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The new framework of international production: prospects for the developing countries[1]

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1. Plan

This paper will start by highlighting the background under which international production has developed during the last few decades (section two). Section three will analyse the new framework of international production which is the result of various changes which have taken and are taking place at both macro and micro levels. Section four will consider the lessons and effects of this new framework. The related prospects for developing countries will be considered in section five. Section six will attempt some suggestions on policies and strategies for the developing countries. The last section will be on conclusions.

2. Background

International production has grown to a very considerable extent since the second World War in both developed and developing countries (LDCs). The necessary conditions for such growth must be seen in the following favourable elements: (a) development in the technology of transportation; (b) developments in the technology of personal communication and data transmission; (c) developments in the organizational structure of large companies and institutions; (d) changes in the international political environment with increase in cooperation and integration. On this last element there has been an interaction between the international political environment and the activities of transnational companies (TNCs) with cause and effect going both ways. In a market environment characterized by rivalry and struggles over market shares, these necessary condition provide also a trigger towards investment decision abroad. Once the technological and organisational know-how are fully known and available, companies are forced to take them up and invest by the nature of the competitive environment in which they operate. In order to increase/substain their market shares they will either try to take up investment opportunities before their rivals or they will follow their rivals' lead. Thus the existence of these necessary favourable conditions for foreign investment meant that companies were led to invest in order to improve their competitive position vis-á-vis rivals, or in order to follow initial moves from other firms in games of moves and counter-moves of defense and attack(2). These necessary conditions are not, however, the only trigger. The motives for international production and foreign direct investment (FDI) at the micro level are many and form the basis of a large and growing literature.

The role of international production in developed and developing countries has traditionally been seen in the context of the following:

(i) The distinction between resources-based FDI and demand-based FDI. The first type of FDI was seen as motivated by the need/desire to secure advantages through the ownership and control of sources of raw materials. The second type of FDI was seen as motivated by the need/desire to secure markets. The first type was seen as directed towards developing countries and the second type as directed towards developed countries.

(ii) An ideology of distrust and even hostility towards inward activities of TNCs which affected both developed and developing countries but was stronger in the last ones.

On both (i) and (ii) we have seen very considerable changes in the last fifteen-twenty years[3]. In order to analyse the context of these changes, as well as their motivation, effects and policy implications, we must review briefly the major developments that have taken place in international production and its environment in the last few decades.

3. The new framework

The new framework of international business activities is the results of many changes related to the type of activity, the geographical and/or industry structure or the type of involvement by companies. In dealing with such changes it may be useful to distinguish between trends related to the macro sphere and those related to the sphere of companies and industries[4].

However before considering these trends I would like to mention some ideological elements which may have affected the attitude towards TNCs' activities. As already mentioned the last fifteen years have seen a more positive attitude towards TNCs, worldwide. This is the result of various elements and in particular: (1) A stronger awareness on the part of TNCs themselves of cultural differences and of the need to adapt to them and generally to be more sensitive than in the past. (2) Stronger awareness of global environmental issues on the part of large TNCs. The UNCTC (1992 ch.III) notes how a combination of awareness in terms of environmental needs, and fear of external intervention had led to self-regulation by many companies. (3) A more cooperative political environment at the international level particularly within the developed countries. (4) The recent recession which has made welcome investments previously considered to be crowding-out local initiatives. (5) Last, but not necessarily least, the advent and spread of the internalization/transaction cost theory of the growth of the firm and internationalization. This theory emphasises the efficiency elements in the growth of the firm due to savings in the transaction costs deriving from market transaction. Its original formulation in Coase (1937) followed by Williamson' developments (1981) was in relation to the existence and growth of the firm; it has later been extended to cover the emergence and growth of TNCs by Buckley and Casson (1976). The theory has strong welfare implications, as large firms and TNCs are seen as efficiency driven institutions developing in response to the need to curtail costs due to market transactions. One of the consequences of the wide acceptance of this theory[5] has been a strong contribution to a positive attitude towards the activities of TNCs. This is likely to have affected the attitude of the academic community towards TNCs' activities, and, indirectly, the attitude of policy makers at government and institutional level.

