INTRODUCTION

Transnational corporations (TNCs) are a powerful force for binding national economies together. Through complex corporate strategies and intricate network structures, TNCs engage in international production characterized by a sophisticated intra-firm division of labour for each corporate function. As a result, about one third of the world's private sector productive assets are under the common governance of TNCs, with varying degrees of integration.

The growing influence of TNCs can be seen in the increase in the stock of foreign direct investment (FDI) and the growth in the number of TNCs and their foreign affiliates. Part One of the present report documents those changes. During the 1980s, and especially after 1982, annual FDI flows grew rapidly. By 1992, the global stock of FDI had reached approximately $2 trillion, which generated about $5.5 trillion in sales by foreign affiliates. The pace of growth slowed during 1991 and 1992, but that is probably a temporary phenomenon, largely due to recession in the biggest economies.

The universe of TNCs is large, diverse and expanding: Chapter I provides an overview of its dimensions and characteristics. By the early 1990s, there were 37,000 TNCs in the world, with over 170,000 foreign affiliates. There were 24,000 TNCs based in 14 major home developed economies, up from 7,000 in 1970. Even those figures understate the number of firms that operate as TNCs, both because of measurement difficulties, and because firms carry out their transnational activities and exert control over foreign productive assets through a variety of non-equity arrangements—subcontracting, franchising, licensing, and the like—as well as through the formation of strategic alliances. These forms of international expansion occur with little or no FDI, and are therefore only partially captured by FDI data or by firm-level data defined by equity participation. More than 90 per cent of TNCs are headquartered in the developed countries and less than 1 per cent are from Central and Eastern Europe. Those from developing countries account for approximately 8 per cent of all TNCs and 5 per cent of the global stock of FDI.

The TNC universe is highly concentrated in terms of the share of foreign assets controlled by the largest firms. According to data for selected countries, roughly 1 per cent of parent TNCs own about half the stock of FDI of their home countries. The largest 100 TNCs are estimated to account for one-third of the total world stock of outward investment in 1990.

The continuing growth of FDI is being facilitated by developments in the policy framework. At the multilateral level, examples include the adoption of the Guidelines on the Treatment of Foreign Direct Investment by the World Bank. They propose general standards of fair and equitable treatment, national treatment and most-favoured-nation treatment. Those standards apply, in principle, to all activities of foreign investors, from setting up abroad to the ultimate disposal of an investment. Elsewhere, the United Nations Conference on Environment and Development (UNCED), held in Rio de Janeiro in June 1992, adopted the *Agenda for the 21st Century*. It considers generic management issues and recommends that corporations establish world-wide corporate policies on sustainable development. These include policies to facilitate the transfer of clean technology to developing countries, to go beyond the existing practices and adopt no less stringent standards of operation as in their home country, and to report annually on their environmental records. These developments at the multilateral level, combined with an initiative of the OECD to examine the feasibility of a "wider" investment instrument, suggest that the search for a more comprehensive approach to FDI and the activities of TNCs continues.

At the bilateral and national levels, too, policy developments continued in 1992. The number of bilateral investment treaties concluded by OECD countries reached 506 at the end of 1992, with a marked growth in the participation of Latin American countries and the newly independent states in Central and Eastern Europe. Nationally, all 79 new legislative measures adopted in 1992 in 43 countries were intended to liberalize the rules on FDI; in 1991, 80 of 82 measures were more liberal (as reported in the *World Investment Report 1992: Transnational Corporations as Engines of Growth*). Other significant policy changes included legislative actions to increase intellectual property protection and to provide the legal conditions for the participation of TNCs in the privatization of state industries, a major source of FDI growth.

Foreign direct investment in the 1980s was increasingly concentrated within the Triad (the European Community, Japan and the United States), as described in the *World Investment Report 1991: The Triad in Foreign Direct Investment*. In the early 1990s, however, FDI flows to developed countries declined, while those to developing countries increased, especially in Asia and Latin America and the Caribbean, in response to rapid economic growth and fewer restrictions.

