be anticipated that country of ownership impacts on transaction cost differences, although perhaps more important factors are the reasons why a firm chose to enter Malaysia. In addition, one would expect the age of a plant to be positively related to local linkages, as transaction costs may be reduced over time through increased local knowledge. Processes such as just-in-time are generally developed gradually, and so cause local input ratios to increase over time. Firms with high proportions of locally recruited engineers and managers are expected to reduce local transaction costs, as the degree of understanding between domestic and foreign firms increases. In addition, firms employing older technology are expected to face lower transaction costs when dealing with local suppliers, as older technology is more readily understood, and specifications for components more easily communicated than for new technology.

Finally, one would anticipate that the reason why a firm chose to set up in Malaysia also impacts on transaction cost differentials between firms. For example, affiliates that were set up as a result of

existing investment in Malaysia would be expected to gain from the local knowledge already attained, and thus have lower transaction costs than other firms. Also, firms that have for example taken the decision to invest in Malaysia in order to enter local markets are expected to have facilities to deal with local firms, and thus be more willing to engage local suppliers.

Hypotheses concerning local input linkages

Based on the above distinctions, one can suggest a set of hypotheses concerning the variation of local input linkages within an industry:

- that older plants will have greater linkages, as linkages are expected to develop over time;
- that country of ownership is important, as this will impact on both local/ foreign input price ratios, and on relative transaction costs;
- that firm size is insignificant. This variable is included in other similar studies, but given appropriate model specification, is expected to be insignificant. It is generally included as a proxy for transaction or co-ordination costs, which should be picked up by other variables. The significance (or lack thereof) of this variable can loosely be seen as a test of the extent to which variations in transaction costs are captured by other variables in the model;
- that joint ventures have higher input linkages than wholly foreign owned ventures;
- that assembly operations have higher levels of local inputs. This is very much an empirical question, as to the source of such components, relative to the source of inputs of manufacturing plants;
- that firms that adopt technology to suit local conditions have higher levels of local inputs. There are for example several firms that operate old technology in Malaysia, adapted to local conditions;
- that firms with high levels of locally recruited engineers and managers have higher levels of local inputs;
- that the reasons why firms were attracted to Malaysia impact on local input linkages; and

- that the types of investment incentives offered impact on local input linkages.

Given these hypotheses, it is important to understand why a firm chose to enter Malaysia, and also the importance of the various subsidies available.

Reasons why firms entered Malaysia

The reasons for firms to enter Malaysia included:

- a desire to enter the local market;
- to supply other foreign firms in Malaysia;
- low labour costs;
- existing involvement in Malaysia;
- to avoid import restrictions;
- to secure local materials or components; and
- political stability.

Of these, it is assumed that the desire to enter the host market, and an existing involvement in Malaysia, are indicative of a firm seeking to lower relative transaction costs associated with local firms. The desire to secure local materials is indicative of a higher productivity of local components. These three variables are expected to be associated with higher levels of local input linkages. Conversely, avoidance of import restrictions is indicates that a firm is merely assembling imported components, and so local input linkages will be lower.

In the area of investment incentives availability, the following types may be spelt out:

- pioneer status[3] incentives;
- export incentives;
- investment tax allowances;

[3] Pioneer status is an incentive given under the Promotion of Investments Act 1986. Pioneer status is granted after taking into consideration the value added, local content, level of technology and the industrial linkages involved. Pioneer status is given to companies undertaking the following activities: i. promoted products/activities; ii. high tech products/activities; iii. strategic products of national importance; iv. R&D; v. small scale industries. Firms that are eligible for pioneer status are exempted from 70 per cent to 100 per cent of their statutory income tax for a period of 5 years to 10 years (10 years especially for iii and iv).

- reinvestment allowances;
- research and development (R&D) incentives;
- training incentives; and
- industrial adjustment incentives.

Tax incentives are hypothesised to be indicative of low levels of linkages, while pioneer status suggests that a firm has committed to forging links with local suppliers and engaging in R&D. As such, pioneer status is expected to be positively associated with R&D linkages. Also, export incentives are argued to have a positive effect on local input linkages. Finally, joint ventures (JV), and whether a TNC has modified source country technology to suit local conditions (MODIFY), are expected to be positively related to local input linkages.

Results

Clearly, with such a dependent variable, the ordinary least square (OLS) method is not appropriate. The dependent variable is bounded, and also expressed merely in percentage terms, so there is every reason to assume that the sample is not drawn from a normal distribution. There are two possibilities here, following G.S. Maddala (1983). The first is to use a TOBIT (censored regression) model, following James Tobin (1958). The other alternative is to carry out the logistic transformation on the dependent variable and estimate the transformed model using OLS.[4] In either case, the large number of dummy variables that are available here invites the researcher to determine the parsimonious form of the model. This is because one is testing with such dummies simply whether the particular dummy causes the level of linkages to differ from the norm, with all others suppressed into the constant. As such, therefore, a parsimonious form is determined, while testing for the sensitivity of the coefficients to the inclusion or exclusion of other variables. Standard specification tests reveal that the TOBIT is the appropriate specification for these data. The results are given in table 3.

[4] This involves the following transformation. With Y_i as the observed variable: $Z_i = \frac{Y_i}{1-Y_i}$. Thus allowing Z_i , the dependent variable in the regression, to be drawn from a normal distribution.

Table 3. Determinants of variation in backward linkages

	TOBIT 1		TOBIT 2		Logistic transformation	
Variable	Estimate	t stat	Estimate	t stat	Estimate	t stat
C	0.394	0.25	0.243	0.96	0.132	0.157
SALES	-0.005	0.38			0.011	0.173
AGE	0.017*	1.51	0.008**	1.62	0.054***	2.30
TECHAGE	0.061*	1.48	0.063**	1.96	0.273***	2.23
LOCAL ENG	0.203***	4.68	0.090***	3.05	0.684***	2.94
LOCAL MAN	0.199***	4.45	0.110***	2.89	0.631***	2.64
ENTER LOCAL	0.191***	4.08	0.195***	3.64	0.893***	3.63
SUPPLY LOCAL	0.188***	2.30	0.152**	2.07	0.258***	2.28
LOCAL COMPONENTS	0.204***	3.62	0.131***	3.67	0.421**	1.91
EXISTING INVOLVEMENT	0.128***	3.04	0.055**	2.68	0.704***	2.37
IMPORT RESTRICT	-0.166***	3.41	-0.107***	-2.25	-0.922***	3.53
PIONEER	0.035**	1.62	0.065**	1.84	0.068	1.29
EXPORT SUBSIDY	0.077***	3.53	0.083***	2.67	0.656**	2.08
INVESTMENT TAX ALL.	-0.080***	5.93	-0.049***	4.65	-0.69***	4.96
TRAINING INCENTIVE	-0.085*	1.56	-0.058*	1.53	-0.111	1.17
R&D INCENTIVE	-0.110**	1.95	-0.089**	1.77	-0.333	1.54
IND ADJUSTMENT	0.012**	1.74	0.017***	2.56	0.274**	1.75
JV	0.024	0.44			0.323	1.08
MODIFY	0.006***	5.39	0.005***	4.52	0.126***	2.29
ASSEMBLY	-0.110***	2.65	-0.112***	3.01	-0.404**	1.84
US	0.155***	2.46	0.084**	1.87	0.187*	1.56
σ	0.0807	7.61***	0.127***	8.64		
R^2_{CONT} [a]	0.633		0.589			
R^2_{MZ}	0.490		0.412			
$\bar{R}^2$					0.847	
F					4.981***	

*** significant at the 1 per cent level; ** significant at the 5 per cent level; * significant at the 5 per cent level.

This specification passes LR heteroskedasticity tests for all possible variables.[b]

[a] The measures of goodness-of-fit, are the standard measures for the TOBIT model, following Veall and Zimmerman (1994). Veall and Zimmerman (1994) show that the McKelvey and Zavoina (1975) (R^2_{MZ}) is the single most appropriate choice, while the conditional Tobit estimate, (R^2_{CONT}) may overestimate, as it is conditional only on the positive observations.

[b] Following Maddala (1983), this is based on a test that b=0 in the following specification: $\sigma_i^2 = (a + bZ_i)^2$ This was done for all of the non-dummy explanatory variables, as well as number of employees, the level of R&D, total wages and the value of assets of the firm. In all cases, one rejects the hypothesis that b>0.

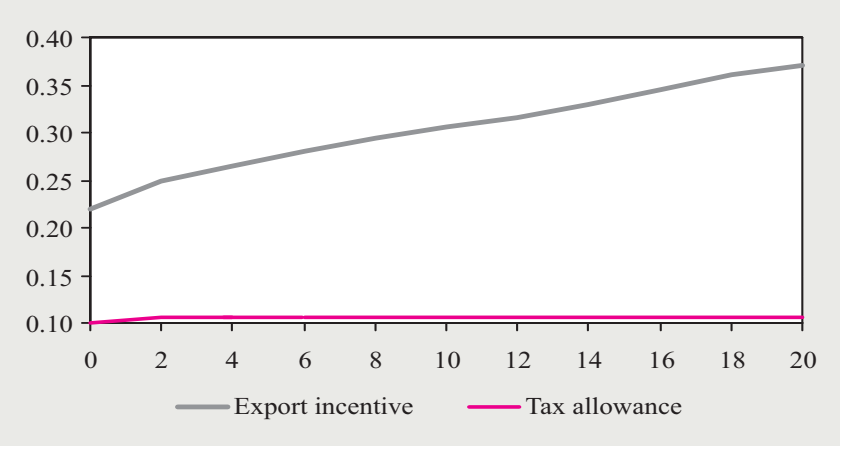
Given the results demonstrated in columns one and two, an attempt was made to combine several of the dummy variables, for example, combining the "local access" variables, or the R&D, training and investment incentives into a composite dummy variable. This however was rejected by standard econometric tests. As such, the TOBIT 2 model represents the parsimonious form of the regression. For comparison, the results derived from OLS on the logistic transformation model are presented. It is clear that the model is robust to such alternative specifications.

The results confirm not only the general predictions of the model, but also the approach. Once the variables relating to transaction costs are included, firm size becomes irrelevant. Clearly, United States firms are more embedded in Malaysia than the others, suggesting that linkages with United States firms are greater than for Japanese, EU or other South-East Asian firms. This suggests that the situation is not so much that Japanese firms have lower local input linkages than average (as is often suggested), but that United States firms have more. In addition, the results show clearly that a major obstacle to increasing local input linkages are the transaction costs associated with foreign firms trading with local firms. In cases in which a TNC employs significant numbers of local managers or engineers, with, one assumes, significant local knowledge, these costs are reduced, and local input proportions are increased. Equally, in cases in which Malaysia has been able to demonstrate significant location advantages (in the form of local factor endowments) or a local market for the product, linkages are forged automatically. There is also evidence that firms that have been able to build on successful investments have developed the strongest linkages between themselves and the domestic sector. The results also show however that it is difficult to create this situation artificially in the form of import restrictions, as these simply foster minimum compliance and attract firms merely seeking to assemble imported components. The same can be said of the incentives that take the form of subsidies for training, investment or R&D. In common with many other studies around the world, the evidence suggests that such subsidies merely encourage "branch plant" activity, with firms investing where they can obtain the greatest subsidy, and generating few links with the local economy. There is however evidence that two of the incentive schemes have had a desirable effect.

The pioneer scheme, and the export subsidy scheme have attracted TNCs that forge local links, suggesting that government intervention can have the desirable effect, but that schemes have to be effectively targeted.

A useful way of interpreting the policy prescriptions of these results is to use the marginal effects calculated from the TOBIT regression, to compare, for example, the effects on local input linkages. It is possible, for example, to compare the impacts that different policies have on local input linkages within a firm over time. For example, figure 1 illustrates the different effects that, export incentives and simple investment tax allowances are expected to have on local input linkages over time, keeping everything else constant. This illustrates that, over time, certain policies may be expected to have a far greater beneficial effect than others.

Figure 2. Government policy and local input linkages over time



This illustrates that a firm in receipt of export incentives would start with local inputs accounting for 17 per cent, which over 20 years would double to 35 per cent, keeping the age of technology constant. A firm in receipt of the more general investment tax allowance has virtually constant local inputs at around 10 per cent. The contrast here is particularly pertinent, as neither of these

particular incentives specify local input proportions as a requirement. It is clear, however, that incentives that are only given to firms undertaking to meet certain conditions, such as exports or the creation of local value added, have a greater effect than investment incentives that take the form of simple subsidies of particular activities.

Conclusions and policy implications

The initial conclusion from this study is that there are indeed significant linkages between foreign affiliates and domestic firms in Malaysia. However, it is also true to say that these linkages, to borrow from Turok (1993) are of the "dependent" nature rather than "developmental". It is also clear that general subsidies do little to stimulate these linkages, as they simply encourage "branch plant" organisation by a TNC, or plants that merely assemble imported components for export. There is evidence however that such linkages are strengthened and developed over time, and that older technology is transferred more readily to the domestic sector. This is important, as it is indicative of the problem faced by many developing economies. Such countries are able to attract and assimilate older foreign technology by virtue of being able to facilitate large scale labour intensive production. However, their ability to gain access to newer foreign technology is distinctly limited, as only TNCs that employ older technology foster local input linkages with domestic suppliers.

The traditional explanations for the lack of local input linkages within TNCs have often focused on the extent to which a TNC is simply unwilling to engage local suppliers, and the degree to which such behaviour is then detrimental to the development of the host country. This article has however demonstrated that such an approach is not valid, and that an understanding of the differing costs of local vis-à-vis source country suppliers, including transaction cost differences, is the overriding factor. To this end, it is important to note that the extent to which TNCs employ local labour in technical or managerial positions will quickly reduce the transaction costs associated with TNCs buying from local firms and lead to an increase in local input linkages. From a policy perspective, there should be an emphasis as regards inward investment incentives to seek to reduce the transaction costs associated with local inputs. For example, while

it is generally assumed that TNCs operating in Malaysia employ high proportions of locally recruited manual workers, the employment of local people in managerial or technical positions is seldom considered as one of the conditions for a firm to receive an investment subsidy. The results here suggest that this is a policy initiative that should be considered by development agencies, from the perspective of contributing to the development of linkages, and therefore technology transfer and other spillovers from FDI.

The results concerning the relationship between the various policy initiatives and local input linkages provide some clear policy implications. In the most general terms, firms that simply received a subsidy, either in the form of investment tax allowances or training or R&D subsidies, generate very little in terms of local input linkages, and as such technology transfer is limited. Equally, firms that have been attracted to Malaysia simply to avoid import restrictions are likely to engage in branch plant activity, and again the local development from FDI is limited. However, there is evidence that investment incentives that are targeted at specific outcomes, and require certain commitments of the recipients, are more effective in fostering local input linkages. For example, to an extent the *Pioneer Initiative* takes the form of a tax allowance, but places several conditions on the recipient (one of which is a local content requirement). There is evidence that this policy has been effective, not only in generating local input linkages, but also in fostering technology transfer. The same can be said, perhaps more surprisingly, of export incentives. One thinks of export incentives as being designed to attract TNCs that simply want to export assembled components that have previously been imported. The explanation of this, one imagines, is linked to the extent to which the technology employed in an assembly operation is modified for local conditions, which again encourages local input linkages.

There is little evidence that joint ventures encourage local input linkages. This is contrary to the apparent beliefs of policy makers, who tend to suggest that joint ventures internalize technology and encourage the involvement of local firms. This however does not appear to occur, possibly because the imported technology is not disseminated beyond the local partner.

Finally, it is often claimed that Japanese TNCs are the least likely to foster local input linkages, preferring to use Japanese firms with whom they have vertical relations elsewhere. While there is not specifically any evidence of this, there is evidence that United States firms have higher local input linkages than other firms, which is possibly a function of the distance between Malaysia and the home country compared with firms from other parts of South-East Asia.■

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Is divestment a failure or part of a restructuring strategy? The case of Italian transnational corporations

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This article argues that the way in which transnational corporations are able to face the unfamiliar dimensions of foreign markets influences divestment of their foreign affiliates. Specifically, large and well-experienced transnational corporations support effective investment/divestment decisions by collecting costly information, and through incremental learning. Conversely, small and less experienced firms have to adopt more exploratory strategies, often based on hazardous gambling on emerging opportunities. As a consequence, the latters are more likely to divest their foreign affiliates because of a *failure* (defensive voluntary divestment). On the contrary, whenever large and experienced firms divest, that is more likely due to competitive restructuring (offensive voluntary divestment). Variables related to the nature of the affiliate itself (e.g. size, age, ownership arrangement, and diversification degree) also influence the likelihood of different divestment types. We provide empirical evidence with a study of the divestments undertaken by the Italian transnational corporations over the period 1990-1996.

Introduction

Divestment of foreign affiliates by transnational corporations (TNCs) has attracted the interest of researchers for many decades. Nonetheless, the existing literature has generally adopted a negative

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interpretation of divestment, basically due to the fact that divestment is seen as admission of failure to be treated with secrecy (Hamilton and Chow, 1993). It therefore features seemingly negative and undesirable characteristics. However, more recently a critical re-analysis of the problematique of foreign divestment has begun to emerge (e.g. Benito, 1996; Hennart, et al., 1997). This new perspective claims the need of distinguishing among different types of divestment.

This article focuses on this latter issue. Specifically, it argues that divestment can be distinguished between:

- *failure*, which occurs when an affiliate fails to meet the expected performance; or

- *restructuring*, which occurs when a parent company has to free resources and re-direct them towards more profitable initiatives. Such a need may stem from changes in the business environment and/or in the firm's competitive advantages.

Firms operating in a foreign market have to cope with several unfamiliar dimensions and suffer from cognitive limits and adverse asymmetry. Therefore, they adopt different strategies and measures to face uncertainty and risk. These strategies reflect firms' financial and managerial resource availability. Large firms, which do not suffer from any serious constraints, could gather information through costly and time-consuming activities. Likewise, firms that have already operated in foreign markets are able to exploit their learning-through-experience knowledge, and reduce uncertainty inherent to foreign markets.

On the other hand, small and less experienced firms find it more suitable to attempt tentative moves on foreign markets, often gambling on emerging opportunities. In fact, proceeding this way, they reduce both the actual costs and the potential sunk costs. Nonetheless, the dark side of this exploratory strategy is a higher likelihood of failure.

Accordingly, our main hypothesis is that a divestment undertaken by small and less experienced firms is more likely to be

due to a failure. Conversely, large and experienced firms are more likely to divest within the context of a more articulate restructuring strategy. However, it is also argued that a divestment depends on the affiliate's characteristics. Specifically, the likelihood of failure is strongly influenced by both the absolute and relative (to the parent company) size of an affiliate. Conversely, the age of an affiliate, its ownership arrangement (i.e. the entry mode on the foreign market adopted by the parent firm), and its degree of diversification (as to respect to the parent company's activity), equally influence the two types of divestment.

Empirical evidence in support of the interpretative model is provided with regards to the divestment of foreign affiliates by Italian TNCs during the 1990s. The period considered suits the purpose of this study particularly well as it is a period in which the Italian economy enjoyed considerable international growth. Specifically, the hypotheses advanced have been tested through a multinomial logit model run on a sample of 1,053 foreign affiliates established by Italian firms before 1990. The life of these affiliates has then been analyzed throughout the subsequent five years.

The article is organized as follows. The second section illustrates the theoretical background and develops our hypotheses as to the variables influencing a firm's attitude to divest. The third section presents the data employed in the analysis and the characteristics of the sample. The fourth section contains the econometric model and the variables considered. The fifth section is devoted to the findings of the econometric analysis. Some summarizing remarks and industrial policy implications, in the sixth section, conclude the article.

Theoretical background and hypotheses

During the past decades, firms have increasingly adopted growth strategies based upon progressive commitment to global markets. Therefore, a vast theoretical and empirical literature about entry mode choice (Kogut and Singh, 1988; Agarwal and Ramaswami, 1992; Larimo, 1993; Mutinelli and Piscitello, 1997), and exit from foreign markets (for a recent survey, see Benito and Larimo, 1995) has emerged.

The first studies on divestment became available in the 1970s (Torneden, 1975; Boddewyn, 1979a, b). Although providing information about the magnitude, causes and processes of foreign divestment, these studies lacked the theoretical and methodological refinements provided later for foreign *vs.* domestic divestment (Boddewyn, 1983a) in the United States and Europe (Harringan, 1981). Additionally, differences between investment and divestment decision-making processes have been often considered only apparent and rarely real, and divestment theory has been seen simply as the reversal of FDI theory (Boddewyn, 1983b). Moreover, these studies generally considered divestment as incontrovertible evidence of the failure of activities and programmes. It stems therefore from a painful decision associated with past bad judgement, current inability to handle problems, or an even worse future. For this reason and for the related difficulties in obtaining appropriate data, empirical studies have been so far scarce and mainly aimed at investigating effective strategies that can reduce the risk of failure in international expansion.

Only more recently has the international business literature begun to recognize the need of distinguishing between different types of divestment (e.g. Gomes-Casseres, 1989; Delacroix, 1993; McDermott, 1994; Benito, 1996; Hennart, et al., 1996, 1997) and to take into account the existence of different exit modalities (e.g. complete sell-off of the assets involved to another company, spin-off, management buy-out or liquidation).

In this article, we follow the distinction suggested by Michael McDermott (1994). He distinguished between *defensive* voluntary foreign divestment or *failure*, when undertaken in response to heavy losses; and *offensive* voluntary foreign divestment, when undertaken to sustain the parent company's competitive advantage. In particular, we argue that divestment of a foreign affiliate can be considered as:

- a *failure*, when it refers to the fact that a foreign affiliate failed to comply with the expected results (in terms of profitability, return, growth etc.). That forced the parent company to get rid of it, in an attempt to restore its competitive advantages;

- a *restructuring*, when it is associated with the need of implementing successful strategies to cope with external environmental changes (Weston, 1989), or with changes occurred in the parent company's competitive advantages. These changes make it indeed relatively more profitable to re-direct resources towards other initiatives, or to focus businesses that are too diversified (Duhaime and Grant, 1984; Hamilton and Chow, 1993).

Some theoretical and empirical studies (e.g. Casson, 1994; Mariotti and Piscitello, 1995) already concluded that firms operating in a foreign market have to cope with numerous unfamiliar dimensions and suffer from cognitive limits and adverse asymmetry. In particular, direct investments (overall control, equal or minority share) in production facilities abroad (FDI) requires to scan the world for investment opportunities and to collect and channel information in order to support effective decisions. Firms face higher uncertainty and risks in three ways:

- gathering the relevant information through costly and time-consuming activities that imply important allocation of managerial capabilities (Casson, 1994);

- increasing the information through learning-through-experience (Johanson and Vahlne, 1977);

- reducing absolute risks involved in FDI by limiting the irreversible investments, which would turn in sunk costs in case of failure, through a trials and errors strategy (Barkema, et al.,1996).

Large firms have at their disposal bigger amounts of resources to devote to the acquisition of information and to monitor worldwide opportunities. Therefore, they are able to adopt efficiently the first strategy. Likewise, firms enjoying more international experience in managing operations abroad are likely to be better able to exploit positive externalities deriving from the experiential knowledge of the foreign environment, the market, the clients, the problems and the opportunities (Eriksson, et al., 1997).

On the other hand, FDI is intrinsically difficult to handle for smaller firms. Although smoother international communications have reduced the amount of managerial resources required to reach a decision on FDI, the limited financial and human resources of smaller firms still constitute a restriction when it comes to operating abroad. The costly information acquisition interacts with management shortages. Consequently, smaller firms frequently take short cuts and inadequately evaluate alternatives.

Of course, even for smaller firms international experience could reduce the need of undertaking costly activities for collecting information. Nonetheless, as conditions for going abroad were traditionally unfavourable, especially for smaller firms, experience goes hand in hand with size. Indeed, only recently technological developments in communications, transportation and financial services have enabled small and medium firms to exploit better opportunities on international markets (UNCTAD, 1993, forthcoming).

As a consequence, smaller firms tend to adopt quite different behaviour, pursuing more gradual and evolutionary approaches based on trials and errors and aimed at reducing potential sunk costs stemming from unsuccessful FDI. A specific hypothesis on FDI behaviour put forward in the mid-1950s (Barlow and Wender, 1955) – the "gambler's earnings hypothesis" – may be relevant to the explanation of foreign operations of smaller firms. In the hypothesis, TNCs are likened to gamblers, who, beginning the game with a small stake (the initial investment), continually plough back their "winnings" (profits) into the game until a real "killing" is made. Underlying this behaviour are three features of interest:

- FDI follows an exploratory strategy in order to see whether further FDI is desirable. Therefore, a risk-averse firm is likely to under-invest and to begin with a small stake, economizing on the costs of investigation and organization;

- the process has a dynamic of its own. When a firm has a small successful foreign affiliate, uncertainty is lower

and the cost of search for further profit approximates zero. The argument is that, rather than scanning the world for further, possible more profitable opportunities, the firm reinvest in the existing affiliate;

- gambling on emerging opportunities in foreign markets rather than implementing an effective decision making implies a higher probability that the initial FDI will result in a failure. The rationale is that the expected cost of failure is lower than the actual cost of gathering (quasi) perfect information.

As a whole, our fundamental hypothesis is that FDI by smaller and less experienced firms is more volatile. Therefore, its subsequent divestment is more likely to be due to a failure than a divestment undertaken by large and well experienced TNCs. In fact, the latter more frequently results from an articulate restructuring strategy.

However, the parent company's characteristics constitute only part of the story. In fact, the framework on the likelihood of divestment could be enriched with relevant aspects regarding the affiliate's peculiarities.

Firstly, we argue that the affiliate's dimension could have a significant impact on the likelihood of failure:

- *Start-up size*. According to the literature about firms' turnover (for a survey, see Caves, 1998), smaller entrants in a new business would be expected to show higher exit rates. In fact, firms less confident about entry conditions and their untested capabilities might rationally start out small, limiting their sunk commitment while gathering evidence on their unknown capability. On the other hand, entrants holding more positive expectations make larger initial commitments. Empirical evidence neatly fits this framework, finding that entrants' hazard rates decrease with their initial size (Wagner, 1994; Audretsch and Mahamood, 1995). Our hypothesis on gambling strategy perfectly conforms to this interpretation. As a

consequence, we expect: the smaller the start-up size of foreign affiliates (i.e. the higher the propensity of firms entering a foreign market to adopt an exploratory strategy), the higher the likelihood of their *ex-post* failure.