3i. The main macro trends can be thus be summarized:

a) A steady relative shift in the shares of Foreign Direct Investment going to developed and developing countries. The percentage stock of inward FDI into developing countries has moved from over sixty per cent before the second World War to twenty five per cent in the 1980s. These trends are, partly, related to the shift from resources-based FDI to manufacturing FDI.

b) The emergence of trading and investment blocs centred particularly around the Triad of USA, Japan and European Community. Each bloc has developed a cluster of developing countries linked to it. The Triad is responsible for over eighty per cent of outward FDI and for an increasing percentage of inward FDI.

c) Changes in the size, pattern and geographical structure of international trade, particularly relevant has been the increase in intra-firm trade.

d) The political changes in the former socialist countries have brought in new possibilities for international business both in relation to trade and to location of production[6].

e) The start and growth of de-regulation movements which originated in some developed countries (particularly the UK) and snow-balled into other developed countries as well as into the developing ones. This had effects on the size and structure of FDI.

f) Increase in the number of TNCs from developing countries.

g) Increase in the stock of FDI in services. Services FDI is not displacing manufacturing FDI though it is growing at a faster rate. Particularly high has been the growth rate in finance-related and trade-related services.

3ii. The main <u>micro trends</u> can thus be summarized:

h) Foreign investments through mergers and acquisition have increased considerably and at a faster rate than greenfield investments.

i) Increase in the number of smaller companies investing abroad. The smaller TNCs now account for about half the universe of TNCs in most home countries.

j) Companies have developed new ways of foreign involvement and in particular are increasingly engaged in collaborative agreements with firms in other countries. Joint ventures between large and medium-size companies as well as subcontracting between large and smaller firms have increased.

k) Large companies throughout the world have increased their foreign production and they have being doing it by spreading production into a larger and larger number of countries[7].

l) The advent and adoption of flexible production systems - aided by new information and design technology - means that efficient production can be achieved with lower scale. This makes it viable to have a wider geographical spread of production; it also allows companies to cater for diversified and changing tastes and thus allows the flexibility of adapting to different markets, different inputs and costs conditions as well as different cultural conditions.

4. Lessons from the new framework

The new framework is creating an environment of much stronger internationalization and much stronger integration in a wide sense. The stronger internationalization derives from the increase and wider spread of TNCs activities as well as from the international cooperation at the level of governments (particularly in developed countries) and from the changed situation in the relationship between western countries and former socialist ones.

The stronger integration manifests at many levels and in particular the following ones. The growth of services production raises the issue of links between services and manufacturing. While many services are - to a large extent - indirectly linked to the level of activity in manufacturing (such as financial and trade-related services) others are very closely and directly linked to manufacturing. In this last category we can include products such as software production or manufacturing design. Information technology is, in many cases, providing the integration link between manufacturing and services. Reich (1991b ch.7) highlights the linkages between the categories of "manufacturing" and "services" in this passage (p. 85):

"The distinction that used to be drawn between "goods" and "services" is meaningless, because so much of the value provided by the successful enterprise - in fact, the only value that cannot easily be replicated worldwide - entails services: the specialized research, engineering, and design services necessary to solve problems; the specialized sales, marketing, and consulting services necessary to identify problems; and the specialized strategic, financial, and management services for brokering the first two. Every high-value enterprise is in the business of providing such services".