Chapter II looks at the regional distribution of FDI. The decline of FDI inflows to developed countries can be attributed, in part, to slow growth and recession in the European Community, Japan and North America. The attractiveness of these economies as hosts was further reduced since domestic profitability also declined. In addition, recession has reduced the ability and willingness of TNCs from these economies to expand abroad. Japan in particular saw its FDI outflows decline substantially as domestic financial weaknesses on top of declining profitability hampered the ability of Japanese TNCs to invest abroad.

At the same time, FDI to developing countries expanded as a result of the resurgence of strong economic performance in a wide spectrum of developing countries in Asia and Latin America, renewed opportunities from the exploitation of natural resources in Africa and countries' continuing efforts to liberalize and privatize. The growth of TNC activities in Latin America and Asia has been further stimulated by progress towards a North American Free Trade Agreement and, in Asia, by various governmental initiatives to promote trade and FDI. The general trend towards liberalization and privatization has also been evident in Central and Eastern Europe where inflows continue to grow.

The rapid increase in FDI throughout the world has been accompanied by a pronounced change in its sectoral composition, from the primary sector and resource-based manufacturing towards services and technology-intensive manufacturing. Those trends are elaborated in detail in chapter III. Undoubtedly, the growth of services FDI reflects structural changes in domestic economic activity and advances in information technology. However, its initial growth was constrained by restrictive practices introduced for strategic, political or cultural reasons. Consequently, the recent wave of liberalization has had a particularly marked effect on services FDI, which is likely to continue during the coming decade. Significant capital-intensive service industries (such as telecommunications and air transportation) have only recently opened up to FDI, providing new opportunities for TNCs.

The stock of FDI in the primary sector is now dwarfed by that in other sectors. However, it still grew quite impressively during the 1980s. Indeed, in developed market economies, its inward stock grew faster than in any other sector and faster than the stock of primary sector inward FDI to developing countries. This unexpected development was brought about by the combined effect of intense merger activity, notably in petroleum, and the search for safer investment locations. However, as more developing countries introduce open and stable FDI regimes, there are signs that locational decisions in the primary sector are again emphasizing natural advantages. But the continuing uncertainty in some resource-rich in economies in transition, particularly the Russian Federation and southern Africa, will affect future flows of FDI in this sector.

The stock of FDI in the secondary sector has declined, relative to services, although in developing countries in 1990 its stock was still considerably larger than that in other sectors. The significant changes in manufacturing have been more qualitative in their nature. In particular, there has been a shift from labour-intensive manufacturing towards more capital-intensive industries, both across and within countries. During the 1980s, this was most pronounced in the inward stock of FDI in the newly industrializing economies. Furthermore, increasing technological demands in much of manufacturing are leading to new forms of corporate activity. Non- and low-equity FDI have become established means to control assets abroad, and strategic alliances have expanded, particularly in those industries with short product cycles and high research-and-development costs.

In addition to discussing the regional and sectoral aspects of the growth of FDI, Part One of the present report also analyses patterns in the long-term growth of global FDI. The decline in world-wide FDI flows in 1991 and 1992 has marked the end of a period of constantly and rapidly rising flows that began in 1982. This slow-down raises the question, examined in chapter IV, of the extent to which the surge in FDI flows in the 1980s was the result of short-term factors—the strong growth of the world economy and the boom in mergers and acquisitions activity—or whether the influence of long-term factors is also changing the underlying trend.

The pattern of FDI flows in the second half of the 1980s was the result of an inter-play between short and long-term factors. Similar to domestic investment, FDI flows are strongly correlated with the growth of gross national product. The strong growth of the world economy in the 1980s boosted the growth of FDI flows from the major home countries. The mergers-and-acquisitions boom also promoted the surge in FDI. The impact of those short-term factors amplified the effect of long-term factors—policy-related developments and changes in the structure of the world economy as a result of the operations of TNCs. Policy-related developments included the liberalization of trade and investment regimes, especially in the developing countries; the spread of privatization allowing TNCs to enter previously closed industries; changes in the exchange rate between the dollar and the yen, prompting a wave of Japanese FDI; and regional integration schemes, notably the European Community, that induced considerable intra- and interregional investments. Structural factors—the size of international production and its increasingly integrated nature—also influenced the underlying trend.