- *Relative size*. Managerial difficulties can arise when the size of a foreign unit is large in comparison to the parent company. Severe problems in exercising control and managing the affiliate could cause unexpected negative results, thus increasing the likelihood of failure.

Secondly, we argue that other aspects could *a priori* equally influence the two types of divestment:

- The *age of an affiliate*. The likelihood of divestment increases with a foreign affiliate's age. Indeed, according to population ecologists (Hannan and Freeman, 1984, 1989), after an early "honeymoon effect" (Hudson, 1987; Fichman and Levinthal, 1991; Li 1995), the environment begins to act as a selective mechanism that eliminates both less efficient affiliates and unsuccessful branches that need restructuring (Benito and Larimo, 1995). Nonetheless, as the age of affiliates increases, they tend to develop dense webs of exchange and close relationships in their business environment. Therefore, their divestment becomes more and more difficult.

- The *ownership arrangement*. Foreign affiliates originated by acquisition or joint ventures are more likely to be divested (Hennart, et al., 1997) as they require "double-layered acculturation" (Barkema, et al., 1996) and considerable management skills. Greenfield and wholly owned investments are more likely to survive because of the lower integration costs required.

- The *diversification rate*. Affiliates that correspond to the parent company's diversification strategy are more likely

to be divested. According to the competence-based view (Teece, et al., 1994), diversification into unfamiliar activities requires additional specific competencies and resources, thus adding uncertainty and risk to the internationalization activity. Therefore, it increases the likelihood of failure as well as the likelihood of restructuring, because of the need of re-alignment and re-focusing of activities far from the core business (e.g. Hoskisson and Johnson, 1992; Pennings, et al., 1994).

Finally, other explanations related to industry- and country-specific variables impact the divestment likelihood, as put forward by the empirical literature (Dunning, 1980; Chow and Hamilton, 1993; Benito and Larimo, 1995; Li, 1995; Barkema, et al., 1996; Benito, 1996). We will consider such aspects, as control variables, in the following econometric model.

The data

The data used in this article have been obtained from a database developed at Politecnico di Milano with the support of CNEL (National Council for Economy and Labour). The database REPRINT records Italian direct investments in production facilities and their divestments over the period 1986-1996 (for a detailed description of the database, see Cominotti and Mariotti, 1997). In particular, we focus on the period 1990-1996. This period witnessed a noteworthy upsurge of international investment in production facilities by Italian firms. Table 1 shows that the foreign activities in manufacturing by Italian TNCs involved 1,067 affiliates (both minority- and majority-owned) in 1990. That number has increased throughout the period considered. The divestment of foreign manufacturing affiliates considerably increased during the same period too.[1] Therefore, in order to study divestment decision we considered the total number of foreign manufacturing affiliates that existed in 1990. We then investigated if they had exited by 1996.

[1] It is worth remembering that we do not consider different events for liquidation or sales. Divestment is defined as an operation leading to the parent firm's withdrawal.

Table 1. Evolution of Italian FDI and divestments in manufacturing industries, 1990-1996

Year	Number of Italian TNCs	Number of foreign affiliates	Number of new affiliates	Number of divested affiliates	Balance
	Total number at the end of the year		Flow referred to the year		
1990	340	1 067	225	55	170
1992	394	1 321	327	92	235
1994	546	1 600	229	78	151
1996	622	1 842	187	66	121

Source: Cominotti and Mariotti, 1997.

The empirical model

The model and the dependent variable

In order to model divestment and specifically to operationalize the distinction between *failure* and *restructuring*, we rely on a definition suggested by the international strategic managerial literature (e.g. Hoskisson and Hitt, 1988; Hoskisson and Johnson, 1992). According to that definition, corporate restructuring corresponds to a phase of contextual divestitures and opportunities to re-allocate resources.

This rationale suggests both to place the analysis in a long term perspective and to consider divestment and investment activities undertaken by a parent company in the same period.

The six-year period considered represents a favourable historical context for Italian activities in production facilities abroad.[2] That allowed us to adopt a contingent approach which facilitated the

[2] The number of investors almost tripled in the decade 1986-1996 (rising from 263 to 622), as did the number of foreign affiliates (from 671 to 1,842). The trends are similar in the first half of the 1990s when those figures almost doubled (table 1).

uncomfortable task of discriminating between *failure* and *restructuring*. In fact, if during such a favourable period a TNC experienced only a divestment of foreign affiliates without re-directing the released resources towards other contingent growth opportunities, its divestment can be considered a *failure*. Conversely, an international *restructuring* strategy pursued by firms is characterized both by divestments aimed at freeing resources, and simultaneous investments that allow the re-orientation of a firm's international activities.[3]

We modelled the outcome of a firm's expansion into foreign markets undertaken before 1990 as a "choice" among the following three discrete alternatives:

- survival in the foreign market (labelled as SURVIVAL);
- divestment due to a failure of an affiliate (labelled as FAILURE);
- divestment due to a more complex restructuring strategy pursued by a parent company (labelled as RESTRUCTURING).

We classified each outcome *i* of a firm's international expansion as SURVIVAL if an affiliate still existed by 1996; as FAILURE if the affiliate had been divested by 1996 and the parent company did not undertake any other investment abroad in the same period; and as RESTRUCTURING otherwise, that is a parent company undertook at least another foreign initiative either in another country or in another business. These three alternatives are defined as exclusive and exhaustive.

The sample considered is constituted by the 1,053 foreign affiliates existing at the beginning of the period considered, 197 of

[3] Although such a kind of operationalization is generally too simplistic to capture different facets of the phenomenon, nonetheless it fits quite well into the contingent context of the study. Additionally, it is also worth noting that the possibility can hardly be ruled out that even single divestment events could be part of a more general restructuring strategy pursued by a firm.

which had been divested by1996.[4] Accordingly, with our definition, the divestments have been classified in the following way (table 2):

- 70 (corresponding to the 35.5 per cent of the total number of divestment) can be considered as FAILURE;
- 127 (corresponding to the 64.5 per cent) can be considered as RESTRUCTURING.

Table 2. Characteristics of the sample of divestments

Item	Number	Per cent
Foreign affiliates divested by 1996	197	100
- divestment as failure	70	35.5
- divestment as strategic action	127	64.5

Source: Cominotti and Mariotti, 1997.

Given the nature of the dependent variable, the model is a multinomial logit. The unit of analysis is the single divested affiliate.[5] The model provides the estimates of the impact of the explanatory variables on the probability that the *i*-th observation belongs to a particular category. In particular, the estimated multinomial model is:

$$\text{Prob}(\text{DIVEST}_i = j) = \frac{\exp(\beta_j' x_i)}{\sum_{k=0,1,2} \exp(\beta_k' x_i)} \qquad j = 0, 1, 2 \qquad (1)$$

[4] It is worth noting that, since in this context it would be misleading to consider as a divestment the withdrawal of a foreign affiliate due to the simultaneous exit of the parent company, 14 observations (corresponding to 8 parent of firms which did not survive the divestment of the foreign affiliates) have been excluded from the sample. Importantly, only a small share (2.2 per cent) of Italian TNCs did not survive throughout the period considered. In fact, they represent a sub-sample of firms relatively more successful than the domestic ones. Moreover, the sample does not include all the affiliates, both established and divested within the period 1991-1995.

[5] The empirical literature has traditionally modeled divestment through simple binomial logit (e.g. Benito and Larimo, 1995) and business longevity through survival techniques (e.g. Hennart, et al., 1996; Li, 1995). Aiming at analyzing different categories, Hennart, et al. (1996) used different binomial models for each category. Nonetheless, since the events considered are exhaustive and mutually exclusive, a multinomial model is the most appropriate.

In order to remove the indeterminacy of this model, a convenient normalization is to assume that $\beta_0 = 0$. Therefore, while any other exit would have been equally acceptable, in the estimation we set to 0 the parameters relative to the survival of the foreign affiliate (Green, 1993).

The probabilities are therefore:

$$\text{Prob}(\text{DIVEST}_i = j) = \frac{\exp(\beta_j' x_i)}{1 + \sum_{k=1,2} \exp(\beta_k' x_i)} \quad j = 1, 2$$

$$\text{Prob}(\text{DIVEST}_i = 0) = \frac{1}{1 + \sum_{k=1,2} \exp(\beta_k' x_i)}$$

The model has been estimated by maximum likelihood using the following log likelihood function:[6]

$$\ln L = \sum_i \sum_{j=0,1,2} d_{ij} \ln \Pr(\text{DIVEST}_i = j)$$

With reference to the model (1), the research hypotheses may be empirically specified by formulating a set of hypothesis upon the coefficients β^{FAILURE} and $\beta^{\text{RESTRUCTURING}}$. Specifically, having estimated a positive value for a parameter of the former vector implies that an increase in the related variable lowers the probability of SURVIVAL with respect to FAILURE, while having estimated a positive value for a parameter of the latter vector implies that an increase in the related variable lowers the probability of SURVIVAL with respect to RESTRUCTURING.

The independent variables

According to our theoretical framework and to other previous empirical studies (e.g. Duhaime and Grant, 1984; Benito and Larimo, 1995; Hennart, et al., 1996, 1997), the independent variables refer to:

[6] Consistency, asymptotic normality and efficiency are guaranteed reasoning along the lines of Kaufmann (1987).

- *firm-specific variables*, concerning both the parent company's and the affiliate's characteristics;
- *industry-specific variables*, related to the characteristics of the industry of the affiliate;
- *country-specific variables*, related to the characteristics of the country in which each divestment occurs.

The model developed allows us to test the research hypotheses concerning the different impact of variables upon the two typologies of divestment (see table 3 for the expected sign of $\beta^{FAILURE}$ and $\beta^{RESTRUCTURING}$).

Table 3. Expected sign of the independent variables on the likelihood of divestment

Variable	$\beta^{FAILURE}$	$\beta^{RESTRUCTURING}$
Variables related to the parent company		
Size (PAR_SIZE)	-	+
International experience (EXP1, EXP2)	-	+
Variables related to the subsidiary		
Start-up size (STARTUP)	-	n.s. (a)
Relative size (REL_SIZE)	+	n.s. (a)
Age (AGE)	∩	∩
Entry Mode (ACQUI, JV)	+	+
Diversification (DIVERS)	+	+
Country-specific variables		
Cultural and geographical distance (CULTDIST, DISTANCE)	+	+
Growth of the foreign market (GDP)	-	-
Country risk (DRISK)	+	+
Industry-specific variables		
R&D Intensity (R&D)	?	?
Capital Intensity (KL)	-	-
Industry Growth (GROWTH)	-	-

(a) n.s. = not significant

(i) Firm-specific variables

Variables related to the parent company

- *Size*. The variable PAR_SIZE is the parent company's size. It is measured by the number of domestic employees of the parent firm in 1990. According to the hypothesis on the different behaviour of small and large firms in facing uncertainty and risk involved in FDI, we expect a negative impact of PAR_SIZE on FAILURE, and a positive one on RESTRUCTURING.

- *International experience*. The cumulative international experience of the parent company has been proxied by EXP1 and EXP2. Specifically, EXP1 is the length measured by the length of time (i.e. number of years) a parent company has been engaged in international operations prior to 1990. The variable EXP2 is the number of foreign countries in which a parent company operates. According to the hypothesis on learning-through-experience, we expect a negative relationship (both for EXP1 and EXP2) with FAILURE and positive with RESTRUCTURING.

Variables related to an affiliate

- *Start-up size*. The variable STARTUP is the initial size of an affiliate, measured by the number of employees. According to the hypothesis that the smaller an affiliate, the higher the likelihood of exit, we expect a negative relationship between STARTUP and FAILURE.

- *Relative size*. The variable REL_SIZE is the relative dimension of an affiliate. It is measured by the ratio of an affiliate's size to the parent firm's size in 1990. According to the hypothesis about increasing potential difficulties in coordinating and managing relatively large affiliates, we expect a positive impact of REL_SIZE on FAILURE.

- *Age*. The variable AGE is the age of the affiliate in 1990.[7] In line with our theoretical framework on selection mechanisms, we expect an upwards U-shaped relationship of AGE with the likelihood of divestment (both FAILURE and RESTRUCTURING). In order to capture this non-linear effect, we introduced the quadratic term (AGE2).

- *Ownership arrangement*. The variable ACQUI is a dummy equal to one if an affiliate has been acquired by the parent company, and zero if it originated from a greenfield investment. Likewise, JV is a dummy equal to one if an affiliate is part of a joint venture, and zero otherwise.[8] According to the hypothesis on "double-layered acculturation", we expect a positive influence of ACQUI and JV both on FAILURE and RESTRUCTURING.

- *Diversification*. The variable DIVERS is a dummy equal to one if an affiliate is diversified (i.e. it does not belong to the same primary business) with regards to the parent company, and zero otherwise. According to our hypothesis in line with a competence-based view, we expect the sign of DIVERS to be positive both for FAILURE and RESTRUCTURING.

(ii) Industry-specific variables

- *R&D intensity*. The variable R&D is a proxy for the R&D intensity of the industry of the affiliate. It is measured as the percentage of employees in R&D activities in the manufacturing industry in 1991 (Istat, 1991). The empirical evidence so far provided about the impact of

[7] This variable allows for the fact that we actually observe events that had begun before the period considered and that the sample excludes affiliates that both entered and exited before 1991 (Hennart, et al., 1996).

[8] According to most of the existing literature, we considered an affiliate as part of a joint venture when the parent company owned more that 10 per cent but less than 95 per cent of the equity of the affiliate.

R&D intensity on divestment is mixed and uncertain. On the one hand, R&D-intensive industries constitute rapidly changing and risky competitive environments (Hannan and Freeman, 1984; Shapiro, 1986; Audretsch, 1991) which may force a parent company to move away from its current position. On the other hand, perceived barriers to exit in R&D intensive industries are higher due to the large sunk investments in research and the development and marketing of new products. Such higher barriers are likely to make divestment more difficult. Accordingly, we do not have any a priori expectation about the influence of R&D on FAILURE and RESTRUCTURING.

- *Capital intensity*. The capital intensity of an industry has been proxied by the variable KL. This variables measures the value of fixed investments per employee in 1991 (Istat, 1991). Since higher levels of capital intensity require high sunk costs, the barriers to exit from the industry are also higher (Porter, 1976). For this reason, we expect a negative impact of KL on both FAILURE and RESTRUCTURING.

- *Industry growth*. The variable GROWTH is a proxy for industry growth rate. It is measured as the percentage change in the number of employees in an industry in the period 1981-1991 (Istat, 1991). It has been extensively shown in the empirical literature (e.g. Duhaime and Grant, 1984) that the general economic environment growth negatively influences divestment. Accordingly, we expect a negative impact of GROWTH on both the divestment typologies.

(iii) Country-specific variables

- *Cultural and geographical distance*. The variable CULTDIST stands for the cultural distance between a host and the home country. This variable has been built by applying the formula proposed by Bruce Kogut and Harbir Singh (1988), and which is based on the indicators

suggested by Geert Hofstede (1980). The literature agrees that the higher the socio-cultural distance between home and host countries, the higher the uncertainty for a foreign investor. This uncertainty leads to a higher likelihood of divestment (Benito and Larimo, 1995; Barkema, et al., 1996; Benito, 1996; Hennart, et al., 1996). Similarly, we hypothesize that greater geographical distance between the two countries could also have a positive impact on divestment. Therefore, we introduced the variable DISTANCE, measured by the distance (kms) between the Italian and the foreign country's capital. We expect that both CULTDIST and DISTANCE positively impact both FAILURE and RESTRUCTURING.

- *Growth rate and risk of the foreign country*. The variable GDP is a proxy for the economic growth of a host country. GDP is measured by the relative change in the country's GDP during the period 1990-1992 (UNCTAD, 1993). It has been largely shown that the higher the growth rate of a host country, the more likely a foreign investor will have no incentives to divest affiliates (Duhaime and Grant, 1984; Li, 1995; Benito and Larimo, 1995; Benito, 1996; Hennart, et al., 1996). We expect that GDP has a negative impact on both FAILURE and RESTRUCTURING.

  Additionally, we considered a proxy for country risk as perceived by a foreign investor. DRISK is a dummy equal to one if the risk (Institutional Investors Credit Rating Index) increased in the period 1992-1995, and zero otherwise. The expected impact of DRISK is positive both on FAILURE and RESTRUCTURING.

The findings of the econometric analysis

Table 4 presents the descriptive statistics and the correlation matrix for the independent variables in order to assess if multicollinearity exists. The high correlation between the size of the parent company (PAR_SIZE) and its international experience (EXP1,

Table 4. Descriptive statistics of independent variables and correlation matrix

	PAR_SIZE	EXP1	EXP2	STARTUP	REL_SIZE	AGE	ACQUI	JV	CULTDIST	DISTANCE	GDP	DRISK	GROWTH	RD	KL	DIVERS
Mean	13,306.42	20.79	13.66	416.72	0.22	7.41	0.52	0.73	1.18	3,719.38	0.08	0.26	90.84	0.84	14,266.02	0.07
Stad Dev	19,697.42	21.04	17.81	950.33	1.7	10.57	0.49	0.43	0.85	3,533.01	0.2	0.44	32.3	1.49	10,334.30	0.25
Min	25	0	1	11	0.0003	0	0	0	0.23	516	-0.98	0	23	0.002	2,430	0
Max	117,152	89	63	13,402	53.1	89	1	1	3.87	16,205	0.58	1	199.2	7.73	63,705	1
PAR_SIZE	1															
EXP1	0.70	1														
EXP2	0.61	0.43	1													
STARTUP	0.38	0.22	0.14	1												
REL_SIZE	-0.07	-0.08	-0.08	0.13	1											
AGE	0.21	0.43	0.06	0.20	-0.03	1										
ACQUI	0.09	-0.08	0.21	0.08	0.01	-0.38	1									
JV	0.03	0.06	0.13	-0.03	-0.11	0.02	0.15	1								
CULTDIST	-0.00	-0.05	-0.02	-0.02	0.16	-0.03	-0.20	-0.21	1							
DISTANCE	0.08	0.15	0.03	0.06	-0.02	0.11	-0.12	-0.03	0.03	1						
GDP	-0.00	0.00	0.02	-0.04	-0.03	0.02	0.08	0.11	-0.18	-0.08	1					
DRISK	-0.06	-0.02	-0.08	-0.05	0.05	0.09	-0.11	-0.10	0.03	-0.26	-0.11	1				
GROWTH	-0.18	-0.13	-0.16	-0.09	0.01	0.02	-0.10	-0.01	0.04	0.06	-0.07	-0.02	1			
RD	0.19	0.22	-0.03	0.05	-0.03	0.09	-0.05	-0.02	-0.05	0.08	-0.01	-0.00	0.09	1		
KL	0.18	0.13	0.23	0.03	-0.02	0.12	0.02	-0.06	0.07	0.03	-0.06	0.00	-0.03	0.05	1	
DIVERS	0.06	0.03	0.02	-0.05	0.09	-0.07	0.00	-0.07	-0.01	-0.01	-0.05	0.06	-0.03	-0.01	-0.02	1

EXP2) appears to be remarkable (0.70 and 0.61, respectively). This poses some limits to their simultaneous use in the model. Nonetheless, that allows us to interpret size and experience in a similar way, as bigger firms are also the more experienced, and vice versa.

The results of the maximum likelihood estimates of equation (1) are presented in table 5, together with the number of observations, the degrees of freedom, the log likelihood value and some goodness-of-fit tests. The coefficients measure the impact of the variables on the incremental likelihood of FAILURE and RESTRUCTURING with respect to the baseline alternative SURVIVE.

The results obtained corroborate our hypotheses. Indeed, large and more internationally experienced firms are more likely to divest their foreign activities as a consequence of an effective restructuring strategy. Conversely, divestments undertaken by small and less experienced firms are more likely to stem from a failure of their exploratory strategy. PAR_SIZE has a positive effect on RESTRUCTURING ($p< 0.10$), and negative on FAILURE (significant at $p< 0.01$).

Concerning the size of an affiliate, our results show that the start-up size (STARTUP) significantly and negatively influences the likelihood of FAILURE (at $p< 0.05$). That confirms that the likelihood of failure is higher, the smaller the initial size of a foreign affiliate.[9] Indeed, such a situation corresponds to the outcome of a strategy oriented at a risky exploration of the market.

As far as the relative dimension (REL_SIZE) is concerned, its positive impact on FAILURE (at $p< 0.05$) confirms that the difficulties arising when the size of a foreign unit becomes large in comparison to the parent company, increase the likelihood of failure.

[9] The correlation between STARTUP and PAR_SIZE is not very high (0.38), since it is biased by the fact that – particularly at the start-up of FDI – a large parent company can have both large and small affiliates (while, in general, small parent firms have only small affiliates). The correlation would come out higher when considering the total foreign assets of the parent company. (Indeed, large parent companies certainly have a greater amount of total commitment abroad than small firms.)

Interestingly, REL_SIZE shows a significant (at $p<0.01$) negative impact on RESTRUCTURING. Our interpretation is that the parent company may have some hesitation about divesting relatively large affiliates exclusively to free resources, and to re-direct them towards other promising opportunities.

The empirical results also confirm the upwards U-shaped relationship between divestment and an affiliate's age. AGE shows a positive and significant impact on both FAILURE (at $p< 0.01$) and RESTRUCTURING ($p< 0.05$). AGE2 shows instead a negative impact (even if it is significant only for RESTRUCTURING, at $p< 0.10$).

Concerning ownership arrangements, the positive and significant coefficients of ACQUI and JV (on both FAILURE and RESTRUCTURING) support the hypothesis that acquisitions as well as joint ventures are more likely to experience divestment than greenfield affiliates and wholly-owned affiliates. In fact, they require "double-layered acculturation" and integration costs that imply higher complexity and uncertainty.

The positive impact of DIVERS on RESTRUCTURING ($p<0.05$) confirms the hypothesis that TNCs tend to re-focus their business mainly through divestment of affiliates far from their core business.[10]

Finally, as regards the control variables, the country-specific characteristics show an influence on divestment likelihood. Specifically, geographical distance (DISTANCE) positively impacts both on FAILURE ($p<0.01$) and RESTRUCTURING ($p<0.05$), and the foreign country's economic growth (GDP) shows a significant ($p< 0.10$) and positive impact only on RESTRUCTURING.

Concerning industry-specific effects, R&D intensity (R&D) proved to be significant with a positive impact on FAILURE ($p< 0.01$). This corroborates the hypothesis that the likelihood of failure increases because of the risk involved in R&D projects. Similarly, the estimated impact of the industry growth rate (GROWTH) is negative on RESTRUCTURING, while it does not seem to influence

[10] On the other hand, the relationship with FAILURE is not significant.

Table 5. Estimates of the multinomial models (best specification)

Incremental likelihood of FAILURE with respect to SURVIVE					
Variable	Coefficient	Standard Error	T-Statistic	Significance	
CONSTANT	-1.83015	0.55103	-3.32132	0.00090	***
PAR_SIZE	-0.00009	0.00002	-4.00935	0.00006	***
STARTUP	-0.00143	0.00071	-1.99665	0.04586	**
REL_SIZE	0.24820	0.11932	2.08005	0.03752	**
JV	0.48788	0.26704	1.82702	0.06770	*
ACQUI	0.76830	0.25978	2.95757	0.00310	***
AGE	0.07027	0.02654	2.64793	0.00810	***
AGE2	-0.00082	0.00059	-1.37939	0.16777	
GROWTH	-0.00219	0.00361	-0.60641	0.54424	
R&D	0.39420	0.07312	5.39106	0.00000	***
KL	-0.00007	0.00002	-3.44587	0.00057	***
DIVERS	-0.28216	0.56061	-0.50330	0.61476	
GDP	0.37945	0.57658	0.65810	0.51047	
DISTANCE	0.00009	0.00003	2.70743	0.00678	***
Incremental likelihood of RESTRUCTURING with respect to SURVIVE					
Variable	Coefficient	Standard Error	T-Statistic	Significance	
CONSTANT	-0.65499	0.42572	-1.53854	0.12392	
PAR_SIZE	0.00001	0.00000	1.91705	0.05523	*
STARTUP	0.00001	0.00010	0.10318	0.91782	
REL_SIZE	-5.63716	1.33195	-4.23227	0.00002	***
JV	1.31741	0.18995	6.93543	0.00000	***
ACQUI	0.56447	0.20943	2.69531	0.00703	***
AGE	0.04319	0.02030	2.12791	0.03334	**
AGE2	-0.00076	0.00042	-1.81268	0.06988	*
GROWTH	-0.00833	0.00307	-2.71040	0.00672	***
R&D	-0.08942	0.05839	-1.53143	0.12566	
KL	-0.00001	0.00001	-1.19432	0.23235	
DIVERS	0.70710	0.28110	2.51552	0.01189	**
GDP	0.86967	0.47480	1.83167	0.06700	*
DISTANCE	0.00006	0.00002	2.40133	0.01634	**

Total observations	1054	Usable observations	1022
Degrees of freedom	994	Function Value	-525.786
L-ratio	226.372 ***	Mc Fadden R2	0.820
Schwarz Information Criterion	1.117	Akaike Information Criterion	1.054

Legend: *p< 0.10; **p< 0.05; ***p< 0.01.

FAILURE significantly. Lastly, the capital intensity of the industry (KL) negatively and significantly influences FAILURE ($p<0.01$). Since higher immobilization of capital implies higher sunk costs and, consequently, higher barriers to exit, divestment is more likely to be undertaken in case of a failure (that is when losses exceed sunk costs).

Conclusions

This article has empirically addressed the issue of divestment of foreign affiliates by TNCs. The fundamental idea is that a divestment can be associated to both a *failure* of the expectations on an affiliate's performance, and a needed *strategic restructuring* that a firm has to undertake to adapt in order to face unexpected changes in the competitive environment. Parent companies face the risk and uncertainty inherent in international activities through different strategies, depending on their financial and managerial capabilities. Consequently, they experience different likelihoods of failure.

Our results corroborate the idea that large TNCs can more easily collect information about foreign markets, as they can undertake costly activities of monitoring and control. Therefore, they reduce the risk of failure. Likewise, TNCs that have already undertaken FDI benefit from learning-through-experience. For this reason, a divestment of their affiliates is likely to be related to a wider restructuring strategy. On the other hand, small and less experienced TNCs can hardly remove the risk of failure. In fact, their international growth relies often upon exploratory strategies based on gambling rather than on effective decision-making processes.

Additionally, empirical results confirm the crucial role of the dimension of an affiliate. On the one hand, the likelihood of failure decreases when the initial dimension of an affiliate increases. This confirms both the general theory on firms' turnover, and the gambler's earnings hypothesis. On the other hand, the difficulties arising when the size of an affiliate becomes too large in comparison to the parent company, increase the likelihood of failure.