Similarly the development of manufactured materials is blurring the distinction between "raw" materials/resources and manufacturing; it is also creating a new situation in the relationship between developed and developing countries as "raw" materials are substituted with manufactured materials such as plastic for wooden or metal products. This has led to a lower dependence for developed countries on the developing countries which where, traditionally, the suppliers of raw materials(8). This fact is partly reponsible for the decline in the share of outward FDI in the primary sector - as well as for the decline in the share of FDI going to developing countries. Some integration is taking place between private enterprises as collaborative agreements link large companies between themselves and/or with smaller companies. Reich (1991b ch. 7) sees the "New Web of Enterprises", which stems from financial arrangements of large enterprises as well as from subcontracting, as linked to the development of high-value business requiring new skills that generate the high values. The high-value business concentrates only on the high skills activities and "outsources" everything else; from the renting of space for offices and warehouses to the high-volume activities requiring "standard" inputs. Thus the "New Web" emerges. Reich seem to imply that the structure of the "New Web" and thus the dichotomy between which activities (and how much of them) are internalized and which are "externalized", depends largely on the technological requirements of the new type of production, the related skills and their organization as well as the new requirement for customized products. The dichotomy internalization/externalization was explored in Ietto-Gillies (1992 ch. 14) and it was linked mainly to the development of strategies towards labour on the part of large corporations(9). In some cases the desire to circumvent barriers to trade and to access markets have led to substitute direct production for exports. The exercise has thus changed the situation from one of possible strong barrier and obstacles across nations to one of stronger integration. Similarly the desire to benefit from different cost conditions - particularly labour costs - in various countries has led TNCs to develop productive processes that allow location in different countries of components requiring different inputs and skills(10). The market ideology of the eighties has also created stronger links between private enterprises and the public sector. One way or another the strongest force for integration across national boundaries have been and are the transnational corporation. This TNCs-led integration interacts with the policy-led integration initiated and implemented by national governments.

It has been argued elsewhere that the existence of norms, rules, legal requirements at the national or regional level, may lead TNCs to develop strategies for circumventing the rules or taking maximum advantage of differences in norms or legal requirements between nations. Aliber (1970) argued for explanations of FDI on "customs" and "exchange" areas. I have argued that areas of trade union organization can similarly help to explain the growth and pattern of TNCs' activities[(11)]. TNCs may find it profitable to spread production in many countries and in particular to locate in areas with different regulatory labour regimes, as this allows them to face an overall more fragmented labour force and organization.

5. Prospects for the developing countries

The stronger integrative forces are developing alongside tensions and conflicts some of which are new and directly linked to the new pattern of integration. Many of these tensions and conflicts have a direct bearing on the developing countries. As developed market economies compete - successfully - for larger and larger shares of TNCs activities, the developing countries are, in relative terms, the losers. The establishment of areas of economic integration (such as the EC) and the development of the Triad adds to the problems, particularly for those countries who are not "regional insiders" in each leg of the Triad[(12)]. Given the fluid political situation, it is still difficult to make predictions on the business prospects in former socialist countries. Nevertheless there is here an actual and potential source of competition with developing countries in terms of location of international production.

The 1990s decade has started with signs of change in the attitude towards the management of economic systems, particularly in the USA. Words such as manufacturing base, industrial policy, technology, skills development, seem to play a much stronger part in the discourse on explanations of economic trends as well as in the discourse on economic policy. Industrial policy has just started featuring on the agenda of the UK Government. Particularly relevant is the move in the USA towards stronger emphasis on productivity, skills upgrading, education. These policies play a prominent part in the writings of two influential American economists/strategists Michael Porter (1990) and Robert Reich (1991b). Their argument - used in different contexts - seems to be that, in order to achieve sustainable growth, the US economy as well as other flagging western economies (such as the UK one) need to concentrate on strategies that lead to investment in new technologies, increased productivity, upgrading of skills and avoidance of low-skills, low-wages activities. These new ideas are, of course, welcome, after the 1980s low profile on economic prospects and policies. However we must recognise that they have implications for the relationship between developed and developing countries and the role of TNCs in them. If the developed countries are to concentrate on skills upgrading and technology-oriented investment, the by-product of this is that the developing countries will carry on - together with and/or in competition with the former socialist countries - the bulk of low-skills production. Reich (1991, p. 247), whose work is conceived from the prospective of the American economy, writes on this point:

> *In principles, all of America's routine production workers could become symbolic analysts and let their old jobs drift overseas to developing nations, ... In practice, of course, the task of transforming a majority of the American workforce into symbolic analysts would be daunting".*