These long-term factors suggest that the scope for rapid growth of FDI flows remains substantial, over and above the stimulus to those flows from a recovery in the world economy. Imbalances across countries and regions—for example, the low level of FDI flows to Japan—also indicate that there is plenty of room for further growth. The report therefore projects that FDI flows will continue to grow, although cyclical factors will result in short-term fluctuations during the 1990s.

Such projections do not fully reflect the role of TNCs in influencing world development. As discussed in the *World Investment Report 1992*, TNCs have an impact because they embody a package of potentially growth-enhancing attributes, including technology, managerial and organizational know-how, and access to international markets. These are becoming increasingly potent features of the growing integration of the world economy.

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The ability of TNCs to contribute to international economic integration is a result both of their inherent attributes and of how they respond to the economic and policy environment in which they operate. Their strategies and structures are described in Part Two, which analyses the emergence of integrated international production by TNCs. Chapter V examines the evolution of strategies of TNCs, as firms respond to various pressures and opportunities, including improvements in information technologies, the convergence of demand patterns across countries, the intensification of competition and the opening of markets to international trade and FDI. The new strategies imply significant changes in how production is organized across borders; they have led firms to locate a wider range of their value-adding activities abroad.

The strategies of TNCs increasingly involve more complex forms of cross-border integration. Under the simplest strategies—stand-alone affiliates or multi-domestic affiliates engaged in international production while serving a single host economy or host region—affiliates have a high degree of autonomy from the parent firm. They are responsible for most of the activities that comprise their value chain, and in some instances can act as self-contained entities.

As trade barriers fall, as communications technologies improve, and as international competition intensifies, firms are turning to outsourcing for parts of their value-adding operations. They are strengthening the links with their foreign affiliates and with independent firms operating as subcontractors, licensees etc. However, these links are only for specific activities. Outsourcing is based largely upon the cost advantages of a particular host country for a particular component. The affiliate or subcontractor engaged in outsourcing cannot stand alone. It depends upon the parent firm for a number of key activities, while the parent firm depends on the affiliate for part of its overall value chain.

More recently, many TNCs have moved beyond these "simple integration" strategies. They are now treating all activities across the entire value chain as potential candidates for being performed by one or more affiliates. This new approach—"complex integration"—is made possible by huge improvements in communication and information technologies, which allow TNCs to coordinate a growing number of activities in a widening array of locations. This, in turn, changes the way in which TNCs structure their activities. In a number of instances, indeed, information technology is leading to a "re-engineering" of relationships within firms.

Complex integration is also being driven by the tendency for markets to converge. More products are sold in the same or similar form in a growing number of national markets. In addition, competition forces firms to seek cost savings and profits from all segments of their value chains. As a result, companies are arranging certain functions—research and development, procurement, accounting, data entry and processing, as well as activities for specific products or product lines, such as component manufacturing and assembly—in a way that requires close links between parent firms and foreign affiliates, among foreign affiliates themselves and between parents and affiliates and firms linked via alliances. With that type of integration, separate activities performed in international locations are valued according to how they contribute to the objectives of the firm as a whole, rather than their profitability at the host country location.

Integration is also occurring across geographical lines. Multidomestic strategies are being superseded by regional and global strategies. The institution or strengthening of regional integration agreements has helped foster regional strategies of TNCs, an issue analysed in last year's report. Some TNCs are beginning to pursue global strategies that include several major regions and cover the allocation of many elements in their value chains. Thus, activities such as research and development or procurement may be situated in an affiliate in a host country or region and linked to operations elsewhere to produce goods and services that are then sold in many markets.