As for the age of an affiliate, it has been shown that the likelihood of divestment is low at the beginning due to the "honeymoon effect". It increases with the age of the affiliate. The

relation changes after a certain time interval during which the affiliate establishes webs of relationships with the local business environment.

According to previous studies, joint ventures and acquisitions seem to be more sensitive to failure, as they require by their nature "double-layered acculturation" and higher integration costs than wholly owned and greenfield projects.

Finally, affiliates that represent diversified branches of the parent company are more likely to be divested because of restructuring (re-focusing) by the parent firm itself.

This article supports the idea that information is crucial to firms undertaking FDI, as it allows them to reduce the risk of failure. That suggests some policy implications for home and host countries. On the one hand, a careful diffusion at home of relevant information about international growth opportunities worldwide could make the decision-making processes of TNCs and their geographical selection easier. Such "ad hoc" assistance would decrease their need of collecting information, thus reducing the total cost of going abroad. Smaller firms would especially benefit from such an approach. Lower costs and lower risk allow them to undertake a proper decision-making process and to avoid growth strategies exclusively based on risky gambling approaches. Consequently, their risk of failure could be reduced. On the other hand, the contextual dissemination of information about host countries' idiosyncrasies is desirable. This would favour the location process by foreign firms, and their potential further re-investment. Additionally, the provision of qualified after-care services to established foreign affiliates should accompany such a diffusion of information. Indeed, this could reduce the likelihood of failure and the consequent withdrawal of TNCs from a foreign market. Such a joint action could be carried out by national and local institutions/agencies specifically devoted to this purpose.

A coordinated commitment – by both home and host countries – on providing information and assistance to firms could therefore substantially reduce the risk inherent in FDI, and the consequent risk of failure. International cooperation between countries could therefore lead to important results, particularly relevant for the least developed and the developing countries.

The issue tackled in this article could be extended in several directions. The empirical evidence provided supports the need of distinguishing different types of exit by TNCs from a foreign market. In particular, the differences in a firm's behaviour as far as divestment choices are concerned require further careful investigation. The phenomenon should be better analyzed by using more precise proxies that both distinguish between failure and restructuring and also allow for other aspects of the exit mode (complete sell-off of the assets involved to another company, spin-off, management buy out or liquidation). Further evidence is also needed from analyses run over longer time periods. Among other things, they would allow an investigation of the dynamic relationships between the birth and mortality rates of foreign affiliates and their impact on corporate growth and economic development.■

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World Investment Report 1999:
Foreign Direct Investment and the Challenge of Development

Overview

The *World Investment Report 1999* was prepared by a team led by Karl P. Sauvant and comprising Victoria Aranda, Bijit Bora, Persephone Economou, Masataka Fujita, Boubacar Hassane, Kálmán Kalotay, Gabriele Köhler, Padma Mallampally, Anne Miroux, Ludger Odenthal, Juan Pizarro, Marko Stanovic, James Xiaoning Zhan and Zbigniew Zimny. Specific inputs were received from Mehmet Arda, Mattheo Bushehri, John Gara, Khalil Hamdani, Mongi Hamdi, Anna Joubin-Bret, Assad Omer, Olle Östensson, Pedro Roffe, Taffere Tesfachew and Katja Weigl. The work was carried out under the overall direction of Lynn K. Mytelka. This is a reprint of pages 1-49 of the *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development. An Overview* (New York and Geneva: United Nations). UNCTAD/WIR/1999(Overview).

The momentum for the expansion of international production continues to hold, though the world economy is currently affected by a number of factors that could discourage investment, including foreign direct investment (FDI) by transnational corporations (TNCs). FDI flows to developing countries declined in 1998, but that decline was confined to a few countries. Technology flows, as measured by technology payments, continued to grow, partly reflecting the increasing importance of technology in the production process. Cross-border M&As among developed countries have driven the expansion of FDI flows and international production capacity in 1998. This suggests that, in the face of diminished financing and reduced market prospects world-wide, TNCs in the Triad are concentrating on consolidating their assets and activities so as to strengthen their readiness for global expansion or survival once the health of the world economy, including countries affected by the recent financial crises and their aftermath, is fully restored.

TRENDS

Transnational corporations drive international production ...

International production – the production of goods and services in countries that is controlled and managed by firms headquartered in other countries – is at the core of the process of globalization. TNCs – the firms that engage in international production – now comprise over 500,000 foreign affiliates established by some 60,000 parent companies, many of which also have non-equity relationships with a large number of independent firms. The TNC universe comprises large firms mainly from developed countries, but also firms from developing countries and, more recently, firms from economies in transition, as well as small- and medium-sized firms. A small number of TNCs, ranking at the top, are noteworthy for their role and relative importance in international production:

- The world's 100 largest non-financial TNCs together held $1.8 trillion in foreign assets, sold products worth $2.1 trillion abroad and employed some six million persons in their foreign affiliates in 1997 (see table 1 for the top 50 of those firms). They accounted for an estimated 15 per cent of the foreign assets of all TNCs and 22 per cent of their sales. General Electric is the largest among these TNCs ranked by foreign assets, holding the top place for the second consecutive year. Close to 90 per cent of the top 100 TNCs are from Triad countries (European Union, Japan and United States), while only two developing-country firms - Petroleos

  de Venezuela and Daewoo - figure in the list. While company rankings may change from year to year, membership in the list of the 100 largest TNCs has not changed much since 1990: about three-quarters of the TNCs in the list in 1997 were already part of the world's 100 largest TNCs in 1990. Even the ranking of the top TNCs by their degree of transnationality (an index reflecting the combined importance of foreign assets, sales and employment as shares of their respective totals) has been fairly stable. Automotive, electronics/electrical equipment, petroleum and chemicals/ pharmaceuticals are the dominant industries to which firms in the top 100 belong.

- The top 50 non-financial TNCs based in developing countries together held $105 billion in foreign assets in 1997 (see table 2 for the top 25 of those firms). The top companies from developing countries are less transnationalized than the world's

Table 1. The world's top 50 TNCs, ranked by foreign assets, 1997

(Billions of dollars and number of employees)

Ranking by					Assets		Sales		Employment		Transnationality
Foreign assets	Transnationality index[a]	Corporation	Country	Industry[b]	Foreign	Total	Foreign	Total	Foreign	Total	index[a] (Per cent)
1	84	General Electric	United States	Electronics	97.4	304.0	24.5	90.8	111 000	276 000	33.1
2	80	Ford Motor Company	United States	Automotive	72.5	275.4	48.0	153.6	174 105	363 892	35.2
3	44	Royal Dutch/Shell Group[c]	Netherlands/ UnitedKingdom	Petroleum expl./ref./distr.	70.0	115.0	69.0	128.0	65 000	105 000	58.9
4	91	General Motors	United States	Automotive	0.0	228.9	51.0	178.2	...	608 000	29.3
5	29	Exxon Corporation	United States	Petroleum expl./ref./distr.	54.6	96.1	104.8	120.3	...	80 000	65.9
6	75	Toyota	Japan	Automotive	41.8	105.0	50.4	88.5	...	159 035	40.0
7	54	IBM	United States	Computers	39.9	81.5	48.9	78.5	134 815	269 465	53.7
8	50	Volkswagen Group	Germany	Automotive	...	57.0	42.7	65.0	133 906	279 892	56.8
9	4	Nestlé SA	Switzerland	Food and beverages	31.6	37.7	47.6	48.3	219 442	225 808	93.2
10	71	Daimler-Benz AG *	Germany	Automotive	30.9	76.2	46.1	69.0	74 802	300 068	44.1
11	39	Mobil Corporation	United States	Petroleum expl./ref./distr	30.4	43.6	36.8	64.3	22 200	42 700	59.7
12	74	FIAT Spa	Italy	Automotive	30.0	69.1	20.2	50.6	94 877	242 322	40.8
13	16	Hoechst AG	Germany	Chemicals	29.0	34.0	24.3	30.0	...	137 374	76.5
14	2	Asea Brown Boveri (ABB)	Switzerland	Electrical equipment	...	29.8	30.4	31.3	200 574	213 057	95.7
15	9	Bayer AG	Germany	Chemicals	...	30.3	...	32.0	...	144 600	82.7
16	48	Elf Aquitaine SA	France	Petroleum expl./ref./distr	26.7	42.0	25.6	42.3	40500	83 700	57.6
17	60	Nissan Motor Co., Ltd.	Japan	Automotive	26.5	57.6	27.8	49.7	...	137 201	51.1
18	5	Unilever[d]	Netherlands/ UnitedKingdom	Food and beverages	25.6	30.8	44.8	46.4	262 840	269 315	92.4
19	56	Siemens AG	Germany	Electronics	25.6	67.1	40.0	60.6	201 141	386 000	52.1
20	10	Roche Holding AG	Switzerland	Pharmaceuticals	...	37.6	12.7	12.9	41 832	51 643	82.2
21	34	Sony Corporation	Japan	Electronics	...	48.2	40.3	51.1	...	173 000	62.8
22	78	Mitsubishi Corporation	Japan	Diversified	21.9	67.1	41.5	120.4	...	8 401	36.9
23	1	Seagram Company	Canada	Beverages	21.8	22.2	9.4	9.7	...	31 000	97.6
24	32	Honda Motor Co., Ltd.	Japan	Automotive	21.5	36.5	31.5	45.4	...	109 400	64.1
25	38	BMW AG	Germany	Automotive	20.3	31.8	26.4	35.9	52 149	117 624	60.7
26	31	Alcatel Alsthom Cie	France	Electronics	20.3	41.9	25.9	31.0	...	189 549	64.8
27	8	Philips Electronics N.V,	Netherlands	Electronics	20.1	25.5	33.0	33.5	206 236	252 268	86.4
28	21	News Corporation	Australia	Media	20.0	30.7	9.5	10.7	...	28 220	72.8
29	58	Philip Morris	United States	Food/Tobacco	19.4	55.9	32.1	56.1	...	152 000	51.1
30	42	British Petroleum (BP) *	United Kingdom	Petroleum expl./ref./distr	19.2	32.6	36.5	71.3	37 600	55 650	59.2
31	57	Hewlett-Packard	United States	Electronics	18.5	31.7	23.8	42.9	...	121 900	51.1
32	20	Total SA	France	Petroleum expl./ref./distr	...	25.2	23.4	31.9	...	54 391	73.2

/...

Table 1. The world's top 50 TNCs, ranked by foreign assets, 1997 (concluded)

(Billions of dollars and number of employees)

Ranking by					Assets		Sales		Employment		Transnationality
Foreign assets	Transnationality index[a]	Corporation	Country	Industry[b]	Foreign	Total	Foreign	Total	Foreign	Total	index[a] (Per cent)
33	68	Renault SA	France	Automotive	18.3	34.9	18.5	35.6	45 860	141 315	45.7
34	18	Cable and Wireless Plc	United Kingdom	Telecommunication	...	21.6	7.8	11.5	33 740	46 550	74.7
35	79	Mitsui & Co., Ltd.	Japan	Diversified	17.9	55.5	52.3	132.6	...	10 994	35.8
36	30	Rhone-Poulenc SA	France	Chemicals/pharmaceuticals	17.8	27.5	11.5	15.0	...	68 377	65.7
37	55	Viag AG	Germany	Diversified	17.4	32.7	15.9	27.6	...	95 561	53.3
38	41	BASF AG	Germany	Chemicals	...	26.8	23.9	32.2	...	104 979	59.5
39	82	Itochu Corporation	Japan	Trading	16.7	56.8	48.7	117.7	2 600	8 878	33.3
40	76	Nissho Iwai Corporation	Japan	Trading	16.6	40.4	32.3	75.5	2 068	6 398	38.8
41	72	Du Pont (E.I.)	United States	Chemicals	16.6	42.7	20.4	39.7	...	98 000	41.8
42	25	Diageo Plc	United Kingdom	Beverages	...	29.7	17.6	22.6	63 761	79 161	71.0
43	19	Novartis	Switzerland	Pharmaceuticals/chemicals	16.0	36.7	21.0	21.5	71 403	87 239	74.4
44	94	Sumitomo Corporation	Japan	Trading/machinery	15.4	43.0	15.1	95.2	...	8 694	25.9
45	88	ENI Group	Italy	Petroleum expl./ref./distr.	14.6	49.4	12.5	34.3	23 239	80 178	31.7
46	86	Chevron Corporation	United States	Petroleum expl./ref./distr.	14.3	35.5	13.8	40.6	8 610	39 362	32.1
47	52	Dow Chemical	United States	Chemicals	14.3	23.6	11.3	20.0	...	42 861	56.4
48	69	Texaco Incorporated	United States	Petroleum expl./ref./distr.	14.1	29.6	22.3	45.2	...	29 313	45.3
49	61	BCE Inc.	Canada	Telecommunication	13.6	28.2	15.5	23.2	...	122 000	50.9
50	65	Xerox Corporation	United States	Photo equipment	13.5	27.7	9.0	18.2	...	91 400	48.7

Source: UNCTAD/Erasmus University database.

[a] The index of transnationality is calculated as the average of three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

[b] Industry classification for companies follows the United States Standard Industrial Classification as used by the United States Securities and Exchange Commission (SEC).

[c] Foreign assets, sales and employment are outside Europe.

[d] Foreign assets, sales and employment are outside the United Kingdom and the Netherlands.

... Data on foreign assets, foreign sales and foreign employment were not made available for the purpose of this study. In case of non-availability, they are estimated using secondary sources of information or on the basis of the ratios of foreign to total assets; foreign to total sales and foreign to total employment.

* Mergers between Daimler-Benz and Chrysler, resulting in Daimler-Chrysler and between British Petroleum and Amoco, resulting in BP-Amoco, are not documented yet as they took place in 1998.

Note: The list includes non-financial TNCs only. In some companies, foreign investors may hold a minority share of more than 10 per cent.

Table 2. The top 25 TNCs from developing countries, ranked by foreign assets, 1997

(Millions of dollars and number of employees)

Ranking by					Assets		Sales		Employment		Transnationality
Foreign assets	Transnationality index[a]	Corporation	Country	Industry[b]	Foreign	Total	Foreign	Total	Foreign	Total	index[a] (Per cent)
1	12	Petroleos de Venezuela S.A.	Venezuela	Petroleum expl./ ref./distr.	9 007	47 148	32 502	34 801	11 849	56 592	44.5
2	10	Daewoo Corporation	Republic of Korea	Diversified	...	22 946	...	18 802	...	...	50.8
3	4	Jardine Matheson Holdings Ltd. [c]	Hong Kong, China/ Bermuda	Diversified	6 652	11 970	7 983	11 522	..	175 000	75.0
4	5	First Pacific Company Ltd.	Hong Kong, China	Electronics	6 295	11 386	7 416	8 308	40 400	51 270	74.4
5	9	Cemex, S.A.	Mexico	Construction	5 627	10 231	2 235	3 788	10 690	19 174	56.6
6	17	Hutchison Whampoa, Ltd.	Hong Kong, China	Diversified	4 978	15 086	1 899	5 754	17 013	37 100	37.3
7	7	Sappi Limited	South Africa [d]	Paper	3 830	4 953	2 419	3 557	9 492	23 458	61.9
8	29	China State Construction Engineering Corporation	China	Construction	3 730	7 230	1 530	5 420	5 496	258 195	27.3
9	14	China National Chemicals Import and Export Corporation	China	Diversified	3 460	5 810	11 240	17 880	625	8 905	43.1
10	23	LG Electronics Incorporated	Republic of Korea	Electronics and electrical equipment	3 158	15 431	5 175	17 640	32 532	80 370	30.1
11	35	YPF Sociedad Anonima	Argentina	Petroleum expl./ ref./distr.	3 061	12 761	911	6 144	1 908	10 002	19.3
12	50	Petroleo Brasileiro S.A. - Petrobras	Brazil	Petroleum expl./ ref./distr.	..	34 233	..	27 946	..	41 173	4.4
13	39	Sunkyong Group	Republic of Korea	Diversified	2 561	24 572	9 960	31 692	2 600	32 169	16.6
14	15	Hyundai Engineering & Construction Co.	Republic of Korea	Construction	..	8 063	..	5 405	..	30 981	37.6
15	43	New World Development Co. Ltd.	Hong Kong, China	Construction	2 060	14 030	800	2 580	..	14 840	15.3
16	3	Guangdong Investment Ltd.	Hong Kong, China	Diversified	1 898	3 053	676	924	15 080	16 500	75.6
17	13	Citic Pacific Limited	Hong Kong, China	Diversified	1 834	8 733	912	2 154	8 262	11 800	44.5
18	30	PETRONAS - Petroliam Nasional Berhad	Malaysia	Petroleum expl./ ref./distr.	..	20 990	..	10 055	..	13 000	25.9

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Table 2. The top 25 TNCs from developing countries, ranked by foreign assets, 1997 (concluded)

(Millions of dollars and number of employees)

Ranking by					Assets		Sales		Employment		Transnationality
Foreign assets	Transnationality index[a]	Corporation	Country	Industry[b]	Foreign	Total	Foreign	Total	Foreign	Total	index[a] (Per cent)
19	41	Shougang Corporation	China	Diversified	1 600	6 640	1 040	4 390	..	218 158	16.2
20	6	Fraser & Neave Limited	Singapore	Food and beverages	1 578	4 273	1 230	1 912	11 461	13 131	62.8
21	40	Samsung Electronics Co. Ltd.	Republic of Korea	Electronics and electrical equipment	..	16 301	..	13 050	..	57 817	16.3
22	16	Singapore Airlines Limited	Singapore	Transportation	1 546	9 111	3 454	4 727	2 957	13 258	37.4
23	21	Companhia Vale do Rio Doce	Brazil	Transportation	1 509	14 332	3 320	4 744	7 432	42 456	32.7
24	25	Enersis S.A.	Chile	Electrical services	..	14 281	..	890	..	14 366	28.2
25	8	Acer Incorporated	Taiwan Province of China	Diversified	1 376	2 946	3 204	4 217	6 792	12 342	59.2

Source: UNCTAD, FDI/TNC database.

[a] The transnationality index (TI) is calculated as the average of the sum of three ratios for each TNC: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

[b] Industry classification for companies follows the United States Standard Industrial Classification which is used by the United States Securities and Exchange Commission (SEC).

[c] The company is incorporated in Bermuda and the group is managed from Hong Kong, China.

[d] Within the context of this list, South Africa is treated as a developing country.

.. Data on foreign assets, foreign sales or foreign employment were not made available for the purpose of this study. In case of non availability, they are estimated using secondary sources of information or on the basis of the ratios of foreign to total assets, foreign to total sales and foreign to total employment.

Note: The list includes non-financial TNCs only. In some companies, foreign investors may hold a minority share of more than 10 per cent.

Table 3. The top 10 TNCs based in Central Europe,[a] ranked by foreign assets, 1998

(Millions of dollars and number of employees)

Ranking by					Assets		Sales		Employment		Transnationality
Foreign assets	Transnationality index[b]	Corporation	Country	Industry[c]	Foreign	Total	Foreign	Total	Foreign	Total	index[b] (Per cent)
1	4	Latvian Shipping Co.	Latvia	Transportation	399.0	505.0	201.0	214.0	1 631	2 275	81.5
2	10	Podravka Group	Croatia	Food & beverages/ pharmaceuticals	285.9	477.1	119.4	390.2	501	6 898	32.6
3	9	Gorenje Group	Slovenia	Domestic appliances	256.4	645.9	642.2	1 143.3	607	6 717	35.0
4	5	Motokov a.s.	Czech Republic	Trade	163.6	262.5	260.2	349.1	576	1 000	64.8
5	1	Atlantska Plovidba, d.d.	Croatia	Transportation	152.0	167.0	47.0[d]	47.0	-	528	95.5
6	8	Pliva Group	Croatia	Pharmaceuticals	142.1	855.1	334.3	463.0	1 616	6 680	37.7
7	17	Skoda Group Plzen	Czech Republic	Diversified	139.1	973.4	150.7	1 244.5	1 073	19 830	10.6
8	2	Adria Airways d.d.	Slovenia	Transportation	129.4	143.7	97.7	97.7	-	585	95.0
9	21	MOL Hungarian Oil and Gas Plc.	Hungary	Petroleum & natural gas	128.3	2 881.6	203.4	2 958.1	628	20 140	5.1
10	25	VSZ a.s. Kosice	Slovakia	Iron & steel	72.0	1 445.0	0.2	876.0	58	26 719	1.7

Source: UNCTAD survey of top TNCs in Central and Eastern Europe.

Note: Includes non-financial TNCs only. In some companies, foreign investors may hold a minority share of more than 10 per cent.

[a] Based on survey responses received from Croatia, Slovenia, Hungary, Lithuania, Slovakia, Czech Republic, Macedonia (TFYR), Rep. Moldova, Romania and Ukraine.

[b] The index of transnationality is calculated as the average of three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

[c] Industry classification for companies follows the United States Standard Industrial Classification as used by the United States Securities and Exchange Commission (SEC).

[d] Including export sales by parent company.

100 largest TNCs. They are domiciled in a handful of economies: Hong Kong (China), Republic of Korea, China, Venezuela, Mexico and Brazil. Their industrial composition is different from that of the world's top 100 TNCs, with food and beverages, petroleum, construction and diversified activities being the most important industries.

- The list of the 25 largest TNCs based in Central Europe (not including the Russian Federation) — published for the first time in this year's *World Investment Report* — identifies a new nascent group of investors which, together, held $2.3 billion in assets abroad in 1998 and had foreign sales worth $3.7 billion (see table 3 for the top 10 of those firms). Employment in their foreign affiliates, however, is low, a factor that reduces the value of the transnationality index for these firms. Most of the top TNCs from Central Europe are active in transportation, chemicals and pharmaceuticals, and natural resources.

The largest TNCs as described above are determined on the basis of the value of assets that they control abroad. Control of assets is usually achieved by a minimum share in equity or ownership, which defines FDI. Increasingly, however, TNCs are also operating internationally through non-equity arrangements, including strategic partnerships. A rising number of technology partnerships have been formed, in particular in the information technology, pharmaceutical and automobile industries in the 1990s. Such partnerships assist firms in their search for ways to reduce costs and risks, and provide them with the flexibility required in an uncertain and constantly changing technological environment. Knowledge-based networks, a dimension not captured by the traditional measures of international production, can be a crucial factor of market power in some industries.

... which takes place in an increasingly liberal policy framework.

The trend towards the liberalization of regulatory regimes for FDI continued in 1998, often complemented with proactive promotional measures. Out of 145 regulatory changes relating to FDI made during that year by 60 countries, 94 per cent were in the direction of creating more favourable conditions for FDI (table 4). The number of bilateral investment agreements also increased further, reaching a total of 1,726 by the end of 1998, of which 434 had been concluded between developing countries. Close to 40 per cent of the 170 treaties signed that year were between developing countries. By the end of 1998, the number of treaties for the avoidance of double taxation had reached a total of 1,871.

At the regional and interregional levels, rule-making activity on FDI continued to be intense in all regions, mainly in connection with the creation or expansion of regional integration schemes, and typically involving rules for the liberalization and protection of FDI. The most important development in 1998 was that the negotiations on a Multilateral Agreement on Investment within the OECD were discontinued; however, work in the OECD continued in several other investment-related areas. Overall, the question of governance in international business transactions has been a recurrent subject in discussions and work related to international instruments in recent years.

Table 4. National regulatory changes, 1991-1998

Item	1991	1992	1993	1994	1995	1996	1997	1998
Number of countries that introduced changes in their investment regimes	35	43	57	49	64	65	76	60
Number of regulatory changes	82	79	102	110	112	114	151	145
of which:								
More favourable to FDI [a]	80	79	101	108	106	98	135	136
Less favourable to FDI [b]	2	-	1	2	6	16	16	9

Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, table IV.1, p. 115.

[a] Including liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives.

[b] Including changes aimed at increasing control as well as reducing incentives.

International production has many dimensions ...

International production involves a package of tangible and intangible assets. Its principal global features (which, of course, differ from country to country) can be captured in various ways (table 5):

- On the production side, the value of the output under the common governance of TNCs (parent firms and foreign affiliates) amounts to about 25 per cent of global output, one third of it in host countries. Foreign affiliate sales (of goods and services) in domestic and international markets were about $11 trillion in 1998, compared to almost $7 trillion of world exports in the same year. International production is thus more important than international trade in delivering goods and services to foreign markets. In the past decade, both global

Table 5. Selected indicators of FDI and international production, 1986-1998

(Billions of dollars and percentage)

Item	Value at current prices (Billion dollars)			Annual growth rate (Per cent)				
	1996	1997	1998	1986-1990	1991-1995	1996	1997	1998
FDI inflows	359	464	644	24.3	19.6	9.1	29.4	38.7
FDI outflows	380	475	649	27.3	15.9	5.9	25.1	36.6
FDI inward stock	3 086	3 437	4 088	17.9	9.6	10.6	11.4	19
FDI outward stock	3 145	3 423	4 117	21.3	10.5	10.7	8.9	20.3
Cross-border M&As [a]	163	236	411	21.0 [b]	30.2	15.5	45.2	73.9
Sales of foreign affiliates	9 372	9 728 [c]	11 427 [c]	16.6	10.7	11.7	3.8 [c]	17.5 [c]
Gross product of foreign affiliates	2 026	2 286 [c]	2 677 [c]	16.8	7.3	6.7	12.8 [c]	17.1 [c]
Total assets of foreign affiliates	11 246	12 211 [c]	14 620 [c]	18.5	13.8	8.8	8.6 [c]	19.7 [c]
Exports of foreign affiliates	1 841 [c]	2 035 [c]	2 338 [c]	13.5	13.1	-5.8 [c]	10.5 [c]	14.9 [c]
Employment of foreign affiliates (thousands)	30 941	31 630 [c]	35 074 [c]	5.9	5.6	4.9	2.2 [c]	10.9 [c]
Memorandum:								
GDP at factor cost	29 024	29 360	..	12.0	6.4	2.5	1.2	..
Gross fixed capital formation	6 072	5 917	..	12.1	6.5	2.5	-2.5	..
Royalties and fees receipts	57	60	..	22.4	14.0	8.6	3.8	..
Exports of goods and non-factor services	6 523	6 710	6 576 [c]	15.0	9.3	5.7	2.9	-2.0 [c]

Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, table I.2, p. 9.

[a] Majority-held investments only.
[b] 1987-1990 only.
[c] Estimates.