For the developing countries there may be short/medium term positive results from this situation: as the developed economies move out of the recession, the developing ones will, at least, pick up some low-skills activities. However in the longer term there is a danger of perpetuating the underdevelopment situation and culture. The years before the second World War saw a distinction in FDI based on resources versus market. This distinction no longer holds as production processes are planned and implemented across countries and as raw materials supplies have lost relative importance in production and thus in the FDI motivation. The new framework and developments are bringing a distinction between skills-based FDI versus unskilled-based FDI. The FDI dichotomy between resources and manufacturing, is being replaced by the dichotomy skilled/unskilled labour processes. The integration across developed and developing countries may be stronger but it is taking place along the "skills" lines. Thus the emerging prospects may spell dangers for the developing countries. As the internationalization process advances and the mobility of capital increases, the destiny of nations is more and more linked to the skills and competencies of their workforce. Thus strategies that force developing countries into a low-skills role for their workforce is bound to detract from their prospects for development. Besides, technological developments are leading to the creation of a relative smaller number of unskilled jobs.

There are, however, also opportunities. Among the opportunities we could list the following. If - as Reich maintains - the developed countries will continue to specialize in high-value, high-skills production and progressively relocate the high-volume, routine production to developing countries, this may lead to considerable investment opportunities in developing countries. High-volume production does indeed require large capital investment. A second opportunity may be linked to the fact that TNCs may want to spread production into areas regulated by different labour organizations. As developed countries integrate more and their labour becomes involved into the integration programme (eg. EC Social Chapter or call for uniformity of wages and work conditions in East and West Germany) companies may look outside the areas of integration for the location of some of their activities. Both developing countries and some countries of the former socialist bloc may become attractive alternative locations. A possible further opportunity is put forward by Julius (1993). In an analysis of broad scenarios for the world foreign investment prospects she sees the foreign direct investment of the eighties as driven, to a large extent, by the de-regulation policies. She writes (p.19):

> *In the 1980s the fastest growing sectors and recipient countries were those where the policy environment has been liberalised and where economic growth was strong. Where is policy liberalisation likely to proceed furthest and growth be highest in the 1990s? Prediction is risky, but one plausible scenario is that it will be in the developing countries. That is where privatisation and deregulation are moving fastest right now. In Chile, Mexico*

and other Latin American countries; in Poland, Hungary and elsewhere in East Europe; in Europe; in India; in China; even in Ghana and Namibia the swift toward economic liberatisation is gathering force. The market-oriented path to develop inevitably includes a greater role for the private sector and more open policies towards trade and foreign investment.

However, we must remember that considerable amount of foreign direct investment driven by de-regulation leads to acquisition of existing assets rather than to greenfield investment. Thus, unless considerable improvements are achieved in terms of efficiency and prospects for future greenfield investment (by foreign and/or domestic companies), the investment driven by de-regulation in itself is not likely to improve the prospects for development.

6. Possible strategies and policies

From the previous section it should be clear that the next decade will spell dangers and also bring opportunities for the developing countries. Are there overall strategies which we could recommend in order to take advantage of opportunities and minimize the dangers?

The first thing to remark is that overall strategies for development on the part of single developing countries or cluster of them as well as on the part of international agencies dealing with development, are needed. Given the global strategies of TNCs, appropriate parallel or countervailing strategies by developing countries must take account of the international environment and thus involve - where feasible and appropriate - multilateral partnerships and agreements.

Another general point to stress is the need to create stable economic environment, one in which uncertainty is reduced as much as possible. While a considerable amount of uncertainty is exogenous and uncontrollable, the last two decades have seen a considerable amount of uncertainty generated by policies in both developed and developing countries. Change in policies have now become so frequent that it is often difficult to know what the initial aims where and whether the large number of U turns have led the system to its initial course or away from it. I am told that farmers no longer consider the weather as the main source of uncertainty and unpredictability: change of government policies has become their most unpredictable variable. Investments are essential for development and growth; given the medium- to long-term horizon for investments the uncertainty generated by frequent change of policies in both developed and developing countries is bound to lead to lower take up rate of investment opportunities.