Integration is proceeding at different rates across industries and functions. The cross-national division of labour has undoubtedly proceeded most rapidly in certain manufacturing industries, such as automobiles and electronics, and in services industries, such as air transport. Research and development, spurred by advances in information technologies, are increasingly spanning natural borders, both within firms and between firms through strategic alliances. But a truly global research-and-development and manufacturing system is still restricted to a relatively small number of firms. Financial management is probably the most global of the major corporate functions, stimulated by electronic transfers and the 24-hour trading day. Marketing has also taken advantage of communications technologies, but is still subject to national, regional and cultural differences in consumer tastes and habits. Such activities as data processing and software-writing can take place almost anywhere in the world. On the other hand, regulatory differences mean that accounting and legal reporting are still largely nationally based. In principle, however, virtually every corporate function can be located anywhere and carried out in an integrated manner for a corporate system as a whole. To the extent that this is the most cost-effective way of organizing production—as it seems to be—it becomes a benchmark for firms that have not yet seized this opportunity or have not yet been driven by competitive pressures to re-engineer themselves.

The strategies adopted by TNCs go together with changes in organizational structures, an issue examined in chapter VI. In particular, complex strategies have led to more complex mechanisms for organizing international production. Within firms, the decentralization of functional activities has led to a greater use of regional headquarters to manage regional activities, product headquarters located in host economies to manage the regional or global organization of particular products, and functional headquarters in host economies to manage firm-wide activities for a specific function. The dispersion of activities along the value chain leads to a dispersion of responsibility for those functions.

In addition, the growth of strategic alliances has led to cross-firm linkages geared to specific activities frequently limited to well-defined periods of time. Strategic alliances usually involve shared functional responsibility and can blur the boundaries of the firm. The multiplicity of intra- and interfirm linkages, combining horizontal and vertical lines of authority and resource flows between units and across countries, can best be described in terms of networks. The growth of such networks is a major source of the deepening of economic linkages between countries.

Although the nature of integration by TNCs has tended to become more complex, many firms continue to maintain older and simpler ways of organizing their international production. This is partly because the conditions leading towards complex integration are still evolving, and also because many of the simpler organizational forms remain useful. In addition, many firms will be unable or unwilling to adapt to changing conditions, but will continue to survive for some time.

Complex strategies, pursued with greater functional integration both within and across firms and over a wide geographical area, combined with network structures of organizing activities, describe integrated international production *at the level of the firm*. The aggregation of the activities of those TNCs that are involved in such production creates a system of integrated international production *at the level of countries*. For Japan and the United States, between a quarter and a third of private-sector productive assets are potentially under the common governance of TNCs pursuing integrated international production. For the world as a whole, this percentage may be one-third. Chapter VII considers the characteristics of this form of economic integration and its impact on developing countries.

Integration can occur at different levels. Economic growth, the reduction in tariff barriers during the post-war period and the recent spread of regional integration agreements have stimulated the exchange of goods and services among countries. This "shallow" form of integration opens many areas of an economy to the influence of international economic developments. The conditions that stimulate shallow integration also encourage TNCs to establish cross-border production systems that lead to "deep" integration, which is integration at the level of the production of goods and services as a result of complex corporate strategies and network structures.

Economic integration is an evolutionary process. Links between countries move from a relatively shallow type, to somewhat deeper (but still limited) integration through international production by TNCs pursuing multi-domestic or simple integration strategies, to links that are deeper, richer and more complex. These last describe integrated international production.

The power of TNCs in stimulating deep integration stems from their role as central organizers of a broad range of economic activities. They are helped in this by the liberalization by many host countries of regulations on foreign control of assets. In addition, the proliferation of regional integration agreements—most prominently the Single Market within the European Community—stimulates deep integration, as they increasingly contain provisions liberalizing *both* trade and FDI. Thus, these agreements, described frequently as free-trade agreement, are *also* "free-production agreements" among national economies. As a result, the division of labour across countries increases, and trade and technology flows, especially intra-firm, but also interfirm, expand.