Note: Not included in this table are the value of worldwide sales by foreign affiliates associated with their parent firms through non-equity relationships and the sales of the parent firms themselves. Worldwide sales, gross product, total assets, exports and employment of foreign affiliates are estimated by extrapolating the worldwide data of foreign affiliates of TNCs from France, Germany, Italy, Japan and the United States (for sales and employment) and those from Japan and the United States (for exports), those from the United States (for gross product), those from Germany and the United States (for assets) on the basis of the shares of those countries in the worldwide outward FDI stock.

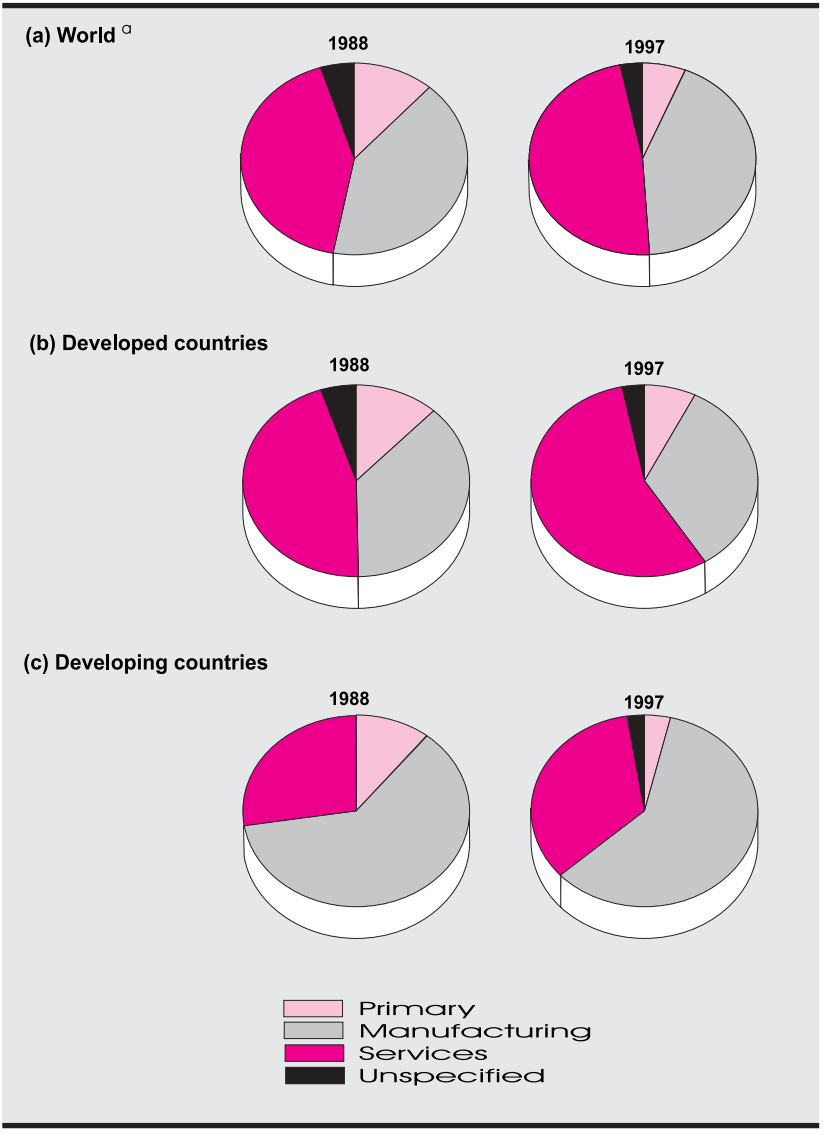
output and global sales of foreign affiliates have grown faster than world gross domestic product as well as world exports. Judging from data on FDI stock, most international production in developed countries is in services, and most international production in developing countries is in manufacturing (figure 1). For both groups of countries, FDI in the primary sector has declined, while FDI in services in developing countries is gaining in importance. These shifts reflect changes in the structure of the world economy, as well as changing competitive advantages of firms and locational advantages of countries, and the responses of TNCs to globalization and liberalization.

- Technology flows play an important role in international production. Technology embodied in capital goods exported to foreign affiliates is measured by the value of those exports. Technology provided via contractual agreements is measured by the value of payments and receipts associated with them. And technology transmitted through training is measured by the cost of resources used in the training. Technology payments and receipts of countries in the form of royalty payments and licence fees have risen steadily since the mid-1980s, and the intra-firm (between parent firm and foreign affiliate) share of these expenditures, already high, has also risen (figure 2). These changes reflect the fact that FDI is increasingly geared to technologically-intensive activities and that technological assets are becoming more and more important for TNCs to maintain and enhance their competitiveness. Much of the increase has taken place in developed countries where royalty payments and receipts have risen faster than FDI flows. These countries accounted for 88 per cent of payments and 98 per cent of receipts of cross-border flows of royalties and licence fees world-wide in 1997.

- Innovation and research and development (R&D) are at the heart of the ownership advantages that propel firms to engage in international production. On the basis of data for Japanese and United States TNCs, it seems that the bulk of R&D expenditure is undertaken by parent firms in their home countries and, when located abroad, mostly in developed countries. Affiliates tend to spend much less on R&D, especially in comparison to the R&D expenditures of the host countries in which they are located, notable exceptions being Ireland and Singapore.

- International trade is stimulated by international production because of the trading activities of TNCs. At the same time, international production takes place because trade is not

Figure 1. Inward FDI stock, by sector, 1988 and 1997
(Percentage)

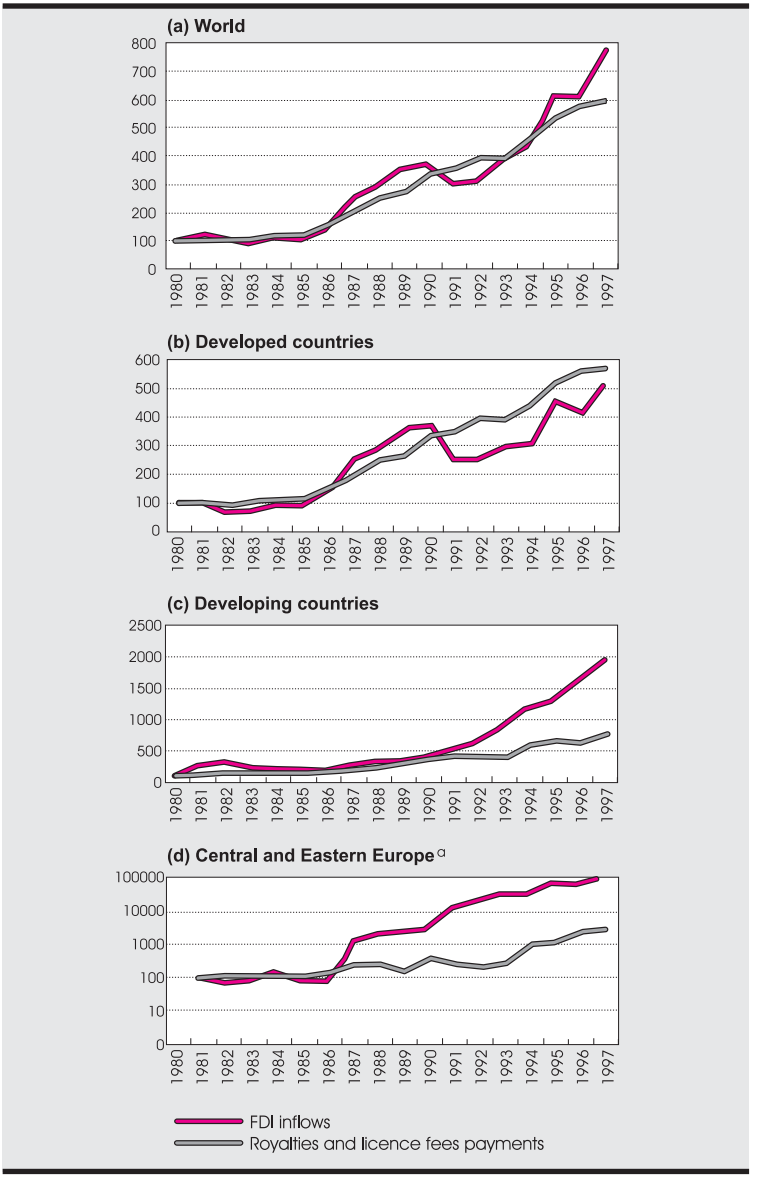


Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, figure I.13, p. 27.

[a] Not including Central and Eastern Europe.

Figure 2. Growth of technology payments and FDI flows, by group of countries, 1980-1997

(1980 = 100)



Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, figure I.5, p. 14.

possible in some cases, such as in the case of certain services that are location-bound because of the need for proximity between buyers and sellers. Trade within TNCs and arm's-length trade associated with TNCs are estimated to account, together, for about two-thirds of world trade, and intra-firm trade, alone, for one-third. High propensities to export on the part of foreign affiliates may be accompanied by high propensities to import, which can lead to trade deficits.

- International production generates employment opportunities that are particularly welcome in host countries with high rates of unemployment. In recent years, employment in foreign affiliates has been rising despite stagnating employment growth in TNC systems as a whole, i.e. when parent firms are also taken into account. The trend towards increasing employment is more pronounced for foreign affiliates in developing countries. However, employment in foreign affiliates is typically a small share of total paid employment in these countries, amounting to not more than two per cent of the workforce. In the manufacturing sector, which receives the bulk of FDI, this share is higher.

- Financial flows associated with international production consist of funds for financing the establishment, acquisition or expansion of foreign affiliates. The source of these funds can be the TNC itself – new equity from parent firms, loans, and/or earnings of foreign affiliates that are reinvested, together defined as FDI. There are also sources of funds external to a TNC, raised by foreign affiliates in host countries and international capital markets. The expenditure of TNCs on establishing, acquiring or expanding international production facilities is therefore higher in value than the amount normally captured by FDI flows.

- The capital base of international production, regardless of how it is financed, is reflected in the value of assets of foreign affiliates. This is about four times the value of the FDI stock in the case of developed countries, but only marginally higher than the value of the FDI stock in the case of developing countries.

The extent to which a particular host country is involved in international production can be measured by an index of transnationality. It captures the average of the following four ratios: FDI inflows as a percentage of gross fixed capital formation for the past three years; inward FDI stock as a percentage of GDP; value added of foreign affiliates as a percentage of GDP; and employment

of foreign affiliates as a percentage of total employment. Among developed countries, New Zealand has the highest transnationality index and Japan, the lowest. Among developing countries, Trinidad and Tobago has the highest index and the Republic of Korea, the lowest. Small host countries tend to score high in terms of the transnationality index (figure 3).

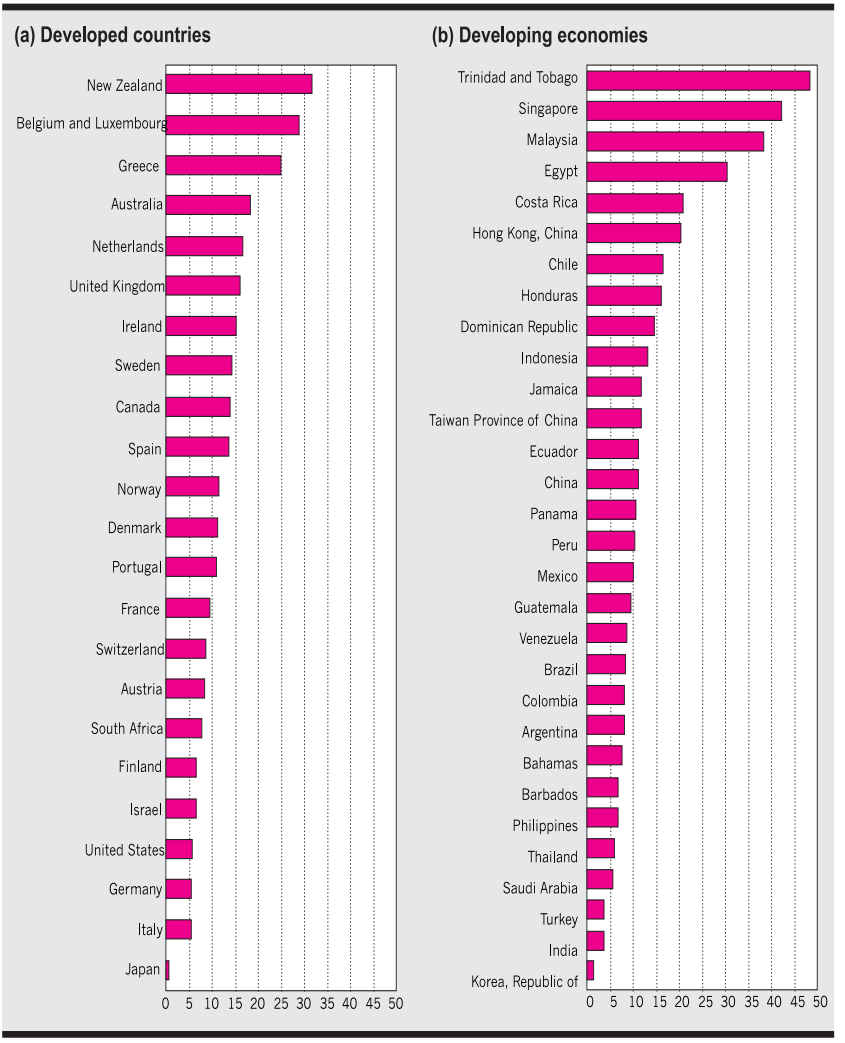
... that manifest themselves differently in different regions.

With the exception of data on FDI (one source of finance for international production), comprehensive data on the global dimensions of international production are not available. Judging from the growth in FDI inflows and outflows (figure 4) as well as in other variables related to the activities of foreign affiliates, however, more and more firms engage increasingly in international production. In 1998, despite adverse economic conditions such as the financial crisis and ensuing recession in several Asian countries, the financial and economic crisis in the Russian Federation and the repercussions of these crises in some Latin American countries, declining world growth, trade, and commodity prices, and reduced bank lending, portfolio investment and privatization activity, FDI inflows increased by 39 per cent globally, the highest rate since 1987. In 1998, FDI inflows reached $644 billion, and are projected to increase in 1999 as well. Mergers and acquisitions (M&As) have fuelled the increases in FDI, with a rise of more than $202 billion in the value of M&As transacted in 1998 as compared with that in 1997. The importance of M&As as modes of expansion of international production implies that the net addition to total physical production capabilities annually is less than that implied by the value of annual FDI flows, since most of the additions may well be created by simply a change in ownership.

The record level reached by world FDI flows in 1998 despite the prevailing gloomy economic environment also masks a high concentration of FDI: the largest 10 home countries accounted for four-fifths of global FDI outflows. It also masks divergent trends for developed and developing countries (table 6). In the former, economic growth remained stable, largely unaffected by the recession in Japan or the financial crisis. FDI inflows to and outflows from developed countries soared to new heights – to about $460 billion and $595 billion, respectively, in 1998. Economic growth rates in developing countries in Asia plummeted due to the financial crisis and recession, but FDI flows there declined only moderately, cushioned by the impact of currency depreciation, policy liberalization and a more accommodating attitude towards M&As. Nevertheless, largely because of reduced inflows into a few Asian economies, FDI flows to developing countries as a group declined from $173 billion

Figure 3. Transnationality index[a] of host countries,1996

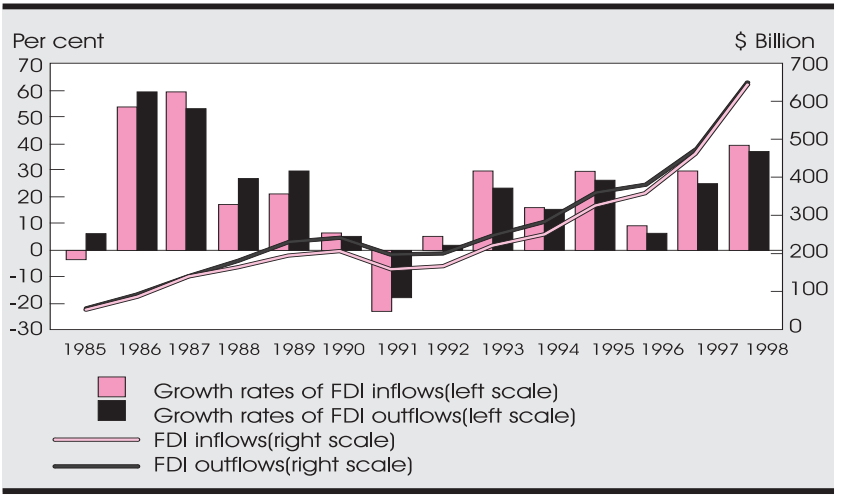
(Percentage)



Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, figure I.8, p. 17.

[a] Average of the four shares: FDI inflows as a percentage of gross fixed capital formation for the last three years; FDI inward stock as a percentage of GDP; value added of foreign affiliates as a percentage of GDP; and employment of foreign affiliates as a percentage of total employment.

Figure 4. World FDI inflows and outflows: value and annual growth rates, 1985-1998



Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, figure I.3, p. 9.

to $166 billion. Moreover, the FDI gap among developing countries widened further, with the top five countries receiving 55 per cent of all the developing-country inflows in 1998 and the 48 least developed countries receiving less then one per cent.

Most FDI is located in the developed world, although the developing countries' share had been growing steadily until 1997, when it reached 37 per cent. The subsequent decline (to 28 per cent) in that share in 1998 reflects the strong FDI performance of developed countries in that year. Among developed countries, most FDI is located — and originates — in the Triad, which accounted for almost two-thirds of the outward stock of developed countries in 1997.

Differences in the size as measured by gross domestic product of host economies are an important factor accounting for the differences observed in the shares of various regions and countries in world FDI flows. However, developing countries as a group receive more FDI per dollar of gross domestic product than do developed countries. Furthermore, if differences in economies' size are taken into account, the FDI gap among groups of developing regions diminishes. This is not surprising since FDI is attracted to developing countries also by factors (such as natural resources) not directly related to the size of their economies; it also suggests that the significance of

Table 6. Regional distribution of FDI inflows and outflows, 1995-1998

(Percentage)

	Inflows				Outflows			
	1995	1996	1997	1998	1995	1996	1997	1998
Developed countries	63.4	58.8	58.9	71.5	85.3	84.2	85.6	91.6
Western Europe	37.0	32.1	29.1	36.9	48.9	53.7	50.6	62.6
European Union	35.1	30.4	27.2	35.7	44.7	47.9	46.0	59.5
Other Western Europe	1.8	1.8	1.9	1.2	4.2	5.8	4.6	3.1
United States	17.9	21.3	23.5	30.0	25.7	19.7	23.1	20.5
Japan	-	0.1	0.7	0.5	6.3	6.2	5.5	3.7
Other developed countries	8.5	5.3	5.6	4.1	4.4	4.6	6.4	4.9
Developing countries	32.3	37.7	37.2	25.8	14.5	15.5	13.7	8.1
Africa	1.3	1.6	1.6	1.2	0.1	-	0.3	0.1
Latin America and the Caribbean	10.0	12.9	14.7	11.1	2.1	1.9	3.3	2.4
Developing Europe	0.1	0.3	0.2	0.2	-	-	0.1	-
Asia	20.7	22.9	20.6	13.2	12.3	13.6	10.0	5.6
West Asia	-0.1	0.2	1.0	0.7	-0.2	0.6	0.4	0.3
Central Asia	0.4	0.6	0.7	0.5	-	-	-	-
South, East and South-East Asia	20.4	22.1	18.9	12.0	12.5	13.0	9.6	5.3
The Pacific	0.2	0.1	-	-	-	-	-	-
Central and Eastern Europe	4.3	3.5	4.0	2.7	0.1	0.3	0.7	0.3
World	100	100	100	100	100	100	100	100

Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, table I.3, p. 20.

a given amount of FDI for a country depends upon the country's income level. However, even when differences in gross domestic product are controlled for, developed countries remain more important as regards FDI outflows, although the gap between them and developing countries diminishes. Moreover, on a *per capita* basis developing countries receive (and invest abroad) less FDI than do developed countries, reflecting the concentration of population in the former and the concentration of FDI in the latter.

FDI flows from developing countries accounted for 14 per cent of global outflows in 1997, but only eight per cent in 1998. Despite the sharp dip in 1998, the overall trend remains positive: more and more TNCs from developing countries are becoming competitive internationally and possess ownership advantages that allow them to invest abroad, mainly in other developing countries. However, only a handful of developing countries account for the bulk of developing country FDI outflows. Most intra-developing country FDI activity is recorded in East and South-East Asia, especially among ASEAN countries, and recently in Latin America, especially among MERCOSUR members. There are signs that FDI flows from East and South-East Asia to Latin America and Africa are picking up. One way to assist South-South FDI flows is to help firms from developing countries to obtain insurance from MIGA for their investments abroad. As such insurance often depends on the preparation of environmental assessment studies (which, for many firms, especially smaller ones, are quite expensive), the establishment of a trust fund that would provide assistance in this respect should be considered.

Driven by M&As, FDI flows to developed countries register an impressive increase …

Record FDI inflows into, and outflows from, developed countries are behind the 1998 surge in global FDI. Developed countries accounted for 92 per cent of global outflows and 72 per cent of global inflows in 1997. The developed country picture is characterized by an intensification of TNC-led links between the United States and the European Union, each of them being the largest source of FDI for the other, and by the emergence of Australia, Canada and Switzerland as significant FDI recipients. The cornerstone of the 1998 surge of FDI was, however, the marked growth of FDI flows into the United States and a few European countries, reflecting their solid economic fundamentals.

Most new FDI in 1998, especially between the United States and the European Union, was in the form of M&As. In fact, cross-border M&As drove the large increases in both inflows and outflows

for the United States and the strong FDI performance of the developed world as a whole. A new phenomenon is the growth of cross-border M&As in Japan. For developed countries, the value of cross-border M&A sales reached a record $468 billion in 1998.

The European Union was the largest source of FDI, registering $386 billion in outflows in 1998. The United Kingdom, with about $114 billion, was the lead European Union investor. In contrast to the boost to intra- and extra-European Union investment in the late 1980s and early 1990s that resulted from anticipation of the Single Market Programme, steps towards monetary integration manifested by the adoption of a single currency have so far had only little effect on FDI. Flows to members of the European Monetary Union (EMU) increased only slightly more than those to non-members in 1998, and the share of EMU members in total FDI inflows to the EU was still lower than in 1996. This could change in 1999 and beyond, as, with the implementation of the monetary union, its advantages and disadvantages for the location of FDI are understood better.

Japan's outflows declined from $26 billion in 1997 to $24 billion in 1998, while inflows remained at almost the same level as in 1997, i.e. $3.2 billion. Economic recession at home and in neighbouring Asia (translating into fewer sales and lower profits) has reduced both the motivation and the ability of Japanese TNCs to invest abroad. This was manifested by lower outflows of new equity and reinvested profits. Japanese TNCs were hard hit in Asia, suffering losses and having to shift to export-oriented production to the extent possible. To alleviate their difficulties, Japanese TNCs are restructuring their overseas operations. On the other hand, despite the recession in Japan, investment opportunities in Japan, particularly for M&As, are leading to an increase in inflows. Although lower FDI outflows and higher FDI inflows are reducing the gap between FDI inflows to and outflows from Japan, the low level of the former may affect Japan's trade structure.

As this brief review shows, cross-border M&As were the driving force of increased FDI flows in 1998. There are many factors that explain the current wave of M&A – a wave that does not seem to be deterred by the relatively poor results that have been observed with respect to M&As, particularly in some industries. These include the opening of markets due to the liberalization of trade, investments and capital markets and to deregulation in a number of industries, and fiercer competitive pressures brought about by globalization and technological changes. Under these conditions, expanding firm size and managing a portfolio of locational assets becomes more important for firms, as it enables them to take advantage of resources and

markets world-wide. The search for size is also driven by the search for financial, managerial and operational synergies, as well as economies of scale. Finally, size puts firms in a better position to keep pace with an uncertain and rapidly evolving technological environment, a crucial requirement in an increasingly knowledge-intensive world economy, and to face soaring costs of research. Other motivations include efforts to attain a dominant market position as well as short-term financial gains in terms of stock value. In many instances, furthermore, the dynamics of the process feeds upon itself, as firms fear that, if they do not find suitable partners, they may not survive, at least in the long run.

... while the developing regions present a diverse picture. FDI flows into Latin America and the Caribbean rose, ...

Despite the turbulence in financial markets, FDI flows into Latin America and the Caribbean in 1998 were more than $71 billion, a five per cent increase over those in 1997. The MERCOSUR countries received almost half of this amount. With more than $28 billion, Brazil was the largest recipient, followed by Mexico with $10 billion. As commodity prices fell sharply, portfolio investment dried up, speculative currency attacks multiplied and positive current account balances turned negative, FDI capital inflows served as a stabilizing force for Latin America and the Caribbean overall. Privatization of service or natural-resource state enterprises is still an important driving force of FDI inflows into Latin America and the Caribbean. Large markets, especially those of NAFTA and MERCOSUR, also provided lucrative investment destinations. To the extent that FDI is concentrated in services and other non-tradable industries, profit and dividend remittances, as well as expectation regarding remittances, could have implications for the balance-of-payments of the host countries. In Brazil, for instance, profit and dividend remittances increased by about 18 per cent to an estimated $7.7 billion in 1998.

The United States remains the largest investor in Latin America and the Caribbean. The European Union, however, has made significant gains as a source of FDI to that region, and is beginning to challenge the traditional dominance of the United States. Spain in particular has been a significant investor, accounting for one third of all European Union FDI in Latin America and the Caribbean in 1997. FDI outflows from Latin America and the Caribbean rose to more than $15 billion 1998 – but more than two-fifths of that originated from offshore financial centres and cannot therefore be attributed solely to Latin American and Caribbean TNCs. An estimated $8 billion was invested within the region; Argentinian, Brazilian and Chilean TNCs were especially active in intra-regional FDI.

... compensating partly for a moderate decline in Asia and the Pacific; ...

Although down by 11 per cent to $85 billion in 1998, FDI flows to Asia and the Pacific appeared to have weathered the financial crisis that threw several Asian countries into turmoil and slashed growth rates. It proved to be the most resilient form of private capital flows, even in some of the countries directly hit by the crisis. Contributing to its resilience were the availability of cheap assets due inter alia to currency devaluations, FDI liberalization, especially as regards M&As, intensified efforts to attract FDI, and the still solid long-term prospects of the region.

