BOOK REVIEWS

Christos N. Pitelis and Roger Sugden, eds.
The Nature of the Transnational Firm
(Routledge, London, 1991).

This book reviews modern thinking on select issues of the origin of transnational corporations (TNCs) by prominent researchers in the field of international business. It is divided into nine distinct chapters which bring together different views on the origin of TNCs.

In the first chapter, Christos Pitelis and Roger Sugden introduce the contents of the book and emphasize the internalization of markets as the rationale for the existence of TNCs. The existence of market failures increases transaction costs. This, in turn, encourages firms to internalize those costs within a single corporate structure. In other words, if transaction costs were removed, there would be no rationale for TNCs to exist. Such an approach to TNCs currently holds sway over Hymer's theory (1960), which holds that it is the desire of a firm to exercise market power and reap monopoly advantages that induces it to invest abroad.

In chapter II, John Cantwell provides a valuable survey and critical assessment of theories of international production. It is difficult to find (if not impossible) a general theory that explains all aspects of international production and all actions of firms. Cantwell discusses five main theories of international production:

- The market-power approach holds that the existence of substantial market power at home may diminish incentives to invest at home, since the firm already has a strong market position there. Thus, firms are induced to invest abroad. To become a TNC, however, a firm need not be a monopolist or an oligopolist in the domestic market. In fact, many TNCs are small and medium-sized firms possessing limited market power at home.
- The internalization theory is based on the premise that an intra-firm cooperative relationship in business may be more efficient than an arm's-length transaction between individual firms which involves transaction costs. It is argued, for example, that it is quite costly to trade technology at arm's length. The internalization

theory stresses profit maximization through efficient intra-firm trade in intermediate products. That distinguishes it from the market-power model which is largely based on the exclusion of potential rivals from the market.

- The eclectic paradigm synthesizes parts of the basic theories of the firm and provides an analytical model for practical research. To invest abroad, firms must simultaneously possess ownership-specific advantages, such as superior technology, and opportunities for the internalization of activities. These, combined with location-specific advantages in the host country result in foreign direct investment (FDI) on the part of firms.

- The macroeconomic approaches to international production include the product-cycle model, the investment-development cycle model and the impact of financial influences on FDI. According to the product-cycle model, a rise in incomes in developed countries fosters innovation and leads to the introduction of new goods and technologies. Once these become mature, the production of goods (the product-cycle model does not explicity refer to services) is transferred to developing countries. Such a move can substitute for imports. The experiences of recent years — the growth of integration of affiliates within TNCs and intra-firm trade, and the geographical concentration of FDI in developed countries — have diminished the usefulness of the product cycle model in explaining FDI. The investment-development cycle model is based on the proposition that "...the level of inward and outward direct investment of different countries, and the balance between the two, depend upon their national stage of development" (p. 39). It has been observed that, in recent years, countries are beginning to invest abroad at a much earlier stage of development than before, and the duration of the product cycle itself has been shortened considerably. The strength of a host country's domestic currency may be another motive for FDI. Long-term movements in exchange rates may reflect trends in industrial competitiveness and thus affect the growth of FDI.

- The competitive international industry model considers oligopolistic competition in the same industry as a prime explanation for firms to become TNCs. Competition among firms is preserved,

but it is "stable" rather than intense. Examples of such behaviour may be found in FDI by computer firms from the United States in Europe.

As far as the research agenda for the future is concerned, Cantwell expects that the new theories of transborder business activity may look at the link between innovation and entrepreneurship.

In chapter III, Mohammad Yamin sheds light on a nearly forgotten part of Hymer's seminal contribution to the understanding of TNCs. While Hymer's market-power theory is well known, his other important contribution, the removal-of-conflict theory, has been largely ignored. Conflict theory is an early variant of the internalization theory. Rather than interacting through an imperfect international market which frequently produces tensions, firms decide that those frictions may be eased or eliminated if they operate under a single corporate umbrella. Firms believe that their profits may be augmented if they are owned, controlled and managed from a single centre, instead of interacting at arm's length in a market that is conflict-prone. Firms become TNCs when they remove potential conflicts in their dealings with foreign competitors.