Just how many countries will be affected by this new system remains unclear. Foreign direct investment has tended to be concentrated among the industrialized economies, particularly the Triad, with a clustering of developing countries and economies in transition around each Triad member. To some extent, this is because FDI follows trade, which is itself regionally concentrated. However, trade is more concentrated than FDI within regions. This suggests that trade may have played a prominent role in intraregional integration, whereas FDI has a greater capacity for promoting global integration. The emergence of integrated international production, which is likely to be more widely dispersed, should further strengthen the potential of FDI as a force for global integration. If that happens, trade may also begin to show more cross-regional patterns, given the linkages between FDI and trade.

The extent to which individual countries become part of, and benefit from, the emerging integrated international production system depends upon the interaction of their location-specific advantages with the changing firm-specific advantages that TNCs enjoy in the context of integrating their functional activities on a regional or global basis. The emergence of complex integration strategies and structures implies changes in the nature of the ownership, internalization and locational advantages of TNCs. In particular, ownership advantages are becoming system-wide in nature and are exploited through either intra-firm or interfirm mechanisms. The result is a broader range of opportunities for host countries to attract TNC activities, but also higher requirements in terms of human resources and infrastructure, as well as open frameworks for trade and investment. Given the differentiation that prevails as regards attributes of developing host countries, the types of investments they can attract are likely to differ; it should also be recognized that the emerging international production system may leave many developing countries largely untouched for the time being.

For those countries that do become part of the system, participation in the international division of labour is increasingly determined and coordinated by TNCs and their affiliates. The possibility to attract specific corporate functions may allow a host country to realize its own comparative advantages better. However, to reap the full benefits, developing countries must build up their indigenous human resources through education and training and their physical and technical infrastructure through investment.

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All these changes raise a wide range of policy issues, some of which are examined in Part Three. It deals with corporate nationality, parent-affiliate relations and responsibilities, the international allocation of the taxable income of TNCs and policy options for host countries to maximize the benefits from integrated production. As regards the first three of these issues in particular, the more sophisticated forms of division of labour between foreign affiliates and their parent firms and among foreign affiliates located in a number of countries, a certain decline of economic autonomy of the constituent parts of integrated TNC systems and a certain dispersion of authority throughout those systems are beginning to strain some traditional concepts and approaches.

Chapter VIII looks at the meaning and relevance of the concept of the nationality of corporations. The established approach in national and international law attributes nationality to corporations in accordance with certain criteria. This is done to ascertain what laws are applicable to corporations or to determine the Government that may exercise diplomatic protection on their behalf. Under conditions of integrated international production, this approach is becoming more difficult to apply and also less meaningful. Increasingly elaborate interpretations are needed to keep legal and policy prescriptions in touch with business realities. The growing use of the national treatment standard and of the broad provisions of investment-protection treaties may, in the long run, decrease the practical value of corporate nationality as a legal concept. Yet, informal understandings to clarify the issues and outline principles and procedures for avoiding or resolving conflicts could help to deal with emerging problems.

A second area where integrated international production affects the status and operations of TNCs concerns the relations between parent firms and their foreign affiliates. The traditional legal view is that each affiliate within a larger corporate group is a separate entity with its own rights and responsibilities. In reality, however, the concept of separate corporate personality does not accurately reflect the functional ties between affiliates as a business group, and can hinder the attribution of responsibility among them. In the case of a TNC, the fact that individual affiliates have their assets and operations in several countries poses further jurisdictional and procedural problems that do not confront a domestic company.

Integrated international production compounds those problems. As foreign affiliates become integrated parts of regional and global corporate systems, they may lose autonomy over both managerial and operational aspects. In such an environment, the concept of "parental responsibility" may need to be re-evaluated. A preliminary issue for legal and policy analysis, discussed in chapter IX, is how much responsibility should be shouldered by the parent.

Integrated international production can produce a network structure in which the concept of the parent firm itself takes on a different, more limited meaning. The parent may become more of a coordinating agent for certain corporate activities, which have been dispersed to regional, product-line or functional headquarters or to individual affiliates. The right thing to do may therefore be to focus on relations and responsibilities among all members within a corporate group, rather than on the parent firm or affiliate responsibility; perhaps the concept of "group responsibility" deserves further exploration.