China remains the largest FDI host country in the developing Asian region, receiving $45 billion in 1998. The Republic of Korea saw a dramatic increase in inflows (from less than $3 billion in 1997 to $5 billion in 1998) and became a net FDI recipient with FDI inflows exceeding outflows for the first time in the 1990s. Thailand also experienced a dramatic increase in inflows (by 87 per cent in 1998), as a number of weakened financial institutions were acquired by foreign investors. The Philippines also registered large gains. By contrast, Hong Kong (China), Indonesia, Singapore, Taiwan Province of China and Viet Nam suffered declines.

South Asian economies received small FDI flows; India for example was unable to sustain the high rate of FDI growth it had enjoyed in the recent past.

Continuing earlier trends, the Pacific Island economies received about $175 million in 1998, mostly from Australia, Japan and New Zealand. FDI flows to West Asia remained at a level similar to those of 1997, a year that registered a sharp increase. This was due largely to the low oil prices prevailing in 1998. For the same reason, FDI flows to oil-exporting Central Asian economies lost their growth momentum, but that was partly compensated by increases in the non-oil based economies of Armenia and Georgia.

United States TNCs have been active investors in Asia during the crisis, followed by European TNCs.

Plagued by financing difficulties, TNCs from developing Asian countries decreased their overseas FDI (especially in other Asian countries) by a quarter, investing altogether $36 billion in 1998. Financing shortages led many companies, especially TNCs based in the Republic of Korea, to slow down the acquisition of foreign companies and even to divest some of their assets abroad.

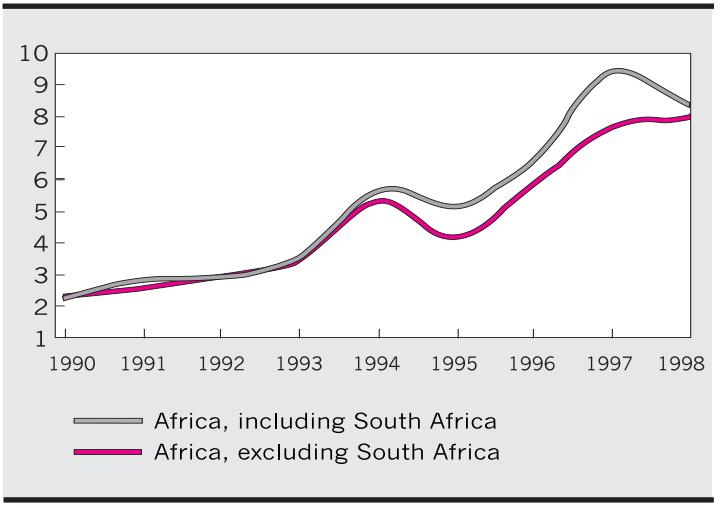
... Africa is still awaiting the realization of its potential ...

FDI inflows to Africa (including South Africa) — at $8.3 billion in 1998 — were down from the record $9.4 billion registered in 1997 (figure 5). This was largely accounted for by a decrease of flows into South Africa where privatization-related FDI — which had reached an unprecedented peak in 1997 — fell back in 1998 to levels of previous years. The rest of the continent registered a modest increase. Overall, Africa benefited from a rise in inward FDI since the early 1990s, but growth in FDI flows to the region was much less than that in FDI flows to other developing countries, leaving much of Africa's potential for FDI unutilized.

A survey of African investment promotion agencies, undertaken by UNCTAD in 1999, indicates where this potential lies, at least in the eyes of those who seek to attract FDI: during 1996-1998, the leading industries that attracted FDI were telecommunications, food and beverages, tourism, textiles and clothing, as well as mining and quarrying. For the years 2000-2003, they are expected to be tourism, food and beverages, telecommunications as well as textile and leather. Independently of specific industries, the five countries that were ranked most attractive to foreign investors in Africa for the period 2000-2003 were South Africa, Nigeria, Botswana, Côte d'Ivoire and

Figure 5. FDI inflows to Africa, 1990-1998

(Billions of dollars)



Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, figure II.11, p. 46.

Tunisia. The countries that were most frequently mentioned as regards the creation of a business-friendly environment were Botswana, South Africa, Nigeria, Uganda and Côte d'Ivoire. Among the countries that were ranked as the top 10 according to the criterion of a business-friendly environment, six countries - Botswana, Ghana, Mozambique, Namibia, Tunisia and Uganda — had been identified as FDI front-runners in *WIR98* (out of seven front-runners). The survey, however, also indicated that, in spite of the reforms that have taken place and the progress expected in a number of African countries in terms of improving the business environment, further work is needed to change the image of Africa and to develop among foreign investors a more differentiated view of the continent and its opportunities.

... and flows into Central and Eastern Europe, except the Russian Federation, reached new highs.

Excluding the Russian Federation, Central and Eastern European countries received record FDI inflows of $16 billion in 1998 — 25 per cent higher than in 1997. The Russian Federation, plagued by low investor confidence, a stagnant privatization programme and dependence on market-oriented investment that suffered a blow from devaluation and economic uncertainty, received only $2 billion, 60 per cent less than in 1997. In most Central and Eastern European countries, FDI is still privatization-led, although a few countries have started a switch to non-privatization-generated investment.

FOREIGN DIRECT INVESTMENT AND THE CHALLENGE OF DEVELOPMENT

The new competitive context raises new challenges for governments and TNCs ...

The development priorities of developing countries include achieving sustained income growth for their economies by raising investment rates, strengthening technological capacities and skills, and improving the competitiveness of their exports in world markets; distributing the benefits of growth equitably by creating more and better employment opportunities; and protecting and conserving the physical environment for future generations. The new, more competitive, context of a liberalizing and globalizing world economy in which economic activity takes place imposes considerable pressures on developing countries to upgrade their resources and capabilities

if they are to achieve these objectives. This new global context is characterized by rapid advances in knowledge, shrinking economic space and rapid changes in competitive conditions, evolving attitudes and policies, and more vocal (and influential) stakeholders.

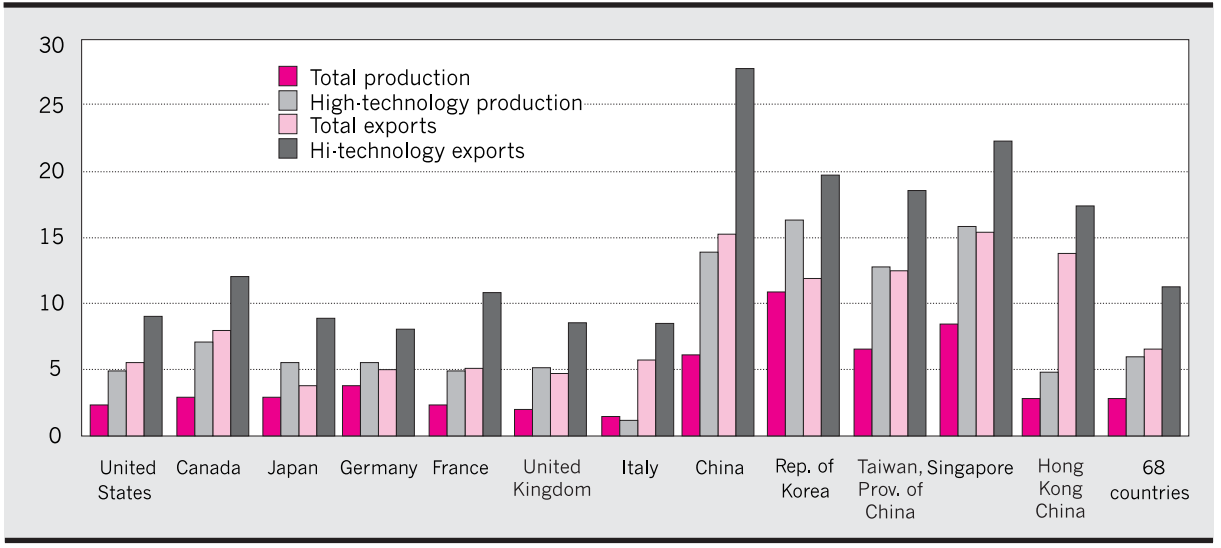
A vital part of the new context is the need to improve competitiveness, defined as the ability to sustain income growth in an open setting. In a liberalizing and globalizing world, growth can be sustained only if countries can foster new, higher value-added activities, to produce goods and services that hold their own in open markets.

FDI and international production by TNCs can play an important role in complementing the efforts of national firms in this respect. However, the objectives of TNCs differ from those of host governments: governments seek to spur *national* development, while TNCs seek to enhance their own competitiveness in an *international* context. In the new context, TNCs' ownership advantages are also changing. In particular, rapid innovation and deployment of new technologies, in line with logistic and market demands, are more important than ever before (figure 6). Thus, TNCs have to change their relations with suppliers, buyers and competitors to manage better the processes of technical change and innovation. And they have to strike closer links with institutions dealing with science, technology, skills and information. The spread of technology to, and growth of skills in, different countries means that new TNCs are constantly entering the arena to challenge established ones.

A striking feature of the new environment is how TNCs shift their portfolios of mobile assets across the globe to find the best match with the immobile assets of different locations. In the process, they also shift some corporate functions to different locations within internationally integrated production and marketing systems (intensifying the process of "deep integration"). The ability to provide the necessary immobile assets thus becomes a critical part of an FDI — and competitiveness — strategy for developing countries. While a large domestic market remains a powerful magnet for investors, TNCs serving global markets increasingly look for world-class infrastructure, skilled and productive labour, innovatory capacities and an agglomeration of efficient suppliers, competitors, support institutions and services. In addition, they may also seek to acquire created assets embodied in competitive host country firms, which may lead to a restructuring of these firms not necessarily beneficial for host countries. Low-cost labour remains a source of competitive advantage for countries, but its importance is diminishing; moreover, it does not provide a base for sustainable growth since rising incomes erode the edge it provides. The same applies to natural resources.

Figure 6. Growth rates of total and high-technology production and exports, 1980-1995

(Percentage)



Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, figure VII.1, p. 195.

... and meeting them requires policy intervention.

There is no conflict between exploiting static sources of comparative advantage and developing new, dynamic ones; existing advantages provide the means by which new advantages can be developed. A steady evolution from one to the other is the basis for sustained growth. What is needed is a policy framework to facilitate and accelerate the process: this is the essence of a competitiveness strategy. The need for such strategy does not disappear once growth accelerates, or economic development reaches a certain level; it merely changes its form and focus. This is why competitiveness remains a concern of governments in developing and developed countries alike. The starting point for this concern is that providing a level playing field and letting firms respond to market signals is sufficient only to the extent that markets work efficiently. The very existence of TNCs is a manifestation that this is not always the case. In the presence of market failures, e.g. when markets fail to exploit existing endowments fully, fail to develop new competitive advantages, or do not give the correct signals to economic agents so that they can make proper investment decisions, intervention is necessary — provided governments have the capabilities to design, monitor and implement policies that overcome market failures.

More specifically, government policies on FDI need to counter two sets of market failures. The first arises from information or coordination failures in the investment process, which can lead a country to attract insufficient FDI, or the wrong quality of FDI. The second arises when private interests of investors diverge from the economic interests of host countries. This can lead FDI to have negative effects on development, or it may lead to positive, but static benefits that are not sustainable over time. Private and social interests may, of course, diverge for any investment, local or foreign: policies are then needed to remove the divergence for all investors. However, some divergence may be specific to foreign investment. FDI may differ from local investment because the locus of decision-making and sources of competitiveness in the former lie abroad, because TNCs pursue regional or global competitiveness-enhancing strategies, or because foreign investors are less committed to host economies and are relatively mobile. Thus, the case for intervening with FDI policies may have a sound economic basis. In addition, countries consider that foreign ownership has to be controlled on non-economic grounds — for instance, to keep cultural or strategic activities in national hands.

The role of FDI in countries' processes and efforts to meet development objectives can differ greatly across countries, depending on the nature of the economy and the government. One vision — pursued, for example, by Malaysia, Singapore and Thailand — was to rely substantially on FDI, integrating the economy into TNC production networks and promoting competitiveness by upgrading within those networks. Another vision — pursued by the Republic of Korea and Taiwan Province of China — was to develop domestic enterprises and autonomous innovative capabilities, relying on TNCs mainly as sources of technology, primarily at arm's length. Yet another, that of the administration of Hong Kong (China), was to leave resource allocation largely to market forces, while providing infrastructure and governance. There is no ideal development strategy with respect to the use of FDI that is common for all countries at all times. Any good strategy must be context specific, reflecting a country's level of economic development, the resource base, the specific technological context, the competitive setting, and a government's capabilities to implement policies (see box 1).

Box 1. UNCTAD's Investment Policy Reviews

Many countries have significantly liberalized their FDI regimes, and governments are keen to know how well their reforms are working: Is there new FDI? Is it of the right kind? What more should be done? With the dismantling of traditional monitoring systems, policy makers may lack a mechanism to generate feedback on the impact of investment measures which are typically implemented by various government bodies and not coordinated. UNCTAD's Investment Policy Reviews (IPRs) are intended to fill this void: to provide government officials with a means of reviewing FDI in a liberal environment.

The IPRs are conducted by UNCTAD, following a standard format and involving staff, international and national experts and inputs from governments and the private sector. The reviews are presented and discussed in national workshops involving public officials and other stakeholders. They are also considered at an international commission in Geneva. The final reports are widely disseminated.

The reviews are undertaken on request. The assumption is that governments are ready to receive independent feedback and to

/...

(Box 1, concluded)

engage in open dialogue with investors and peers. Their expectation is that a transparent and objective presentation of their country's investment policies and opportunities will put their country on the radar screen of international investors. The first round of reviews included Egypt, Peru, Uganda and Uzbekistan. The pipeline of requests includes Ecuador, Kenya, Mauritius, Pakistan, the Philippines and Zimbabwe.

The reviews have a common format of three sections examining: the country's objectives and competitive position in attracting FDI; the FDI policy framework and administrative procedures; and policy options. The reviews go beyond an examination of how well FDI policies look on paper and probe how well those policies work in practice in achieving stated national objectives. Since investor response is based on both policy and non-policy factors, a key feature of the reviews is to survey actual investors on how they perceive current investment conditions and opportunities. Potential investors are also surveyed. Based on an analysis of investor perceptions and of relevant FDI trends at the regional and global levels, the reviews assess the country's core competencies in attracting FDI, and then gauge the effectiveness of policies in leveraging the competitive strengths of a country (relative to other countries) and in ameliorating potential weaknesses. The policy options and recommendations are practical, and are geared to decision-makers in investment promotion agencies. They include technical assistance proposals and follow up. Although having a country focus, the reviews proceed in a global context, comparing a country's policies, strengths and weaknesses in relation to other countries, particularly in the region. The reviews are underpinned by the data and analysis of UNCTAD's *World Investment Reports*.

IPRs are funded primarily through extra-budgetary resources. Individual country projects are funded on a cost-sharing basis by UNDP, the Government of Switzerland, host government institutions and, as appropriate, the local and transnational private sector (to sponsor individual workshops or provide in-kind support, such as technical studies or industry experts).

Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, box VI.3, p. 176.

FDI comprises a package of resources …

Most developing countries today consider FDI an important channel for obtaining access to resources for development. However, the economic effects of FDI are almost impossible to measure with precision. Each TNC represents a complex package of firm-level attributes that are dispersed in varying quantities and quality from one host country to another. These attributes are difficult to separate and quantify. Where their presence has widespread effects, measurement is even more difficult. There is no precise method of specifying a counter-factual – what would have happened if a TNC had not made a particular investment. Thus, the assessment of the development effects of FDI has to resort either to an econometric analysis of the relationships between inward FDI and various measures of economic performance, the results of which are often inconclusive, or to a qualitative analysis of particular aspects of the contribution of TNCs to development, without any attempt at measuring costs and benefits quantitatively.

FDI comprises a bundle of assets, some proprietary to the investor. The proprietary assets, the "ownership advantages" of TNCs, can be obtained only from the firms that create them. They can be copied or reproduced by others, but the cost of doing that can be very high, particularly in developing countries and where advanced technologies are involved. Non-proprietary assets – finance, many capital goods, intermediate inputs and the like – can usually be obtained from the market also.

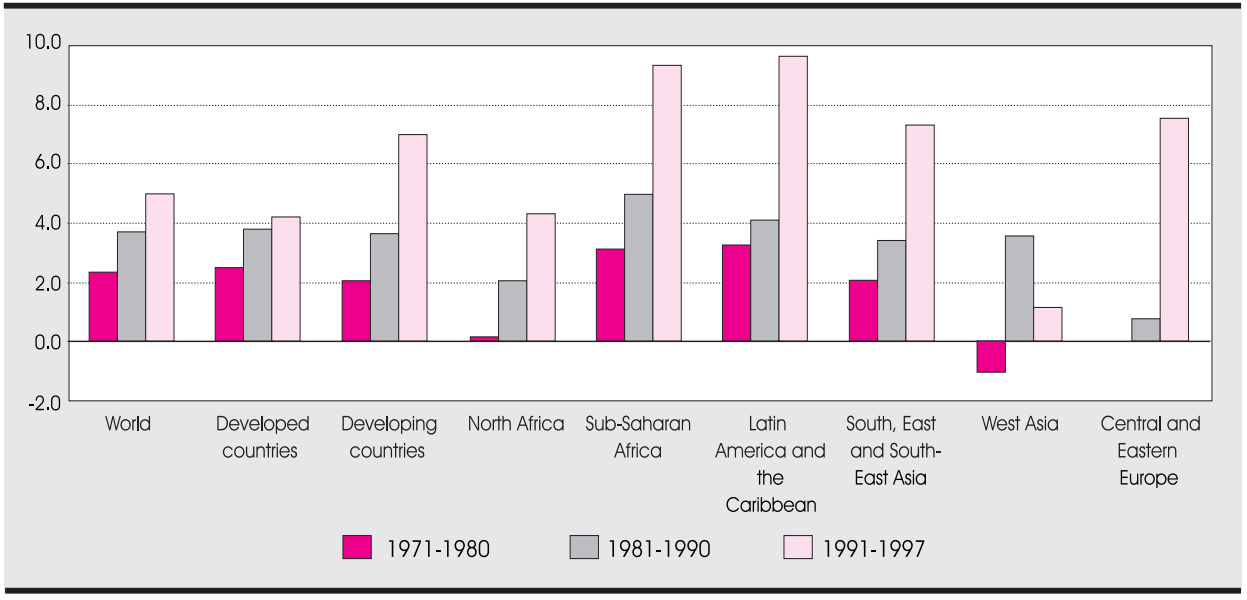
The most prized proprietary asset is probably technology. Others are brand names, specialized skills, and the ability to organize and integrate production across countries, to establish marketing networks, or to have privileged access to the market for non-proprietary assets (e.g. funds, equipment). Taken together, these advantages mean that TNCs can contribute significantly to economic development in host countries – if the host country can induce them to transfer their advantages in appropriate forms and has the capacity to make good use of them. The assets in the FDI bundle are:

- Capital: FDI brings in investible financial resources to host countries (figure 7). FDI inflows are more stable and easier to service than commercial debt or portfolio investment. In distinction to other sources of capital, TNCs typically invest in long-term projects.

- Technology: TNCs can bring modern technologies, some of them not available in the absence of FDI, and they can raise the efficiency with which existing technologies are used. They can

Figure 7. The ratio of FDI inflows to gross fixed capital formation, by region, annual average, 1971-1980, 1981-1990 and 1991-1997

(Percentage)



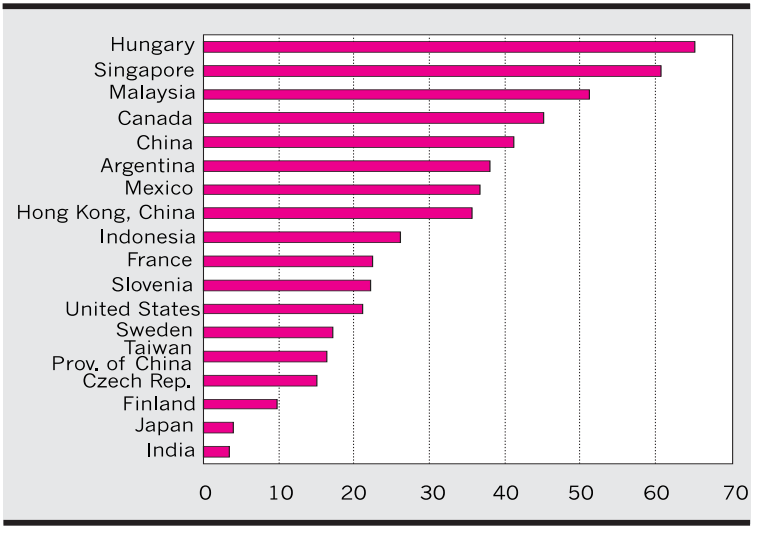
Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, figure VI.1, p. 167.

adapt technologies to local conditions, drawing upon their experience in other developing countries. They may, in some cases, set up local R&D facilities. They can upgrade technologies as innovations emerge and consumption patterns change. They can stimulate technical efficiency and technical change in local firms, suppliers, clients and competitors, by providing assistance, by acting as role models and by intensifying competition.

- Market access: TNCs can provide access to export markets, both for goods (and some services) that are already produced in host countries, helping them switch from domestic to international markets; and for new activities that exploit a host economy's comparative advantages (figure 8). The growth of exports itself offers benefits in terms of technological learning, realization of scale economies, competitive stimulus and market intelligence.

Figure 8. Shares of TNCs in primary and manufactured exports, latest available year[a]

(Percentage)



Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, figure VIII.2, p. 245.

[a] 1991 for India; 1992 for France; 1993 for Mexico; 1994 for Canada, Finland, Malaysia and Sweden; 1995 for Argentina, Japan and Taiwan Province of China; 1996 for Czech Republic, Hungary, Indonesia, Singapore, Slovenia and the United States; 1997 for China and Hong Kong, China.

- Skills and management techniques: TNCs employ and have world-wide access to individuals with advanced skills and knowledge and can transfer such skills and knowledge to their foreign affiliates by bringing in experts and by setting up state-of-the-art training facilities. Improved and adaptable skills and new organizational practices and management techniques can yield competitive benefits for firms as well as help sustain employment as economic and technological conditions change.

- Environment: TNCs are in the lead in developing clean technologies and modern environmental management systems. They can use them in countries in which they operate. Spillovers of technologies and management methods can potentially enhance environmental management in local firms within the industries that host foreign affiliates.

While TNCs offer the potential for developing countries to access these assets in a package, this does not necessarily mean that simply opening up to FDI is the best way of obtaining or benefiting from them. The occurence of market failures mentioned above means that governments may have to intervene in the process of attracting FDI with measures to promote FDI generally or measures to promote specific types of FDI. Furthermore, the complexity of the FDI package means that governments face trade-offs between different benefits and objectives. For instance, they may have to choose between investments that offer short as opposed to long-term benefits; the former may lead to static gains, but not necessarily to dynamic ones.

The principal issues to be addressed by governments fall into the following four groups:

- Information and coordination failures in the international investment process.

- Infant industry considerations in the development of local enterprises, which can be jeopardized when inward FDI crowds out those enterprises.

- The static nature of advantages transferred by TNCs where domestic capabilities are low and do not improve over time, or where TNCs fail to invest sufficiently in raising the relevant capabilities.

- Weak bargaining and regulatory capabilities on the part of host country governments, which can result in an unequal distribution of benefits or abuse of market power by TNCs.

... the benefits of which can be reaped through policy measures ...

While the ultimate attraction for FDI lies in the economic base of a host country and FDI-attracting efforts by themselves cannot compensate for the lack of such a base, there remains a strong case for proactive policies to attract FDI. Countries may not be able to attract FDI in the volume and quality that they desire and that their economic base merits, for one or more of the following principal reasons:

- *High transaction costs*. While most FDI regimes are converging on a similar set of rules and incentives, there remain large differences in how these rules are implemented. The FDI approval process can take several times longer, and entail costs many times greater in one country than in another with similar policies. After approval, the costs of setting up facilities, operating them, importing and exporting goods, paying taxes and generally dealing with the authorities can differ enormously.

- Such costs can, other things being equal, affect significantly the competitive position of a host economy. An important part of a competitiveness strategy thus consists of *reducing unnecessary, distorting and wasteful business costs*, including, among others, administrative and bureaucratic costs. This affects both local and foreign enterprises. However, foreign investors have a much wider set of options before them, and are able to compare transaction costs in different countries. Thus, attracting TNCs requires not just that transaction costs be lowered, but also, increasingly, that they be benchmarked against those of competing host countries. One important measure that many countries take to ensure that international investors face minimal costs is to set up one-stop promotion agencies able to guide and assist them in getting necessary approvals. However, unless the agencies have the authority needed to provide truly one-stop services, and unless the rules themselves are clear and straightforward, this may not help.

- Despite their size and international exposure, TNCs face *market failures in information*. Their information base is far from perfect, and the decision-making process can be subjective and biased. Taking economic fundamentals as given, it may be worthwhile for a country that receives lower FDI than desired to invest in establishing a distinct image of its own and, if necessary,

attempt to alter the perception of potential investors by providing more and better information. Such promotion efforts are highly skill-intensive and potentially expensive, and they need to be mounted carefully to maximize their impact. Investor targeting — general, industry-specific or company specific – could be a cost-effective approach in some cases. Targeting or information provision is *not* the same as giving financial or fiscal incentives. In general, incentives play a relatively minor role in a good promotion programme, and good, long-term investors are not the ones most susceptible to short-term inducements. The experiences of Ireland, Singapore - and, more recently, Costa Rica — suggest that promotion and targeting can be quite effective in raising the inflow of investment and its quality.

Effective promotion should go beyond simply "marketing a country", into coordinating the supply of a country's immobile assets with the specific needs of targeted investors. This addresses potential failures in markets and institutions — for skills, technical services or infrastructure — in relation to the specific needs of new activities targeted via FDI. A developing country may not be able to meet, without special effort, such needs, particularly in activities with advanced skill and technology requirements. The attraction of FDI into such industries can be greatly helped if a host government discovers the needs of TNCs and takes steps to cater to them. The information and skill needs of such coordination and targeting exceed those of investment promotion *per se*, requiring investment promotion agencies to have detailed knowledge of the technologies involved (skill, logistical, infrastructural, supply and institutional needs), as well as of the strategies of the relevant TNCs.

... that also minimize the adverse effects on domestic enterprise development.