Jean-François Hennart, in chapter IV, discusses the transaction-costs (internalization) explanation of the emergence of TNCs. The hierarchical organization of firms may be preferred over spot markets and contracts in order to eliminate transaction costs. Although the market system may work well in the short run, there are cases in which an alternative form of organization—a hierarchy—may better reward parties and curb bargaining through the creation of a central body that organizes business activities. By converting independent agents into employees, the new form of organization reduces transaction costs and the incentive to cheat. While Hymer conceives TNCs as vehicles for reaping monopoly profits and for the internalization of pecuniary externalities, the internalization model looks at TNCs as a mode of organization of business that reduces transaction costs and internalizes non-pecuniary externalities. When a United States steelmaker invests in a Liberian iron-ore mine, it does not do so because of its superior technology in mining; instead it employs specialist firms to manage the mining activity. In other words, a hierarchical mode of organization incurrs lower operation costs than one operating through markets.

Future considerations of the nature of TNCs should not concentrate only on why markets fail, but also on why firms succeed. Firms employ

hierarchies to increase efficiency, but this may also produce adverse effects on the behaviour of individuals who may reduce their efforts and initiative. Therefore, a mechanism to monitor subordinates, as well as the introduction of incentives may be necessary in a hierarchical management structure.

John Dunning, in chapter V, reflects on his eclectic paradigm of international production explaining the level and pattern of foreign production by firms. One of the flaws of the neo-classical theory can be traced to its view of the firm. The firm is only a production unit, while the market alone defines the structure of international resource allocation. While the internalization model of international production is convincing in some cases, it may not explain the structure and location of all international production, since, in some cases, ownership-specific, income-generating advantages are also necessary for FDI to take place. The eclectic paradigm, encompassing those two distinct aspects within a single model, ought to be seen as a framework for the study of TNCs, rather than as a predictive theory.

In chapter VI, Neil Kay returns to the transaction-costs theory and explores specialization, diversification and joint ventures as optional strategies for a firm. Positive externalities make firms specialize, while various barriers cause their diversification. Obstructions to production and trade are also responsible for the decision of firms to become TNCs. Joint ventures with other firms, a relatively costly organizational form, is the preferred mode of organization of business only when there are barriers which obstruct firms from following a diversification strategy.

The strategic behaviour of TNCs is the subject of chapter VII by Edward Graham. A model of strategic behaviour explains the behaviour of firms in terms of the reactions of their rivals. While small firms may decide on a course of action independently, large firms tend to behave strategically, that is, take into account the likely reaction of their competitors to their own actions. The lack of attention devoted to rivalry in international business is a gap that this chapter attempts to close.

Although Sugden places excessive emphasis on the difference in labour costs as a determinant of transborder business activities of firms in chapter VIII, he raises an interesting point. He refers to the development of the English textile industry during 1750-1850 and draws an analogy with the development of TNCs. Prior to the existence of factories, capital-

ists divided production into tasks that were carried out by workers in their homes. Under the factory system, the same division existed, but work was done in the factory where capitalists could control the production process and increase profits, often at the expense of workers. In order to further increase profits, firms began to transfer their operations abroad, since workers there were more likely to accept lower salaries than those at home. In other words, it was the desire to dominate labour markets ("divide and rule") that led domestic firms to become TNCs. Those firms did not pay much attention to efficiency, but rather focused on the improvement of their bargaining position *vis-à-vis* labour. Many operations of TNCs were internationally mobile, while labour had a significantly lower degree of mobility, which jeopardized its bargaining power.

In the last chapter, Pitelis argues that all previous discussion focuses on the supply side, while the demand side remains unexplored. His contribution aspires to integrate the two sides. Firms may restrict competition by merging with rivals (thus internalizing markets) in order to increase profits, but domestic consumption may suffer if the distribution of income is such that a decreasing share of income goes to labour and consumers in general, while an increasing share goes to profit earners. In order to preserve profits, firms look for external markets that can absorb surplus production and, therefore, invest abroad. In most cases, TNCs have advantages over local rivals in host countries and may restrict competition to the detriment of consumers. The search for additional demand is a powerful incentive for firms to become TNCs.

This interesting and thought-provoking collection of essays provides a state-of-the art review of ideas that seek to explain both the existence of TNCs and the location of their activities. It is presented in a readable way so that students of economics, management and organization, as well as others wishing to keep up with developments in the field can understand the rich and, sometimes, not well understood world of TNCs. One omission is that there is no reference to services; or, perhaps, goods and services are tacitly equated. Taken as a whole, this book will reward readers with a profound and modern look at the nature of transnational firms. ■

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