The increasingly complex nature of corporate activities has already resulted in the adoption of group concepts in various areas of law. The practice differs from jurisdiction to jurisdiction, depending on the specific concerns to be tackled. This risks increasing the number of conflicting requirements being imposed on TNCs by States. It would be useful if those countries already experimenting with specific aspects of group concepts were to cooperate whenever some legal uniformity is possible.

Public opinion seems to be relevant to the issue of corporate responsibility. In the public's perception, the business of a parent company and that of its affiliates are typically one and the same. Also, TNCs do recognize that their reputations rest on the behaviour of affiliates as well as parents. Although parent companies have refused to accept legal responsibility for the actions of their affiliates, they have nevertheless been actively involved in out-of-court settlements of law suits brought against their affiliates, especially when environmental catastrophes are involved. Thus, while the law still wrestles with how to allocate responsibility between the TNC parent and its affiliates, solutions may be shaped by public opinion.

The deepening of TNC linkages also raises questions about where groups of associated enterprises earn taxable income, how it is distributed, and how the revenue from taxing their income is ultimately allocated among countries. These questions are discussed in chapter X.

The prevailing conventional approach to the allocation of business income for tax purposes has been to treat the parent firm and its foreign affiliates as separate and independent enterprises, and to apply the arm's-length standard for determining the allocation of taxable income from transactions involving related or unrelated parties. Given the widespread use of various intra-firm arrangements under conditions that differ from those prevailing between independent parties, a number of tests have been developed over the years aimed at determining whether related-party transactions conform with arm's length standards for tax purposes. However, with the growing complexity of the intra-firm division of labour, it is harder to identify separate costs and earnings for individual transactions and to compare them with unrelated-party transactions.

Those difficulties have led authorities to explore other approaches and methods for allocating income. Overall, the general norm appears to be to use the separate enterprise approach when comparable prices exist, and to use an apportionment approach that takes the TNC system as a whole when they do not exist. Finding satisfactory solutions matters as much to Governments as to TNCs. Governments need to prevent an erosion of their revenue base while, at the same time, providing a climate that attracts and retains FDI.

Apart from the legal and policy issues addressed in chapters VIII to X, integrated international production has also implications for the national policy framework concerning TNCs. The rapid growth of FDI during the 1980s has made Governments more aware of the benefits that FDI can bring to an economy in terms of capital, technology, management and access to established distribution networks. In the resulting competition to attract TNCs, FDI regimes in many countries have become broadly similar. In particular, differences regarding right of establishment, fair and equitable treatment, national treatment, nationalisation, compensation, dispute settlement and the repatriation of earnings become less effective as a means to capture FDI. Instead, the nature of the overall policy framework and the economic conditions of production become the key to locational decisions. Possibilities for pro-active policies in this respect are the focus of chapter XI.

There is general agreement that efficient economic institutions and a stable macroeconomic climate are preconditions for attracting FDI. Beyond that, Governments must provide efficient infrastructure and facilitate international trade exports to allow firms to bind into the international production system. However, since integrated international production involves more sophisticated corporate strategies and structures, government policies need to become more sophisticated too. In particular, since every part of the value chain can potentially be located anywhere in the world, Governments need to focus their promotional strategies on attracting those functions in which their countries have a comparative advantage. Furthermore, Governments could give more attention to reducing transactions costs for potential investors, providing post-approval support services and attracting specific TNCs of particular value to the national economy.

Last year's report suggested that policy discussions—nationally, regionally and multilaterally—might benefit from greater attention to FDI issues. As host countries, especially developing countries, seek to boost their competitive position in a world economy that is becoming integrated at the production level, their ability to dovetail their domestic economies to the strategies and structures of TNCs becomes increasingly critical. At the international level, the need to avoid "policy competition" among host countries, as each seeks to attract TNC activities, expands the range of policy issues on the international agenda and may lead to a greater concern for policy harmonization.