Domestic enterprise development is a priority for all developing countries. In this regard, the possible "crowding out" of domestic firms by foreign affiliates is frequently an issue of concern. Crowding out due to FDI could occur in two ways: first, in the product market, by adversely affecting learning and growth by local firms in competing activities; second, in financial or other factor markets, by reducing the availability of finance or other factors, or raising costs for local firms, or both.

The first issue reflects "infant industry" considerations, but without the usual connotation of protecting new activities against import competition. It concerns the fostering of learning in domestic firms *vis-à-vis* foreign firms. FDI can abort or distort the growth of

domestic capabilities in competing firms when direct exposure to foreign competition prevents local enterprises from undertaking lengthy and costly learning processes. Foreign affiliates also undergo learning locally to master and adapt technologies and train employees in new skills. However, they have much greater resources to undertake this learning, and considerably more experience of how to go about learning in different conditions. In these cases, "crowding out" can be said to occur if potentially competitive local firms cannot compete with affiliates at a given point in time.

The case for domestic enterprise protection differs from the infant industry argument for trade protection. When trade protection is eliminated, consumers benefit from cheaper imports and greater product variety; but some domestic production and employment can be lost. In contrast, in the case of local enterprise protection, the absence of such protection from FDI competition does not lead to loss of domestic production and employment in exchange for enhancing consumer benefits; but, indigenous entrepreneurial development may be hampered, particularly in sophisticated activities. The net cost of this is that linkages may be fewer and technological deepening may be inhibited. As with all infant industry arguments, crowding out is economically undesirable if three conditions are met. First, infant local enterprises are able to mature to full competitiveness if sheltered against foreign competition that takes place through (in this case) FDI. Second, the maturing process does not take so long that the discounted present social costs outweigh the social benefits. Third, even if there are social costs, there must be external benefits that outweigh them.

Crowding out can impose a long-term cost on the host economy if it holds back the development of domestic capabilities or retards the growth of a local innovative base. This can make technological upgrading and deepening dependent on decisions taken by TNCs, and in some cases hold back the host economy at lower technological levels than would otherwise be the case. However, it is important to distinguish between affiliates crowding out potentially efficient domestic enterprises and affiliates out-competing inefficient local firms that cannot achieve full competitiveness. One of the benefits of FDI can be the injection of new technologies and competition that leads to the exit of inefficient enterprises and the raising of efficiency in others. Without such a process, the economy can lack dynamism and flexibility, and can lose competitiveness over time, unless competition between local firms in the domestic market is intense, or they face international competition (say, in export markets).

TNCs, however, can also "crowd in" local firms if they strike up strong linkages with domestic suppliers, subcontractors and

institutions. Crowding in can take place when foreign entry increases business opportunities and local linkages, raises investible resources or makes factor markets more efficient. Such stimulating effects are most likely when FDI concentrates in industries that are undeveloped in (or new to) host countries. Where local firms are well developed, but still face difficulties in competing with foreign affiliates, there can be harmful crowding out. However, local firms can also become suppliers to TNCs, or be taken over by them, as discussed below.

A second variety of crowding out reflects an uneven playing field for domestic firms because of a segmentation in local factor markets: TNCs may have privileged access to factors such as finance (which may give them a special advantage especially *vis-à-vis* local firms) and skilled personnel because of their reputation and size. They can thus raise entry costs for local firms, or simply deprive them of the best factor inputs.

Both forms of crowding out raise policy concerns. Most governments wish to promote local enterprises, particularly in complex and dynamic industrial activities. Many feel that the deepening of capabilities in local firms yields greater benefits than receiving the same technologies from TNCs: linkages with local suppliers are stronger, there is more interaction with local institutions, and where innovatory activities take place, knowledge developed within firms is not "exported" to parent companies and exploited abroad, and so on. The few developing economies that have developed advanced indigenous technological capabilities have restricted the entry of FDI (generally, or into specific activities). The possession of a strong indigenous technology base is vital not just for building the competitiveness of local enterprises – it is also important for attracting high-technology FDI and for R&D investments by TNCs.

At the same time, there are risks in restricting FDI *per se* to promote local enterprises. For one thing, it is very difficult in practice to draw the distinction between crowding out and legitimate competition. If policy makers cannot make this distinction, they may prop up uneconomic local firms for a long period, at heavy cost to domestic consumers and economic growth. The danger of technological lags if TNCs are kept out of sophisticated activities in a country is much greater now than, say, several decades ago. So is the risk of being unable to enter export markets for activities with high product differentiation and internationally integrated production processes. It is important however, to strengthen the opportunities for domestic firms to crowd in after the entry of FDI by building up local capabilities and a strong group of small- and medium-sized domestic firms that could develop linkages with foreign affiliates.

The right balance of policies between regulating foreign entry and permitting competition depends on the context. Only a few developing countries have built impressive domestic capabilities and world-class innovative systems while restricting the access of TNCs. Some others have restricted foreign entry, but have not succeeded in promoting competitive domestic enterprises in high-technology manufacturing activities. Success clearly depends on many other things apart from sheltering learning, including the availability of complementary resources and inputs, the size of the domestic market and the competitive climate in which learning takes place. In sum, the infant enterprise argument remains valid, and can provide a case for policy intervention to promote local capability development, but interventions have to be carefully and selectively applied, monitored, and reversed where necessary.

Similar considerations to those highlighted above apply to M&As of local firms by TNCs, including privatization by sale of state enterprises to foreign investors, a common form of foreign entry into Latin America and Central and Eastern Europe, and more recently into developing Asian countries affected by the financial crisis. Some M&As that entail a simple change of ownership akin to portfolio investment can be of lesser developmental value. Some take-overs lead to asset stripping, and large M&A-related inflows can become large outflows when investments are liquidated, possibly giving rise to exchange rate volatility and discouraging productive investment. There may also be adverse effects on local innovatory capacity and competitiveness in trade as illustrated by the acquisition of firms in the automotive and telecommunications industries of Brazil by TNCs. These resulted in a scaling down of R&D activities in the acquired firms. Reduced reliance by Brazilian firms acquired by TNCs on locally produced high-technology inputs also led to increased import penetration in areas such as in automobile parts and components, information technology and telecommunication products. Many countries, including developed ones, are also concerned about the adverse impact of M&As on employment. M&As can also have anti-competitive effects if they reduce substantially the number of competitors in a domestic market, especially for non-tradable products such as most services.

M&As may also yield economic benefits, however. Where the investor makes a long-term commitment to the acquired firm and invests in upgrading and restructuring its technology and management, the impact is very similar to a greenfield investment. In Thailand, for instance, in the context of the recent financial crisis, a number of M&As in the automobile industry are leading to restructuring and increased competitiveness, manifested by increases

in commercial vehicle exports. FDI related to M&As can play an important role in modernizing privatized utilities such as telecommunications and public utilities, as is the case in some instances in Latin America. Foreign acquisitions can prevent viable assets of local firms from being wiped out; this can be particularly important in economies in transition and financially distressed developing countries.

The benefits of M&As (including in the context of privatization) depend on the circumstances of a country and the conditions under which enterprises are acquired and subsequently operated. However, there may be value in monitoring M&As, instituting effective competition policies, and placing limits on them when the macroeconomic situation justifies it.

This raises the question of the effects of FDI on market structure in host countries. There has been a long-standing concern that the entry of large TNCs raises concentration levels within an economy and can lead to the abuse of market power. TNCs tend to congregate in concentrated industries. Whether this leads to the abuse of market power is an empirical question requiring further research. If host economies have liberal trade regimes, the danger of anti-competitive behaviour in such structures is largely mitigated. However, it remains true that effective competition policy becomes more and more important in a world in which large TNCs can easily dominate an industry in a host country.

Positive dynamic FDI effects on host countries require appropriate skills and policies, …

Many important issues concerning the benefits of FDI for technology acquisition and technological capacity-building, skills development and competitiveness revolve around its static versus dynamic effects. TNCs can be efficient vehicles for the transfer of technologies and skills suited to *existing* factor endowments in host economies. They provide technology at very different levels of scale and complexity in different locations, depending on market orientation and size, labour skills available, technical capabilities and supplier networks. Where the trade regime in host (and home) countries is conducive (and infrastructure is adequate), they can use local endowments effectively to expand exports from host countries. This can create new capabilities in the host economies and can have beneficial spillover effects. In low-technology assembly activities, the skills and linkage benefits may be low; in high-technology activities, however, they may be considerable. Unless they operate in highly

protected regimes, pay particularly low wages (as in some export processing zones in low-skill assembly), or benefit from expensive infrastructure while paying no taxes, there is a strong presumption that FDI contributes positively to using host country resources efficiently and productively.

In this context, one of the main benefits of TNCs to export growth is not simply their ability to provide the technology and skills to complement local resources, or labour to produce for export, but to provide access to foreign markets. TNCs are increasingly important players in world trade. They have large internal (intra-firm) markets for some of the most dynamic and technology-intensive products, access to which is available only to affiliates. They have established brand names and distribution channels with supply facilities spread over several national locations. They can influence the granting of trade privileges in their home (or in third) markets. All these factors mean that they might offer considerable advantages in creating an initial export base for new entrants.

The development impact of FDI, however, also depends on the *dynamics* of the transfer of technology and skills by TNCs: how much upgrading of local capabilities takes place over time, how far local linkages deepen, and how closely affiliates integrate themselves in the local learning system (see, as an illuatration, table 7). TNCs may simply exploit the existing advantages of a host economy and move on as those advantages erode. Static advantages may not automatically transmute into dynamic advantages. This possibility looms particularly large where a host economy's main advantage is

Table 7. Collaboration of Indian research centres with TNCs: R&D contracts awarded by TNCs to Indian publicly funded R&D institutes in the early 1990s

Institution	TNC involved	R & D area
IICT, Hyderabad	Du Pont, United States	Pesticide chemistry (by screening agro-chemical molecules).
IICT, Hyderabad	Abbot Laboratories, United States	Synthesis of organic molecules and advisory consultancy.
IICT, Hyderabad	Parke Davis, United States	Supply of medicinal plants.
IICT, Hyderabad	Smith Kline and Beecham, United States	Agrochemical and pharmaceutical R&D.
NCL, Pune	Du Pont, United States	Reaction engineering, process modelling for new polymers, nylon research, catalysis, and a scouting programme.
NCL, Pune	Akzo, Netherlands	Zeolite based catalyst development.
NCL, Pune	General Electric, United States	Processes for intermediates of polycarbonates.

Source: UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, table VII.3, p. 213.

low-cost unskilled labour, and the main TNC export activity is low-technology assembly.

The extent to which TNCs dynamically upgrade their technology and skills transfer and raise local capabilities and linkages depends on the interaction of the trade and competition policy regime, government policies on the operations of foreign affiliates, the corporate strategies and resources of TNCs, and the state of development and responsiveness of local factor markets, firms and institutions.

- The *trade and competition policy regime* in a host economy may provide the encouragement for enterprises, local and foreign, to invest in developing local capabilities. In general, the more competitive and outward-oriented a regime, the more dynamic is the upgrading process. A highly protected regime, or a regime with stringent constraints on local entry and exit, discourages technological upgrading, isolating the economy from international trends. This is not to say that completely free trade is the best setting. Infant industry considerations suggest that some protection of new activities can promote technological learning and deepening. However, even protected infants must be subjected to the rigours of international competition fairly quickly – otherwise they will never grow up. This applies to foreign affiliates, as well as to local firms. A strongly export-oriented setting with appropriate incentives provides the best setting for rapid technological upgrading.

- The second factor concerns *policies regarding the operations of foreign affiliates,* including local-content requirements, incentives for local training or R&D, and pressures to diffuse technologies. The results of the use of such policies have often been poor when they were not integrated into a wider strategy for upgrading capabilities. However, where countries have used them as part of a coherent strategy, as in the mature newly-industrializing economies, the results have often been quite beneficial: foreign affiliates enhanced the technology content of their activities and of their linkages to local firms, which were supported in raising their efficiency and competitiveness. Much of the effort by foreign affiliates to upgrade local capabilities involves extra cost, and affiliates will not necessarily undertake this effort unless it is cost effective and suits their long-term objectives. For the host economy, it is worth doing so only if it leads to efficient outcomes. If upgrading is forced beyond a country's capabilities, it will not survive in a competitive and open environment.

- The third factor involves *TNC strategies.* Corporate strategies differ in the extent to which they assign responsibility to different affiliates and decide their position in the corporate network. TNCs are changing their strategies in response to technological change and policy liberalization, and much of this is outside the scope of influence of developing host countries. Nevertheless, host country governments can influence aspects of TNC location decisions by measures such as targeting investors, inducing upgrading by specific tools and incentives and improving local factors and institutions. This requires them to have a clear understanding of TNC strategies and their evolution.

- The fourth factor, the state and responsiveness of *local factor markets, firms and institutions*, is probably the most important one. TNCs upgrade their affiliates where it is cost-efficient to do so. Moreover, since firms in most industries prefer their suppliers to be nearby, they will deepen local linkages if local suppliers can respond to new demands efficiently. Both depend upon the efficacy and development of local skills and technological capabilities, supplier networks and support institutions. Without improvements in factor markets, TNCs can improve the skills and capabilities of their employees only to a limited extent. They do not compensate for weaknesses in the local education, training and technology system. In the absence of rising skills and capabilities generally, it would be too costly for them to import advanced technologies and complex, linkage-intensive operations.

  At the same time, there are risks that the presence of TNCs inhibits technological development in a host economy. TNCs are highly efficient in transferring the results of innovation performed in developed countries, but less so in transferring the innovation process itself. While there are some notable exceptions, foreign affiliates tend to do relatively little R&D. This may be acceptable for a while in the case of countries at low levels of industrial development, but can soon become a constraint on capability building as countries need to develop autonomous innovative capabilities. Once host countries build strong local capabilities, TNCs can contribute positively by setting up R&D facilities. However, at the intermediate stage, the entry of large TNCs with ready-made technologies can inhibit local technology development, especially when local competitors are too far behind to gain from their presence. Where a host economy adopts a proactive strategy to develop local skills and technology institutions, it may be able to induce TNCs to invest in local R&D even if there is little research

capability in local firms. The appropriate policy response is not to rule out FDI, but to channel it selectively so that local learning is protected and promoted. In countries that do not restrict FDI, it is possible to induce advanced TNC technological activity by building skills and institutions.

... as well as strong bargaining capabilities, regulatory regimes and policy-making capacity.

In some cases, the outcome of FDI depends significantly on how well a host economy bargains with international investors. However, the capacity of developing host countries to negotiate with TNCs is often limited. The negotiating skills and information available to TNCs tend to be of better quality. With growing competition for TNC resources, the need of many developing countries for the assets TNCs possess is often more acute than the need of TNCs for the locational advantages offered by a specific country. In many cases, particularly in export-oriented investment projects where natural resources are not a prime consideration, TNCs have several alternative locations. Host countries may also have alternative foreign investors, but they are often unaware of them. Where the outcome of an FDI project depends on astute bargaining, developing host countries may sometimes do rather poorly compared to TNCs. The risk is particularly great for major resource-extraction projects or the privatization of large public utilities and other companies. Considerable bargaining also takes place in large manufacturing projects where incentives, grants and so on are negotiated on a case-by-case basis. Though the general trend is towards non-discretionary incentives, considerable scope for bargaining still exists, and developing countries tend to be at a disadvantage in this respect.

To strengthen developing countries' bargaining capabilities, legal advice is often required, but the costs of obtaining such advice are usually prohibitive, especially for least developed countries. Establishing a pilot facility that would help ensure that expert advice in contract negotiations is more readily available to developing countries is worth considering. Such a facility would benefit not only developing host countries, but also TNCs by reducing specific transaction costs in the process of negotiations (for instance, by reducing the risk of delays) and, more generally, by leading to more stable and lasting contracts.

To return to the regulatory framework: with liberalization and globalization, there are fewer policy tools available to countries left to influence the conduct of foreign and local firms. The capacities of

host developing countries to regulate enterprises in terms of competition policy and environment policy are emerging as the most active policy-making areas. An effective competition policy is therefore an absolute necessity. However, most developing countries lack such policy. Mounting a competition policy is a complex task requiring specialized skills and expertise that are often scarce in developing countries. It is important for host countries to start the process of developing these skills and expertise, especially if large TNCs with significant market power are attracted to their markets.

Similar concerns arise with respect to the environment. Many developing host countries have only limited regulations on the environment, and often lack the capacity to enforce them effectively. TNCs are often accused of exploiting these in order to evade tougher controls in the developed world. Some host developing countries are accused of using lax enforcement to attract FDI in pollution-intensive activities. The evidence on the propensity of TNCs to locate their investments in order to evade environmental regulations is, however, not conclusive. TNCs are usually under growing pressure to conform to high environmental standards from home country environmental regulations, consumers, environment groups and other "drivers" in the developed and developing world. Many see environment management not only as necessary, but also as commercially desirable. However, it is up to host governments to ensure that all TNCs and domestic firms follow the examples set by the "green" TNCs.

Another important regulatory problem is that of transfer pricing to evade taxes or restrictions on profit remission. TNCs can use transfer pricing over large volumes of trade and service transactions. The problem is not restricted to dealings between affiliates; it may also arise in joint ventures. However, it may well be that the deliberate abuse of transfer pricing has declined as tax rates have fallen and full profit remittances are allowed in much of the developing world. Double-taxation treaties between host and home countries have also lowered the risk of transfer-pricing abuses. However, this problem still remains a widespread concern among developed and developing countries. Tackling it needs considerable expertise and information. Developing country tax authorities are generally poorly equipped to do this, and can benefit greatly from technical assistance and information from developed-country governments in this area.

Managing FDI policy effectively in the context of a broader competitiveness strategy is a demanding task. A passive, *laissez faire* approach is unlikely to be sufficient because of failures in markets and deficiencies in existing institutions. Such an approach may not attract sufficient FDI, extract all the potential benefits that FDI offers,

or induce TNCs to operate by best-practices standards. However, a *laissez faire* FDI strategy may yield benefits in host countries that have under-performed in terms of competitiveness and investment attraction because of past policies. Such a strategy sends a strong signal to the investment community that the economy is open for business. FDI will be attracted into areas of existing comparative advantage. However, there are two problems. First, if attractive locational assets are limited, or their use is held back by poor infrastructure or non-economic risk, there will be little FDI response. Second, even if FDI enters, its benefits are likely to be static and will run out when existing advantages are used up. To ensure that FDI is sustained over time and enters new activities requires policy intervention, both to target investors and to raise the quality of local factors. Needless to say, for the great majority of countries the form of intervention has to be different from traditional patterns of heavy inward-orientation and market-unfriendly policies – it has to be aimed at competitiveness.

What all this suggests is that there is no ideal universal strategy on FDI. Any strategy has to suit the particular conditions of a country at any particular time, and evolve as the country's needs and its competitive position in the world change. Increasingly, it also has to take into account the fact that international investment agreements set parameters for domestic policy making. Governments of developing countries need to ensure, therefore, that such agreements do leave them the policy space they require to pursue their development strategies. Formulating and implementing an effective strategy requires above all a development vision, coherence and coordination. It also requires the ability to decide on trade-offs between different objectives of development. In a typical structure of policy making, this requires the FDI strategy-making body to be placed near the head of government so that a strategic view of national needs and priorities can be formed and enforced.

* * *

In conclusion, TNCs are principal drivers of the globalization process, which defines the new context for development. In this context, there is more space for firms to pursue their corporate strategies, and enjoy more rights than before. The obvious question is: should these increased rights be complemented by firms' assuming greater social responsibility? The notion of social responsibility of TNCs encompasses a broad range of issues of which environmental, human and labour rights have attracted most attention in recent years. In a liberalizing and globalizing world economy, this question is likely to be asked with increasing frequency and insistence. In his Davos

speech in January 1999, the Secretary-General of the United Nations initiated the discussions on this question by proposing a global compact. Perhaps they could be intensified in the framework of a more structured dialogue between all parties concerned. Development would have to be central to this dialogue, as this is the overriding concern of the majority of humankind and because it is, in any event, intimately linked to the social, environmental and human rights objectives that lead the agenda in this area. The dialogue could build on the proposal of a global compact made by the Secretary-General, with a view towards examining how, concretely, the core principles already identified, as well as development considerations, could be translated into corporate practices. After all, companies can best promote their social responsibilities by the way they conduct their own businesses and by the spread of good corporate practices.

The world today is more closely knit, using different means of organization, communication and production, and is more subject to rapid change than ever before. At the same time, the past 30 years show striking – and growing – differences between countries in their ability to compete and grow. They also show how markets by themselves are not enough to promote sustained and rapid growth: policies matter, as do the institutions that formulate and implement them. There is an important role for government policies, but not in the earlier mould of widespread intervention behind protective barriers. Rather, in a globalizing world economy, governments increasingly need to address the challenge of development in an open environment. FDI can play a role in meeting this challenge. Indeed, expectations are high, perhaps too high, as to what FDI can do. But it seems clear that if TNCs contribute to development – and do so significantly and visibly – the relationship that has emerged between host country governments, particularly in developing countries, and TNCs over the past 15-20 years can develop further with potential benefits for all concerned. ■

Global markets and social legitimacy: the case for the 'Global Compact'

Georg Kell and John Gerard Ruggie*

The international economic order constructed after World War II was based on a consensus regarding the role of the State in meeting domestic socio-economic concerns. This consensus has been challenged as global networks of production and finance have become disconnected from any overall system of institutional relations. Economic rule making has greatly extended economic rights of corporations in the global arena but other concerns, such as the environment, human rights and poverty, have not received comparable attention. The resulting imbalance threatens to undo the benefits achieved by liberalization and will persist unless the economic sphere is embedded once more in broader frameworks of shared values and institutionalized practices. We contend that the dynamic interplay between large corporations and non-governmental organizations, both at the micro-level and at the level of global rule making, provides a productive venue for bridging the imbalance between economic globalization and governance. We present the United Nations Secretary-General's proposal for a "Global Compact" with the international business community as one small step in this direction.

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Introduction

The international economic order constructed after World War II reflected a highly advantageous configuration of factors that produced sustained economic expansion. The distribution of economic power in the world favoured an open and non-discriminatory approach to organizing international economic relations. There was broad ideological consensus regarding the role of the State in ensuring domestic employment, price stability and social safety nets. A commensurate body of economic analysis and policy prescriptions existed that enabled the State to act on these preferences. The major corporate actors were national in scope and international economic relations largely comprised arm's-length transactions among separate and distinct national economies. As a result, point-of-entry barriers to economic transactions constituted meaningful tools of economic policy. The prevailing form of nationalism was of a civic and not of an ethnic kind, which facilitated international economic cooperation and, in the case of Western Europe, the process of supranational integration. A set of international organizations was put in place that supported the postwar compromise of embedded liberalism, as it has been called (Ruggie, 1982), most importantly the Bretton Woods institutions, the General Agreement on Trade and Tariffs (GATT) and the United Nations.

Much has changed in the past half century to erode the efficacy of this set of understandings and arrangements. However, no factor has been as consequential as the expanding and intensifying process of globalization (Ruggie, 1996). At bottom, globalization has increasingly disconnected one single element – networks of production and finance – from what had been an overall system of institutional relations, and sent it off on its own spatial and temporal trajectory. This has produced two disequillibria in the world economy, which will persist unless and until the strictly economic sphere is embedded once more in broader frameworks of shared values and institutionalized practices. Major capitalist countries have the domestic and institutional capacity to protect themselves from the worst negative effects of this disequilibrium. The rest of the world, however, is far more vulnerable, and large parts of it, especially in Africa, have become economically marginalized.

A key challenge for the international community, therefore, is to devise for the *global* economy the kind of institutional equilibrium that existed in the postwar *international* economic order. Calls for a new Bretton Woods or for a new economic architecture reflect this quest, although they show little sign of significant progress. We focus here on the longer-term interplay between two sets of key actors in the global economy, transnational corporations (TNCs) and transnational non-government organizations (NGOs), and we do so from the institutional venue of the United Nations. [1]

Civil society actors are increasingly targeting TNCs and the trading system as leverage by means of which to pursue broader social and environmental concerns. We contend that this dynamic interplay provides great potential for attempts to bridge the imbalance between economic globalization and the governance structures that it has left behind.

The United Nations Secretary-General's "Global Compact"

In full appreciation of this dynamic interplay between TNCs and NGOs, United Nations Secretary-General Kofi Annan proposed a Global Compact at the 1999 World Economic Forum in Davos challenging the international business community to help the United Nations implement universal values in the areas of human rights, environment and labour. [2] The initiative has been well received by the corporate community and, at minimum, gives added momentum to the growing recognition that markets require shared values and institutionalized practices if they are to survive and thrive. In this chapter, we first describe briefly the component parts of the global compact; we then offer an account of its positive reception; and finally we draw some conclusions from the case.

The Secretary-General challenged individual corporations and representative business associations to demonstrate good global corporate citizenship by embracing nine principles in the areas of

[1] NGOs are broadly defined here as any non-profit voluntary citizens' group that is constituted at the local, national or international level.

[2] See http://www.un.org/partners/business/

environment, labour and human rights, and by advocating for stronger United Nations organizations in those and related areas. The nine principles are derived from the Universal Declaration of Human Rights (UDHR), the Rio Declaration of the United Nations Conference of Environment and Development (UNCED) held in 1992, and the four fundamental principles and rights at work adopted at the World Economic and Social Summit (WESS) in Copenhagen in 1997 and reaffirmed by the International Labour Organization (ILO) in 1999. The areas and principles chosen are those that are most relevant at the corporate level *and* at the global rule making level, while at the same time rooted in solid international commitments and even treaty obligations. The ILO, Office of High Commissioner for Human Rights (OHCHR) and United Nations Environment Programme (UNEP) are partner agencies within the United Nations itself.

The Compact is pitched at both the micro and the macro-level. While recognizing that governments have the main responsibility for implementing universal values, a novel feature of the Compact is that corporations are asked to embrace these values directly, in their own sphere of operation. Specifically, they are asked to incorporate them into their mission statements and to translate them into concrete corporate management practices. A key tool to facilitate the adoption, implementation and dissemination of these commitments is a web site (www.un.org/partners/business/globcomp.htm) constructed with the help of corporations, business associations, the partner agencies and NGOs. The website showcases good corporate practices and eventually best practices, and it features commentaries by NGOs.

The Global Compact is not designed as a code of conduct. Instead, it is meant to serve as a framework of reference and dialogue to stimulate best practices and to bring about convergence in corporate practices around universally shared values. Of course, it is possible for the Compact to evolve into an instrument of greater precision if and as conditions warrant.

Challenging TNCs in particular to become good corporate citizens that accept responsibility commensurate with the power and rights they enjoy ensures that corporations from developing countries

are not punished for lacking the capacity to behave in the same way (Bhagwatti, 1998). At the macro-level, or the level of global rule making, the Global Compact tries to enlist the business community in an advocacy role on behalf of United Nations. At the global rule-making level, a significantly strengthened United Nations in terms of authority and resources would fill an important governance gap that has been the source of tension and has threatened to undermine multilateralism, as was witnessed at the Third Ministerial Meeting of the World Trade Organization (WTO) in December 1999. A United Nations capable of effectively addressing environmental, labour and human rights concerns, in short, would also help ensure a sustained commitment to the global trade regime.

There are positive indications that the international business community is responding to the challenge. The International Chamber of Commerce (ICC) on 5 July 1999, adopted a statement arguing for a stronger United Nations as the most sensible way forward. The ICC also pledged to work with United Nations agencies to implement the Global Compact at the corporate level.[3] Individual corporations have lent their support and have assisted in the construction of the website, as have leading NGOs in the areas covered by the compact.

If the Global Compact were to succeed, it would have accomplished two things. The United Nations would have enlisted the corporate sector to help close the gap between the strictly economic sphere and the broader social agendas that exists at the global level today, which the corporate sector itself created. The United Nations would have gained corporate backing for a more robust United Nations role in human rights, environment and labour standards, thereby responding to imbalance in global governance structures mentioned above.

On the side of the business community, success will depend in no small measure on the capacity of global business associations to mobilize sufficient advocacy support for strengthening global governance structures in environment, development, human rights

[3] The ICC has already endorsed the notion that a stronger United Nations in the areas of labour, human rights and the environment is the most sensible way forward to secure open markets.

and labour. Only business associations can circumvent the collective action problems faced by individual firms. In the absence of aggregate corporate representation, collective responsibilities can neither be formulated nor implemented. The international community should have a keen interest in promoting representative business associations.

At the corporate level, the question is whether a sufficient critical number of moral first movers will articulate a commitment to embrace social responsibilities, and whether they have the power to establish dominant industry-wide corporate social purposes. A closely related question is whether TNCs will continue to respond to multiple pressures on an ad-hoc basis or whether their response will converge around universal values. The plethora of voluntary initiatives and codes, including labeling schemes, that have emerged over the past years at the corporate, sectoral and national level have several shortcomings: they are selective in content due to the absence of uniform definitions; many lack transparency and provide for inadequate representation of their supposed beneficiaries; and it is not clear to whom they are accountable.[4] As these shortcomings become apparent, pressure for arrangements based on more stable global platforms may increase.

The answer to these questions has a great deal to do with how the dynamic tension that exists today between TNCs and NGOs is played out. We turn now to that subject.

The dynamics of change

The relationship between market and society at the global level is slowly being reshaped. The main protagonists are TNCs and NGOs. And the struggle involves two complementary sets of concerns. First, it is a struggle over prevailing social expectations about the role of corporations, especially large TNCs: is the business of business merely business, or is it something more? Second, it is a struggle over the global trade regime, specifically the extent to which it should accommodate a variety of social agendas. Human rights, labour standards and the environment feature prominently in both

[4] See ILO (1999b) for a comprehensive overview.

instances. Let us take a brief look at the two sets of actors and the issues at stake.

The rise of TNCs in the wake of lower barriers to trade and investment has been widely documented. Foreign direct investment (FDI) flows have steadily increased over the past decades, both in absolute terms and in relation to trade and output. The activities of TNCs have also become more truly transnational as the share of employment, turnover and profit generated in foreign markets has grown. [5] At the same time, TNC strategies to take advantage of broadened market access have generated new approaches to integrated manufacturing networks and marketing strategies that put a premium on global image and branding.

The role of NGOs in the international arena has only recently attracted serious attention and is not yet well understood. NGOs have long been active in international affairs, including at the United Nations (Kane, 1998). However, in recent years their impact has significantly expanded. With the award of the 1997 Nobel Peace Prize to the International Campaign to Ban Landmines came widespread acknowledgment of their growing political influence. Their subsequent role in bringing to a halt the Organisation for Economic Co-operation and Development (OECD) sponsored negotiations on a Multilateral Agreement on Investment (MAI) was further evidence of their powers of persuasion (Henderson, 1999).

The effectiveness of NGOs has much to do with their ability to use the Internet to tap into broader social movements and gain media attention. Relying on high-technology, low-cost means of grassroots advocacy around single issues, they have demonstrated the effectiveness of decentralized and flexible structures combined with non-formalized communication and decision making.[6] Some

[5] Since 1990, the average transnationality index of the top 100 TNCs has increased from 51 per cent to 55 per cent, largely a result of the growing internationalization of assets especially between 1993 and 1996 (UNCTAD, 1999, p. 83).

[6] See Peter Wahl on www.globalpolicy.org/ngos/wahl.htm for a good review of recent trends. Also see Abe Katz, chairperson of the United States Business Council, who devoted his farewell speech to the issue of how NGOs are using the Internet to slow down liberalization (Lucetini, 1998).

NGOs have transnationalized their structures, in a manner comparable to TNCs.[7]

Corporate social responsibility

The changing relationship between society and the corporate community is illustrated by prevailing expectations about corporate social responsibility[8] (CSR) (Friedman, 1984; Donaldson and Dunfee, 1994). While the use of stakeholder pressure to influence the behaviour of corporations is as old as business itself, the meaning of CSR has changed dramatically over the past decade. As recently as 1990, the interaction between business and society remained largely confined to local or national scenes, and the conventional view that the major responsibility of business is to produce goods and services and to sell them for a profit was not seriously questioned.

As liberalization has expanded business opportunities and generated global corporate networks, the bargaining balance in many societies has shifted in favour of the private sector, and in developing countries particularly to TNCs.[9] But this shift, in turn, has provoked attempts by civil society actors and others to orchestrate counter-measures. Unlike the static responses triggered by the first wave of significant transnationalization of the in the early 1970s, however, today's countervailing movements have focused on the social responsibility of corporations, and on ways to alter corporate behaviour through public exposure. Effective use of communications technology and the willingness of the international media to carry stories about corporate misdeeds has greatly increased public focus on corporations.[10]

[7] In particular, environmental NGOs such as World Wildlife Fund (WWF) and Greenpeace, but also Amnesty International (AI), Human Rights Watch and many others.

[8] CSR can be understood as the conditions under which society grants private corporations the right to pursue the maximization of profits. This social contract between a corporation and its host society implies legal requirements or can be understood to include implicit assumptions and expectations. See UNCTAD (1999) for a good overview of the social responsibility of TNCs.

[9] Sales of leading TNCs exceed GDP of regional giants such as Thailand and South Africa (UNDP, 1999, p. 32).

[10] These groups have targeted ("naming and shaming") high-profile corporations such as Nike, Shell and Rio Tinto.

The interaction between NGOs and TNCs around the issue of CSR is highly dynamic and evolving rapidly.[11] But two distinct approaches are taking shape (Sethi, 1994b). At one end of the spectrum, numerous NGOs continue to pursue confrontational approaches, applying a wide range of campaign tools such as provocation, consumer boycotts, litigation and direct protest (Cramb, 1999). At the other end, a growing number of NGOs including the most transnational, such as Amnesty International, Human Rights Watch, WWF and others have entered strategic partnerships with TNCs, recognizing that corporate change leaders can become effective role models or advocates for broader societal concerns.

These partnerships are in an early stage of development, and they are often sponsored by a neutral broker such as a government agency or business NGO.[12] Some TNCs are developing "stakeholder policies", thus trying to cope with the increasing influence and business-orientation of NGOs. These novel forms of business-NGO dialogue have already brought about significant changes in selected areas, especially corporate environmental practices. It remains to be seen whether these experiments will evolve into lasting structures for bridging social and business interests.

Corporations, on the other hand, have had to learn that globalization strategies, particularly global branding, have created not only new opportunities but also vulnerabilities (Wild, 1998).[13] Protecting image and brand names has quickly evolved as a major challenge that had to be met if globalization strategies were to succeed.

[11] For a good discussion forum see www.mailbase.ac.uk/lists/business-ngo-relations/

[12] Examples include the United Kingdom ethical trading initiative, the development of national ethics codes in Canada and Norway and the work of the World Bank on best practices in the extracting industry. Many other initiatives are sponsored by business NGOs such as the World Business Council for Sustainable Development (WBCSD) and the Prince of Wales Business Leaders Forum (PWBLF).

[13] Large corporations no longer advertise their products by the country of origin (e.g. "made in Japan") but establish global brand names and corporate images. These intangible assets have become important in establishing a global presence and by some estimate make up as much as 40 per cent of the market value of corporations.

The need to protect the corporate image has fostered an array of corporate responses, ranging from private sector initiatives at the firm and industry level, to private/public partnership approaches, as well as a renewed interest in regional and international sectoral initiatives (ILO, 1999a). Depending on their vulnerability towards public scrutiny together with the environment and the degree of exposure in which they operate, a few TNCs have publicly broken rank with conventional views and embraced concerns for human rights, the environment and labor in their mission statements, management practices and annual reporting[14] (Cramb and Corzine, 1998).

TNCs are subject not only to external pressure but also to internal needs. Many have begun to confront the challenge of how to integrate into one global corporate culture the increasing number of diverse national cultures of their officers and employees. Success or failure can have a direct impact on the bottom line. Corporate interest in business ethics and good citizenship is, in part, a reflection of this concern. In essence, corporations that take transnationalization seriously in corporate staffing and governance have slowly moved towards the articulation of ever broader sets of values, which are not otherwise essential to contracting or market functioning, in the attempt to define the cultural bonds that hold the company together (The Conference Board, 1999; Environics International Ltd., et al., 1999).

The corporate propensity to respond to civil society concerns and the degree to which these responses are internalized in corporate practices also depends on their market power. Only under conditions of imperfect markets can individual executives afford to guide corporations towards greater ethical norms (Sethi, 1994a).

Overall TNC responses remain highly uneven. While a small but growing number have taken a public stand on ethical issues, it is unclear whether this is a temporary experiment that remains limited to a relatively small number of leading global corporations – mostly

[14] BP and Shell, two front-runners in this movement, caused considerable bewilderment in the business community when they included human rights and sustainable development on their annual report.

active in consumer products and natural resources – or whether it heralds a dominant future trend. Even where innovative responses have been taken, corporations show varying degrees of translating good will declarations into actual management practices, corporate performance and reporting (Watts, 1998).

The trade debate

At the global rule-making level, the relationship between trade, on the one hand, and social, environmental or human rights issues on the other, has emerged as a flash-point of controversy between commercial interests and civil society groups, mostly of developed countries – as the whole world saw at Seattle. Over the past few decades, successive waves of lowering trade and investment barriers have made very apparent the effects of different national policies. Calls for a level playing field and for minimum standards to avoid a race to the bottom have become louder and varying coalitions have been formed to pressure governments to use trade as a means to enforce higher standards or directly change the trading rules to accommodate social agendas.

Those who oppose linking trade with other concerns have argued that this would put too much stress on the trading system, thereby rendering it ineffective; and that it would not solve the problems at hand because the trading system is not designed to solve labour, environmental and human rights issues. Moreover, opponents are deeply concerned that seeking to impose such standards through the trade regime would be an open invitation to exploit them for protectionist purposes, to the grave disadvantages of the developing countries and the trade regime as a whole. Instead, developing countries argue, higher standards in areas such as environment can only be achieved through the process of accumulating skills, capital and technology. Higher standards in areas such as the environment cannot be imposed, they argue but can only be achieved through an incremental process of accumulating skills, capital and technology.

Interestingly, the views of developing countries are increasingly converging with those of TNCs – and outward oriented

corporations of any size – forming a potentially powerful policy coalition that has not yet been fully realized.[15]

The conflict over trade rules was evident in the debates following the conclusion of the Uruguay Round. A compromise declaration was reached at the first WTO Ministerial meeting in December 1996, where it was confirmed that the ILO was the competent body to deal with labour issues, and where a decision was taken to keep environmental issues merely under review within the WTO framework. This was only a temporary lull, however. As preparations for the Third Ministerial Meeting of the WTO gained momentum, conflicts around these issues became more intense again.[16]

As pressure by civil society actors has intensified, various attempts have been made to appease their concerns by increasing the transparency of the WTO and by searching for compromises.[17] President Clinton, for example, proposed in an ILO speech to "build a link" with labour (Clinton, 1999). Renato Ruggiero, as Director General of the WTO, stressed the need for balancing global governance structures, culminating in his proposal for a World Environment Organization (Ruggiero, 1999).

The Third Ministerial Meeting of the WTO in Seattle in early December 1999 thrust civil society movements into the public consciousness. Their common denominator was the use of trade to advance a host of other issues. With 30,000 protesters and about 20,000 labour union members marching in the street, the Seattle event demonstrated vividly how trade and large corporations have become the target of citizen's groups.

[15] This is evident when comparing policy statements of the ICC and of developing countries. The convergence has gradually proceeded over the past few years, to a point where positions are sometimes virtually indistinguishable.

[16] Large demonstrations in Geneva in 1998 showed that the WTO and big business have become a target of social movements of all sorts.

[17] A dialogue forum on development and the environment was held in March, see http://www.wto.org/wto/index.htm, and of arrangements have been made that allows NGOs to attend some debates.

The collapse of the Seattle talks and the failure to agree on another round of trade liberalization was not the result of pressure from the street, however. The talks had to be suspended because trade negotiators failed to bridge conflicting views, especially in the area of agriculture where the European Union tried hard to deflect pressure to reduce farm subsidies. Yet, the demonstrations and the movements preceding them, especially in the United States, had their impact. In an interview after the Seattle talks, the European Union's trade commissioner Pascal Lamy went on record by blaming the collapse of the Seattle talks on the pressure of looming United States presidential elections and President Clinton's call in Seattle for labour standards to be included in trade agreements.[18] In the same vein, India's chief representative at Seattle said that President Clinton's remark about labor standards "made all the developing countries and least-developed countries harden their views. It created such a furor that they all felt the danger ahead".[19]

The Seattle experience showed that civil society groups are increasingly powerful at the corporate, national and international levels and that inter-governmental organizations such as the WTO have yet to learn how to respond. The fact that over 90 per cent of the NGOs that attended the Third Ministerial Meeting in Seattle came from OECD countries indicates a strong northern bias. The voices of the people of the developing countries remain unheard, and in those cases where developing countries' NGOs do participate they are often subsidiaries of NGOs headquartered in OECD countries.

The Seattle meeting confirmed once again that opponents of trade liberalization represent highly heterogeneous groups with different motivations. The spectrum of protesters included a small anarchist minority, a large number of single issue groups concerned with the environment, health and human rights, trade unions who fear that structural adjustments due to market openness are not offset by positive effects of increased competition, and powerful economic interests that seek government protection in areas such as steel and textiles.

[18] See N. Buckley, "Collapse of Seattle talks blamed on U.S.", *The Financial Times*, 7 December 1999.

[19] Reported by Celia W. Dugger , "Why India and others see U.S. as villain on trade", *New York Times*, 17 December 1999.

Numerous activists took up the call to rally against exploitation and environmental destruction in developing countries, while at the same time ignoring the basic fact that trade remains the most viable path to escape poverty and that developed countries continue denying poor countries market access in areas where they stand a chance to compete. Protesters readily took up the slogans of the A.F.L – C.I.O. but were apparently not influenced by development oriented NGOs who understand that poverty is the main cause of child labour and environmental destruction in poor economies and that trade and investment have overall a positive and mutually reinforcing consequences for human rights, development and the environment. This apparent hypocrisy led many observers and commentators refer to developing countries as the real losers of Seattle.

What the debate on CSR and trade have in common

The interaction between TNCs and NGOs at the corporate level and the controversies around global trade reveal a number of consequential tendencies.

First, contrary to conflicts between markets and society during the 1960s and 1970s – for example, the controversial debates around the United Nations Code of Conduct on TNCs – the issue at stake today is not ideological. Opponents of globalization do not advocate an alternative ideology. While they seem united in their intention to oppose markets, most of them thrive because of economic good times and their operations and networking hinge critically on the free access to information technology.

Indeed, most transnational NGOs take positions against TNCs and trade not because they inherently oppose their legitimacy or functional efficacy. They do so primarily because it promises to leverage their own specific interests and concerns. This strategic positioning is greatly facilitated by the fact that the trade regime is not static in its relation to society, nor does it represent a concrete thing. The trade regime is intersubjective in character and reflects the shared meanings and understandings attributed to it by the relevant actors (Ruggie, 1998). As a result, issues can always be characterized

in more than one way. In situations of choice, the act of characterization itself can be strategic in the sense that the actors select a characterization not on the basis of objective facts but on the positional implications of one formulation over the other (Wolfe, 1999).

If such strategic positioning is a central feature of current debates this carries considerable risks, especially in circumstances where it overlaps with real economic interests in protection-seeking industries or other interests. The most likely losers are those that are not party to the game – consumers everywhere and developing countries in particular.

However, while environmental and human rights NGOs may be motivated strategically in the debates around trade and TNCs, their position is given added moral weight by the imbalance in current global governance structures. There is a stark contrast between the available institutional mechanisms to define and enforce global rules that advance the economic interests of TNCs and the under-funded and relatively weak United Nations agencies charged with advancing the causes of the environment, development, human rights and labour. And at the United Nations, there is a wide gap between the ambitious goals and broad commitments embodied in various United Nations conferences on social issues and the degree to which governments are willing to honor such commitments.[20]

Finally, there are some signs that elements in the global corporate community are themselves increasingly concerned by the unsustainability of the current imbalance in global governance structures, recognizing that global markets no less than national ones need to be embedded in broader frameworks of social values and practices if they are to survive and thrive (ICC, 1998a, 1998b, 1999).[21] As a result, they have begun to look to the United Nations to play a

[20] The follow-up process to UNCED exemplifies this trend. Indications are that "Copenhagen +5" will be comparably sobering.

[21] There is an interesting difference between the financial community, especially Wall Street, which continues to oppose any regulation of global markets, and corporations that actually invest long-term productive capital. The rift became obvious during the peak of the Asian financial crisis, with the latter warning about the need for at least some regulation of financial markets.

larger role in setting norms and standards that express not merely the functional values of direct interest to business, but also broader global social issues. At Seattle, Kofi Annan invited participants to view the United Nations as a part of the solution to the problem with which they were grappling (Annan, 1999).

Conclusions

Globalization may be a fact of life, but it remains highly fragile. Embedding global market forces in shared values and institutionalized practices, and bridging the gaps in global governance structures, are among the most important challenges faced by policymakers and corporate leaders alike. The future of globalization may hang in the balance. This challenge has to be met at the micro-level, where we believe the move towards articulating and acting upon universal values offers a viable approach. And it has to be solved at the level of global rule-making, where we believe strengthening the role of the United Nations has a productive role to play. The Global Compact is intended as a contribution to both though by its very nature and scope, it can only make a modest contribution. Let us draw some conclusions from the case.

One can readily appreciate why corporations would be attracted to the Global Compact. It offers one stop-shopping in the three critical areas of greatest external pressure: human rights, environment and labour standards, thereby reducing their transaction costs. It offers the legitimacy of having corporations sign off onto something sponsored by the Secretary-General – and, far more important, the legitimacy of acting on universally agreed to principles that are enshrined in covenants and declarations. And, the corporate sector fears that the trade regime will become saddled with environmental and social standards and collapse under their weight; in comparison, a stronger United Nations in these areas is far more preferable.

The NGO community is divided over the approach. The smaller and/or more radical single issue NGOs believe that the United Nations has entered into a Faustian bargain at best. But the larger and more transnationalized NGOs have concluded that a strategy of

"constructive engagement" will yield better results than confrontation, and they are cooperating with the United Nations. At the same time, it is no doubt true that without the threat of confrontation, engagement would be less likely to succeed. The developing countries have yet to take a position. They fully support efforts to keep the trade regime free of additional conditionalities and barriers. But they are also worried that working with TNCs to improve their practices could become a Trojan Horse to put pressure on the governments of those countries. And if we succeed in our endeavor, the imbalance in global governance structures will be somewhat attenuated.

The experience of working together on the Global Compact has also brought greater coherence to the United Nations entities active in this domain, and the hope that connected behaviour accomplishes far more than fragmented action. Thus, the Global Compact may signal that the United Nations may become a more salient player in the post-Seattle game of forging new instruments through which to manage the consequences of globalization. ■

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BOOK REVIEWS

World Investment Report 1999: Foreign Direct Investment and the Challenge of Development

United Nations Conference on Trade and Development

(New York and Geneva, United Nations) xxxiv + 536 p.

UNCTAD has got it right again. On the cusp of the new century, the special topic of *World Investment Report 1999 (WIR 99)*: *Foreign Direct Investment and the Challenge of Development*, brings us squarely to the fundamental issue of the twenty-first century. More specifically, how can we apply all that we now know and have learned – over the course of the last half century and more – to achieving actionable policies that will result in poverty reduction and real development for the world's population. In the case of *WIR99*, these policies relate to foreign direct investment (FDI).

The role of international capital flows, particularly FDI, are inextricably a part of this discussion. For example, in the decade 1987-1998, FDI has played a significant role in many countries' efforts to lift their populations out of poverty. Over this period the poorest of the poor in East Asia[1] (including China), even allowing for the Asian crisis, fell by some 220 million – a record amount in historical terms and a good indication for future prospects. FDI undoubtedly played a part in this, as documented in previous *WIR*s, but sadly the picture is not universally sanguine. As *WIR99* reports, FDI and other capital flows are noticeable by their absence in the least developed countries.[2] Even in countries receiving considerable numbers of

[1] Population living below $1 per day. The poverty figures presented here are mostly derived from table 1.8 in the World Bank (1999), Global Economic Prospects and the Developing Countries, Washington, D.C.

[2] Despite the decline of utmost poverty in East Asia, the total number of the poorest remains at about 40 per cent of the populations of developing and transitional economies because of the rise in the absolute numbers of the poor in all other regions. The proportion increases to about 55 per cent if the poor are defined in terms of populations living below $2 per day.

transnational corporations (TNCs), they can produce negative as well as positive effects for the local economy and populations. The latter point should encourage policy markers to pause for thought and heed the reports advice:

> *The policy challenge for countries is two-fold: ...to guard themselves ... against engaging in a financial incentives-competition race towards the sky ... and to pursue policies ...[to] attract Fdi and especially benefit from it as much as possible.*

A considerable proportion of the volume is therefore given over to mapping the current empirical and conceptual knowledge on the impact of FDI, as a precursor to determining viable policies, given the specific circumstances of a particular country.[3] Lest the reader of this review think that *WIR99* has simply returned to the agenda of the 1960s and 1970s, it is worth mentioning that, at the outset, the report underlines that the world has moved on and that in an era of globalisation we need to recognise the "changing context of development" in the twenty-first century. In this respect, apart from globalisation per se (covered in *WIR94*), three issues are highlighted: the changing nature and pace of knowledge, especially in the merger of communications and information processing technologies; shrinking economic space and changing competitive conditions (from transportation and communications to networking and organisational forms); and the shift to market-oriented, private sector led economies in developing and transitional economies.

Having established the context, *WIR99* examines how TNCs can complement domestic efforts to meet development objectives. The discussion is split into five (inter-linked) core areas of economic development, each receiving its own chapter:

- increasing financial resources and investment;
- enhancing technological capabilities;
- boosting export competitiveness;
- generating employment and strengthening the skills base; and

[3] Much of the discussion in this review is couched in terms of impact and implications for developing countries, but *WIR99* also assesses these issues from the viewpoint of transitional and developed economies.

- protecting the environment.

These chapters are "state of the art" inasmuch as they draw together – clearly through ongoing debate with leading researchers in the field – what is known about the issues and what the implications might be. Concrete examples, from Mumbai to Sao Paulo are presented, many relevant to least developed countries. Analyses are not confined to manufacturing investments, but take on board the international activity and consequences of service and utility TNCs. As a whole, the chapters offer, in accessible form, valuable knowledge and insight for scholars and policy makers alike. There is also a useful chapter on the social responsibility of TNCs which, ideally, will be taken up as full theme in a later issue of the World Investment Report. The weakest chapter is chapter XI ("Assessing FDI and development") which tries to pull together the preceding discussion, an almost impossible task in the space allowed. Apart from this understandable weakness, WIR99 will prove indispensable as a starting point for investigating Foreign Direct Investment and the Challenge of Devleopment for many years to come.

Finally, mention has to be made of the rest of the report! As usual, there are valuable and pertinent analyses of ongoing trends in FDI and TNC activities. Apart from the tables and graphics in the main report, there are some 130 pages of detailed tables, data and information on FDI. These are highly useful and a continuing testimony to the invaluable service UNCTAD provides to the intellectual and policy communities on a continuing basis.

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Trade and Investment in China: The European Experience

Roger Strange, Jim Slater and Limin Wang (eds.)

(London, Routledge, 1998), 315 pages

This book is one of the Routledge Studies in the Growth Economies of Asia. The three editors have assembled an impressive group of 17 contributors, and set the tone for the entire volume in their assessment of the overall picture (chapter 1) and in their conclusions (chapter 14), as well as in a number of substantive chapters. Their main purpose was to determine how important China is as an economic partner for Europe; how important Europe is as an economic partner for China; and how the bilateral relationship is likely to evolve. In addition to an aggregate assessment of trade and investment in China, section I examines the policy framework and environment within which trade and foreign direct investment (FDI) relations between China and Europe have developed; section II contains six industry studies; and the final section deals with outward investment from China and future prospects.

The principal finding is that, according to official statistics, Chinese-European trade and investment flows are relatively unimportant. China's share in total European Union imports as well as in FDI inflows amounts to less than one-twentieth. Its share in European Union exports is even smaller. From a Chinese perspective, the relationship is, however, more important than these data would suggest. It should be noted that an asymmetrical relationship applies generally between developed and developing countries.

A closer analysis by Roger Strange reveals that the aggregate picture does not reveal the fact that a sizable proportion of such trade and investment goes through Hong Kong, China. When adjustment is made for the ultimate destination of European Union exports and direct investment via Hong Kong, China, the significance of the bilateral relationship becomes more important. The study thus sets a good example of not accepting official figures at face value. Indeed, the dispute about the size of the United States trade deficit with China

would be seen in a different light by using similar and even more detailed adjustments, as presented by K. C. Fung and Lawrence Lau (1999), for example, instead of insistence on the use of the respective countries' official figures.

With respect to FDI in China, no attempt has been made to adjust the official figures or give an indication of the degree of the probable bias, despite questions about overstatement due to "round-tripping" through Hong Kong, China, and bureaucratic incentives to exaggerate achievements.

In contrast, using James Zhan's methodology (Zhan, 1995), significant differences can be shown between official and adjusted figures on China's outward investments, and the order of magnitude of official understatement is clearly stated. It should be pointed out that these differences reflect important capital flight, often hidden in large errors and omissions in China's balance-of-payments statements, and thus raise doubts about the judgement that Chinese companies behave in a manner not significantly different from other transnational corporations (Wang, 1992, p. 273).

In terms of technology transfer, it is suggested that the European variety tends to be of higher quality than most others since its size is larger and it is concentrated in technology intensive upstream industries.

The policy chapters are well documented and informative. This reviewer would have preferred seeing more extensive analysis of its implementation, bearing in mind the Chinese saying that "there is policy at the high level; there is counter-policy at the low level", especially where "the sky is high and the emperor is far away". The chapter on regionalism clearly draws from a larger study by the author (Pomfret, 1998) although the general observation that regional blocs tend to act more like stumbling blocs than building blocs hardly applies to China, since China is unlikely to belong to any of the exclusive regional trading groups. The inescapable conclusion is that China has little choice other than multilateralism.

The industry studies supplement and enrich the macro picture.

There is, however, no uniform format for every chapter, reflecting the fact that most of the contributions are by-products of ongoing independent studies. Some give a full discussion of the theoretical framework while others dwell on the general industry characteristics. Relatively little space is devoted to the European experience, partly because there is no attempt to look at the enterprise level. Thus, little is said about the successes and failures of European firms in China or Chinese firms in Europe. The only empirical investigation based on firm-level questionnaires pertains to the study on the entry mode to China used by banks.

With respect to future prospects, the tone is generally optimistic, both as far as Chinese-European relations and opportunities for European firms in China are concerned. A major reason for this is Europe's role in China's international relations, especially in counterbalancing Japan's and the United States' influence. China's inevitable rise in the world economy would be an additional reason for optimism.

On the whole, the book is a useful contribution to a growing volume of literature in the field. There is enough value-added for the specialist and adequate basic information for the generalist and the novice. The editors are to be congratulated for their care and skill in insuring the lucid exposition of the entire volume and their careful scrutiny of the contents. Even with a fine-tooth comb, few errors have been discovered. The characterization of the State Council as China's parliament rather than its administrative organ or cabinet (p. 190) is a rare exception. Typographical errors are also uncommon, except for a few evident ones (pp. 11, 192, 220) which can be eliminated in a second printing.

The reader should, of course, be aware of the fact that most of the data presented in the book come from the mid-nineties. While the general picture will not be greatly affected by rapidly changing conditions, some specifics will be different. For instance, European Union anti-dumping practices against China will be less harsh as China is no longer classified as a non-market economy. The recent Chinese concessions made to the United States in connection with China's accession to the World Trade Organization, especially in

telecommunications, banking and insurance (Wang, 1998) should have a spill-over effect on the European Union. This reviewer, therefore, looks forward not only to a second printing or an updated version of this book but also to more detailed studies at the enterprise level.

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Foreign Investment in China

Feng Li and Jing Li

(Houndmills, Macmillan, 1999), 265 pages

Foreign direct investment (FDI) is one of the most dramatic features of China's transformation from a planned economy into a market economy. Since the passing in late 1979 of the Equity Joint Venture Law that granted legal status to FDI on Chinese territory, China has gradually liberalized its FDI regime, and has developed an institutional framework regulate and facilitate such investments. The liberalization of the FDI regime and the improved investment environment have greatly increased the confidence of foreign investors in China. Consequently, FDI inflows into China increased rapidly after 1979, and particularly during the 1990s. In 1993 China became the second largest FDI recipient in the world (following the United States) and the single largest host country among the developing countries.

What are the main attractions of China for FDI, what does the foreign investment environment look like and how could foreign investors succeed in doing business in China? This book written by Feng Li and Jing Li attempts to provide answers to these questions. It examines China's FDI environment, including the status of infrastructure and the political, economic and social contexts. Main problems encountered by foreign investors are also investigated, and practical advice for successfully doing business in China is supplied, including understanding and making effective use of g*uanxi*, navigating through a complex legal system, organizing distribution in a large transition economy, and appreciating unique consumer behaviours.

The book starts with identifying the main attractions of China for foreign investors. As the book reveals that the main attractions of China, among many other factors, include its enormous market size and the even greater future potential, its abundant supply of cheap, but reasonably educated and well-disciplined, labour and the

preferential taxation and other policies adopted by the central and local governments to attract foreign investors.

The evolution of China's open door policies in respect of FDI is systematically examined and analysed. Major FDI-related laws and regulations were highlighted and their implications for foreign investors in China were discussed. By examining the key factors that facilitated or led to the major changes in FDI-related laws and regulations, the book concluded that the key dynamics of China's evolving open door policy have been the strong desire of the Chinese leadership to achieve rapid and steady economic development, and the interaction between various internal and external forces. In the 1980s the general tendency was that an increasingly relaxed foreign investment environment was created both for the starting up and the operation of foreign invested enterprises. In the 1990s, the focus of China's opening up is shifting from quantity to quality, and an increasingly selective and proactive approach has been adopted to attract specific types of FDI into selected sectors and locations.

The strength of the book lies in the in-depth analyses of foreign investment environment from chapter 4 to chapter 7. This reflects the authors' rich experiences and deep understanding of the Chinese economy, politics and society.

In their analysis, the authors classified the foreign investment environment in China into hard environment and soft environment. Chapter 4 assessed the characteristics and conditions of China's hard environment for FDI. Major problems restricting the operation and development of foreign invested enterprises, including the energy shortage, the insecure supply of raw materials, and the inadequate transportation and telecommunications infrastructure were identified. The authors argued that, despite nearly twenty years of rapid growth, the general condition of China's hard environment cannot be improved to a level comparable with the developed economies in the short term. However, improvements in certain industries (such as telecommunications) and locations (for example, the special economic zones and some open cities along the coast) have been impressive. Since the early 1990s, new sources of finance have been sought and foreign investors are increasingly encouraged to participate directly

in the development of China's infrastructure (in the form of build-operate-transfer projects). Continuous improvements in the hard environment are therefore inevitable, but many problems will remain for some time to come.

The soft foreign investment environment in China is further divided into general soft environment and operational soft environment. From a historical, political and social perspective, the authors assessed in chapter 5 the general context of China's soft investment environment. From a historical perspective, the book revealed the close relationship between China's opening up and economic prosperity, and its inward-looking, overly self-reliant mentality and national economic backwardness. Therefore, the book concluded that the lessons from China's own history strongly support an opening-up scenario if China intends to achieve economic prosperity and continuous growth. From a political perspective, the book concluded that, despite re-occurring fluctuations and short-term stagnation or set-backs, the reform and the opening up are going to continue. The book argued that the question is how the reform and opening up will proceed and at what speed. From a social perspective, the book argued that, even under a stable political environment, the success of a foreign invested enterprise in China is still not straightforward. The unique culture and social structures in China will have considerable influence on the operation and management of foreign invested enterprises. To justify this point, the authors made great efforts in analysing and highlighting the critical importance of *guanxi*. To understand this unique phenomenon, the book examined the institutional and cultural roots of *guanxi*, and discussed the relevance and importance of *guanxi* to foreign investors in China.

In terms of operational soft investment environment, the book examined some operational problems encountered by foreign investors in such areas as insufficient foreign exchange facilities, incomplete legal system, human resource related problems, social security and welfare, bureaucratism and corruption. The book pointed out that many such problems are closely related to China's transition from a centrally planned economy to a market system. Today, most tactical problems in relation to the incompatibility between central planning and a market economy have been resolved or greatly relieved, but

many politically-related issues have deliberately put aside and their resolution depends on the success of the next round of reforms, for example, reforming the loss-making state owned enterprises and the banking system. The book argued that a comprehensive understanding of these factors is essential for foreign investors to make valid judgements about the quality of China's investment environment and the potential risks involved.

Chapter 7 examined a wide range of issues in distribution and marketing in China. The authors argued that China is a large and rapidly growing market, which is one of the main attractions for foreign investors. However, distribution and marketing in China have been posing serious challenges to foreign invested enterprises, and the unique, geographically varied, and rapidly changing consumer behaviours that characterise a market in transition makes the challenges even greater. They pointed out that because China is still in transition, administrative and market forces will continue to affect the operation of both Chinese and foreign companies in China. At the current stage, the state distribution system of the centrally planned economy has crumbled, but the new distribution system of the market economy has not been fully established. The poor transportation infrastructure and various government regulations and restrictions will continue to affect the development of a fast, reliable, and efficient distribution system. Therefore, the book concluded that, although improvements since the early 1990s have been significant, and foreign invested enterprises now have a wide variety of options available to them in formulating a distribution and sales strategy, the challenge remains.

There are also some shortcomings in the book. For example, first the book overlooked a very valuable part of literature on the theories of FDI. There are many theories seeking to explain FDI; the most recent surveys can be found in John Dunning (1993) and Richard Caves (1996). Among the theories, one organising framework to explain FDI was proposed by Dunning (1977, 1993), who synthesised the main elements of various explanations of FDI, and suggested that three conditions all need to be present for a firm to have a strong motive to undertake direct investment. This has become known as the "OLI" framework: ownership advantages, location advantages,

and internalisation advantages. However, without examining the theories of FDI, the book seems lacking of theoretical background, thus leaving the analysis a little bit superficial.

Second, although the book is mainly focused on an analysis of location advantages of host countries, China's foreign investment environment, a discussion of ownership advantages and internalisation advantages of transnational corporations of source countries will help to understand the motivations of FDI, especially the differences between FDI from the developed countries and from the developing countries, and further help to understand the dominance of developing countries in China's total FDI inflows and the concentration of FDI in labour intensive activities in China.

Third, there is a lack of analysis in the regional differences in terms of opening policies, taxation policies, preferential policies and resource endowments. In fact, it is these regional differences that determined the uneven regional distribution of FDI in China, which further contribute to enlarge the differences in economic growth, per capita income and social development between the coastal and the inland areas.

In general, despite these weaknesses, the book makes some contributions to the existing literature of China's foreign investment environment. It is a valuable guide to foreign investors for avoiding common and expensive pitfalls of doing business in China, and a valuable reference source for consultants, researchers and students in understanding the Chinese market.

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Global Transformations: Politics, Economics and Culture

David Held, Anthony J. McGrew, David Goldblatt
and Jonathan Perraton
(Cambridge and Oxford, Polity Press, 1999),
xxiii + 515 pages

This book is one of the outcomes of an ambitious project funded by the United Kingdom Economic and Social Research Council. Given its wide aim and scope, the project could easily have backfired. It has, in fact, largely succeeded.

The aim of the project is to analyze and assess globalization with regard to key domains of social and economic activity; its scope and impact; its historical antecedents and present context. Though the authors do not see globalization as a new phenomenon, the contemporary phase is given prominence in their treatment.

The domains of globalization considered in eight main chapters are the following: Global Politics and the State; The Military; Global Economic Aspects, with separate chapters on International Trade, Finance and Production; Migrations; the Globalization of Culture; the Environment. The different domains are analysed by specialists in each field though the chapters are not attributed individual authorship. This is in line with the obvious desire of the authors to present the outcome of the project as an integrated whole.

Integration is achieved through the use of a fairly uniform framework and methodology in which the following elements feature more or less throughout:

- Analysis of various historical epochs. The following epochs are considered: pre-modern (up to 1500); early modern (1500 - 1850); modern (1850 - 1945); and contemporary. The historical dimension leads the authors to an analysis of what is special about globalization in different epochs and what is new about the contemporary phase of globalization.

- Analysis of features, scope and impact of globalization, including issues of stratification and of the institutional and technological infrastructures.
- Case studies of six "States in advanced capitalist societies" (United States, United Kingdom, Sweden, France, Germany and Japan).
- Spatial and temporal dimensions are used throughout to assess globalization and in particular the following ones: extensity of global networks (geographical reach); intensity (i.e. quantitative aspects); velocity or speed of interchanges; and impact of global flows on the economy and society.

The introductory chapter contains a very good discussion of various theses on globalization. The authors distinguish between a hyperglobalist, sceptic and transformationist thesis. The distinction is not a matter of taxonomy for its own sake. It has implications for the historical roots and possible future developments of globalization, as well as for the analysis of its impact and the role and power of the State in the economy and society.

Hyperglobalizers see globalization as a new process and epoch in which global markets and competition are the "harbingers of human progress" (p. 3). In this context the nation-states and their governments are seen as unnecessary and as an obstacle to further progress. The prediction is that they will gradually be overtaken by new forms of social organization.

The sceptics consider globalization as an overemphasized concept and process. The majority of businesses and companies – including transnational corporations (TNCs) – are seen as nation-based. The nation-state is seen as the basic unit of governance. There is a need for active economic policies in the face of globalization.

The authors of this book see globalization as a process of "global transformations". It is interesting to note the plural in the title: it can refer to historical epochs or to the various domains of activity affected by the transformations or to both. The arguments for their thesis are convincing. They emerge from the historical

analysis as well as the large amount of empirical evidence on the changes in scope, impact and institutional framework of contemporary globalization.

Each of the chapters dealing with aspects of the chosen domains of analysis is very well developed, documented and argued. There is also a good amount of cross-referencing in line with the aim of an integrated project and outcome. The analysis of institutional infrastructures, their historical developments and current weaknesses and strengths is present in many chapters and particularly in the first one (global politics).

I found particularly strong the chapter on cultural globalization (chapter 7). It is the one that best integrates and explains its subject matter by the use of cultural discourse as well as technological and economic ones. It links the speed and scope of cultural spread to technological developments and to the structure and organization of the industries. It shows how the electronic, as well as linguistic infrastructure supports cultural globalization and how the corporate ownership and the organization structure affect the industry and the consumers. Among the questions raised in the chapter are the issues of challenge of the cultural unity of the nation-states in the face of growing cultural fragmentation. Whether cultural globalization helps to explain and fuel devolutionist, regionalist or independence movements, is left as an open question.

The final chapter concludes, not surprisingly, that contemporary globalization surpasses all previous epochs' globalization trends in all domains and in terms of all the measures used, be they qualitative or quantitative. The authors take a critical stance at alternative theories of globalization particularly the hyperglobalist one with its emphasis on individualism. Instead, they put communities – whether within or across nation-states – at centre stage in the future of world politics and democracy. They see the need to rethink the "home" of politics and democracy in a world in which people's sense of belonging may no longer coincide with the nation-state and its territorial boundaries. Overlapping communities and jurisdictions require new dimensions and processes for politics and democracy.

The book is clearly written and supported by a large amount of data. A number of "grids" help the reader through a complex set of classifications and structures. Ironically, the only sections found by this reviewer to lack full clarity are in the introduction where the authors explain their methodological framework with diagrams and boxes. This is done, ostensibly, to help the reader. However, this reader found the methodology emerging more clearly from the later chapters than from these "explanatory" visual devices.

There are surprisingly few slips for a project of such scope and dimension and a book of this size. I shall mention a couple of ambiguities. The chapter on globalization and culture contains a section on "Transnational Secular Ideologies" which states that "… the steady diffusion of capitalist market relations brought the basic elements of neo classical economics to a wider audience…." (p. 340). Here the uninitiated reader might be led to believe that neo-classical economics faithfully represents capitalist market relations. Many economists would not ascribe to this particular school such high degree of realism. Chapter five (p. 237) defines TNCs rather ambiguously, partly in terms of direct production (for goods), partly in terms of market sourcing (for services). Surely the essence of TNCs is that they produce directly in host countries whatever the nature of the product.

The main problem with the project and the book is its point of departure and overall focus. Manuel Castells (1996, p. 5) takes as his "entry point" in the analysis of contemporary economy and society, the information technology revolution. The new technologies figure in the book under review as part of the technological infrastructure on a par with the institutional infrastructure. They are neither part of the domains of study nor point of departure. This reviewer feels that, in the end, contemporary globalization, its pervasiveness and effects cannot be fully understood without putting two specific elements centre stage: the role of TNCs and the role of information technology. Neither of these two is accorded the key role it plays in the economy and society, except in chapter seven ("Globalization and Culture"). TNCs and their activities are considered extensively and well in chapter five. However, their growth and activities are treated just like another aspect of "intensity" and "extensity" of

globalization rather than the key actors in the development and shape of globalization as we experience it. Similarly, the role of the information technology revolution in globalization is not just part of the infrastructure, it is a major driving force.

The "centre stage" and "entry point" seem to be given to politics. And I do not mean in the sense that the first chapter is on politics (though this may be indicative in itself). It is more that politics and political institutions and processes seem to pervade a large part of the book and some readers may be misled into the conclusion that they are the driving force behind globalization.

In spite of these critical points I found the book excellent in many respects and I recommend it unreservedly for researchers and for postgraduate courses on economic and social aspects of globalization.

Grazia Ietto-Gillies

South Bank University
London
United Kingdom

Reference

Castells, Manuel (1996). *The Rise of the Network Society: The Information Age: Economy, Society and Culture* (Oxford: Blackwell).

JUST PUBLISHED

Handbook on Outward Investment Promotion Agencies and Institutions

ASIT Advisory Studies, No. 14

(Sales No. E.99.II.D.22) ($ 15)

This *Handbook* provides an overview of institutions that support enterprises interested in investing abroad. This assistance varies from information services on investment conditions and opportunities to facilities that provide investment financing and insurance. It is based on an UNCTAD survey undertaken in 1999 of 74 institutions that promote and facilitate foreign investment, or else play a role in assisting developing countries and economies in transition in attracting foreign direct investment. The study distinguishes between outward investment promotion agencies, development finance institutions and investment guarantee schemes, as each responds to a different need of enterprises seeking to identify and realize overseas investment projects. One general conclusion of the study is that across the board many institutions offer special programmes for small and medium-sized enterprises that wish to invest abroad, and that services are often geared to developing countries and economies in transition. The survey also dealt with cooperation arrangements between outward investment institutions and inward investment promotion agencies. Results show that a considerable number of the former already cooperate with the latter, although finance and guarantee institutions do so to a lesser extent.

The Social Responsibility of Transnational Corporations

(UNCTAD/ITE/IIT/Misc.21)

This booklet covers the context for the social responsibility of transnational corporations (TNCs), the meanings of corporate social

responsibility, the growing importance of TNC social responsibility, recent developments in corporate social responsibility, and outlook and policy implications. A limited number of copies is available free of charge upon request.

Trends in International Investment Agreements: An Overview
UNCTAD Series on issues in international investment agreements

(Sales No. E.99.II.D.23) ($ 12)

In the past two decades, there have been significant changes in national and international policies on foreign direct investment (FDI). These changes have been both cause and effect in the ongoing integration of the world economy and the changing role of FDI in it. They have found expression in national laws and practices and in a variety of instruments, bilateral, regional and multilateral. An international legal framework for FDI has begun to emerge. This paper provides both an overview of the developments in the international legal framework for FDI and an introduction to the collection of *UNCTAD Series on issues in international investment agreements*. It sets the overall context for each of the issues separately examined in the different papers in the *Series*.

Lessons from the MAI
UNCTAD Series on issues in international investment agreements

(Sales No. E.99.II.D.26) ($ 12)

This paper considers the factors that contributed to the decision of the members of the Organisation for Economic Co-operation and Development to discontinue the negotiations on the Multilateral Agreement on Investment (MAI), and draws lessons that could be of use for future negotiations on international investment agreements.

The MAI was only one initiative amongst many bilateral, regional and plurilateral instruments related to foreign direct investment (FDI). The context in which these initiatives are negotiated is increasingly being shaped by the process of economic globalization and the current policies of governments to attract FDI. These factors make international agreements that contribute to a predictable environment for desirable FDI. At the same time, they cast domestic policy matters onto the international level. As a result, the substantive issues involved in international negotiations have become subject to particular scrutiny. Therefore, transparency in the conduct of negotiations and the involvement and input of all stakeholders, including civil society, could facilitate securing the necessary support and legitimacy for the negotiations.

An Investment Guide to Ethiopia: Opportunities and Conditions

Published jointly with the International Chamber of Commerce, in association with PricewaterhouseCoopers

(UNCTAD/ITE/IIT/Misc.19)

This *Investment Guide* is the first in a new series whose ultimate objective is to help the participating countries attract more foreign direct investment, especially of the kind they seek. The countries want more investment and investors want more opportunities – the challenge is to bring the two parties together. One aspect of the task is filling an information gap. The other aspect is assisting the countries in improving their investment climates. This is being addressed through the intimate involvement of the private sector in the process that culminates in the production of the *Guides*. Twenty-eight companies that are household names in many parts of the world are championing this effort. The main value-added of these *Guides* is a serious attempt to maximize credibility. These *Guides* are a third-party product. They offer reliable information – where, in some cases, little or none is available. They take into account private-sector assessments (both foreign and domestic) of the investment climate

in each country. They present the investment conditions of each country in a comparative (e.g. regional) context. Each *Guide* comes accompanied by a more informal publication by the country's investment agency. This companion volume describes specific investment opportunities including (but not only) privatization projects. A limited number of copies is available free of charge upon request. Or please visit: http://www.ipanet.net/ipanet/unctad/investmentguide/ethiopia.htm.

WAIPA Annual Report 1999-2000

(UNCTAD/ITE/IIP/Misc.20)

The 1999-2000 *Annual Report* of the World Association of Investment Promotion Agencies (WAIPA) has been prepared as a background document for the WAIPA V General Assembly Meeting in Bangkok, Thailand. It includes an overview of WAIPA activities, a directory of WAIPA members and a copy of the Association's statutes. A limited number of copies is available free of charge upon request.

Investment Policy Review: Egypt

(Sales No. E.99.II.D.20) ($ 19)

The *UNCTAD Investment Policy Reviews* are intended to familiarize Governments and the international private sector with an individual country's investment environment and policies. The *Reviews* are considered at the UNCTAD Commission on Investment, Technology and Related Financial Issues. *Investment Policy Review* of Egypt was initiated at the request of the General Authority for Investment and the free trade zones and received full support of its President and staff. It is hoped that the analysis and the recommendations of this *Review* will promote awareness of the investment environment, contribute to improved policies and catalyze investment in Egypt.

Investment Policy Review: Uzbekistan

(UNCTAD/ITE/IIP/Misc.13)

The *UNCTAD Investment Policy Reviews* are intended to familiarize Governments and the international private sector with an individual country's investment environment and policies. The *Reviews* are considered at the UNCTAD Commission on Investment, Technology and Related Financial Issues. *Investment Policy Review* of Uzbekistan was undertaken in collaboration with the Organisation for Economic Co-operation and Development and with the support of the United Nations Development Programme. The national counterpart was the Uzbekistan Foreign Investment Agency. It is hoped that the analysis and the recommendations of this *Review* will promote awareness of the investment environment, contribute to improved policies and catalyze increased investment in Uzbekistan.

Books received on foreign direct investment and transnational corporations since August 1999

Cantwell, John, ed., *Foreign Direct Investment and Technological Change*. The Globalization of the World Economy reference collection 8 (Cheltenham and Northampton: Edward Elgar, 1999), two volumes, xxiv+518 and x+489 pages.

Garten, Jeffrey E., ed., *World View: Global Strategies for the New Economy* (Boston: Harvard Business School, 2000), xx+340 pages.

Toyne, Brian and Douglas Nigh, eds., *International Business: Institutions and the Dissemination of Knowledge* (Columbia: University of South Carolina Press, 1999), xvii+276 pages.

Wai-chung Yeung, Henry, ed., *The Globalization of Business Firms from Emerging Economies*. The Globalization of the World Economy reference collection 9 (Cheltenham and Northampton: Edward Elgar, 1999), two volumes, xlvi+591 and xi+554 pages.

GUIDELINES FOR CONTRIBUTORS

I. Manuscript preparation

Authors are requested to submit three (3) copies of their manuscript in English (British spelling), with a signed statement that the text (or parts thereof) has not been published or submitted for publication elsewhere, to:

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Articles should, normally, not exceed 30 double-spaced pages (12,000 words). All articles should have an abstract not exceeding 150 words. Research notes should be between 10 and 15 double-spaced pages. Book reviews should be around 1,500 words, unless they are review essays, in which case they may be the length of an article. Footnotes should be placed at the bottom of the page they refer to. An alphabetical list of references should appear at the end of the manuscript. Appendices, tables and figures should be on separate sheets of paper and placed at the end of the manuscript.

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II. Style guide

A. **Quotations** should be double-spaced. Long quotations should also be indented. A copy of the page(s) of the original source of the quotation, as well as a copy of the cover page of that source, should be provided.

B. **Footnotes** should be numbered consecutively throughout the text with Arabic-numeral superscripts. Footnotes should not be used for citing references; these should be placed in the text. Important substantive comments should be integrated in the text itself rather than placed in footnotes.

C. **Figures** (charts, graphs, illustrations, etc.) should have headers, subheaders, labels and full sources. Footnotes to figures should be preceded by lowercase letters and should appear after the sources. Figures should be numbered consecutively. The position of figures in the text should be indicated as follows:

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E. **Abbreviations** should be avoided whenever possible, except for FDI (foreign direct investment) and TNCs (transnational corporations).

F. **Bibliographical references** in the text should appear as: "John Dunning (1979) reported that ...", or "This finding has been widely supported in the literature (Cantwell, 1991, p. 19)". The author(s) should ensure that there is a strict correspondence between names and years appearing in the text and those appearing in the list of references.

All citations in the list of references should be complete. Names of journals should not be abbreviated. The following are examples for most citations:

Bhagwati, Jagdish (1988). *Protectionism* (Cambridge, MA: MIT Press).

Cantwell, John (1991). "A survey of theories of international production", in Christos N. Pitelis and Roger Sugden, eds., *The Nature of the Transnational Firm* (London: Routledge), pp. 16–63.

Dunning, John H. (1979). "Explaining changing patterns of international production: in defence of the eclectic theory", *Oxford Bulletin of Economics and Statistics*, 41 (November), pp. 269–295.

United Nations Centre on Transnational Corporations (1991). *World Investment Report 1991: The Triad in Foreign Direct Investment.* Sales No. E.91.II.A.12.

All manuscripts accepted for publication will be edited to ensure conformity with United Nations practice.

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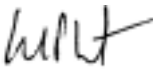

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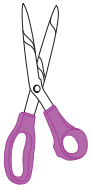

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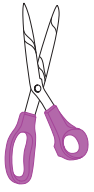

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