The developing countries may need to continue on the path towards a cooperative - albeit controlled-framework for the activities of TNCs. Inward foreign investment may help towards development but it is are no substitute for domestic investment. Thus a strategy of integration between domestic and foreign investment is essential. Specific industries and geographical areas could be targeted for inward investment with priority given to those most likely to lead to further investment (domestic and foreign). The acceptance of low-skills production may be inevitable in the beginning; however this should be accompanied by a strategy leading to the gradual, continous upgrading of the physical and human infrastructure. One possible scenario would be for governments in developing countries to commit direct and indirect revenue from the inward activities of TNCs to: (a) upgrading of skills and education; (b) improving the physical infrastucture. In the upgrading of skills, partnership systems could be developed between foreign TNCs and governments, by which both sides make a commitment to training and upgrading of the workforce leading to more high-level jobs within subsidiaries of TNCs gradually being earmarked for indigenous labour. Collaborative agreements between foreign and domestic partners should be encouraged and appropriate training programmes for local managers set up.

I agree with the UN Transnational Corporations and Management Division (1992) that a promotion strategy for the targeted areas may be needed and that a multinational FDI agency may be of help in desseminating information and generally promoting investment opportunities in developing countries. I also agree on the desirability for transparency of strategies and policies; transparency would help in the promotion drive and would also lead to a better allocation of resources world wide. Greater transparency might also encourage the self assessment process of the country's strategy, its consistency with other overall objectives and might even lead to greater stability of policies and fewer changes of direction. Governments could be encouraged to conduct - with the help of international agencies - assessment on the growth potential of investment projects, as well as on other costs and benefits. Transparency on the assessment procedure and results of any pilot study is also very desirable.

Nevertheless transparency of strategies and policies may be ineffective without greater knowledge and transparency on facts and data. In spite of great efforts, particularly by UN agencies, the data on TNCs' related activities are still unsatisfactory: they are either missing altogether or impossible to compare internationally. A clear case on the first category relates to data on TNCs-generated trade and in particular to intra-firm trade. Hardly any data exist for most developed and developing countries on intra-firm imports. Yet no proper strategy can be developed for TNCs activities without knowledge on the impact of those activities on trade. The effects on trade of such activities have repurcussions not only on the balance of payments but also on employment, activity levels, prospects for future investment.

I would therefore go along with the suggestion for a FDI agency in charge of disseminating facts promoting locations, encouraging transparency, but I feel that a necessary role for such on agency would be to improve the quality and quantity of available offical statistics on TNCs - related activities.

In terms of incentives for attracting direct investment the best ones - from a developmental point of view - are those that help the foreign TNCs while creating long term benefits for the country. Thus the previous stress for expenditure leading to better physical and human infrastucture. Incentives with purely distributional elements should be avoided. This includes the practice of grants and subsidies[13]. Not only they constitute a drain on the scarce resources of developing countries but they may, in fact, be ineffective. The ineffectiveness may, partly, be linked to their wide spreading. In the end, TNCs investments are likely to be guided mainly by their own strategies and by their assessment of the profitability of the venture particularly since grants can be had, now, in most countries in which TNCs locate. Like bribes, once they are widespread, they may no longer be effective in influencing the allocation of resources, or the desired outcome. Their only effect may be distributional: from the public to the private sphere, from developing countries to companies located in developed ones. Francis Bacon, the seventeen century British philosopher and judge, was charged, tried and convicted for taking bribes in his role as judge. He admitted the charge but defended himself by stating that he did not allow the bribes to affect his judgements and sentences. Of course, unlike bribes, grants and subsidies are neither illegal nor unethical. However, like bribes, they may be ineffective when widespread in influencing the allocation of resources. The moral of all this is that governments are better advised to use the "grants and subsidies" money to upgrade the infrastructure. They could target infrastructure (human as well as physical) linked to the industries/areas strategically earmarked for the encouragement of TNCs activities. This should help to create a favourable economic framework for such activities, and thus help both the TNCs and the host country.

Stopping the practice of grants and subsidies is difficult - indeed almost impossible - at the level of single countries. Competition for FDI will ensure that - to avoid losing out in the race - governments will continue to offer - or respond positively to requests for - grants. Thus the way out is to foster the establishment of an international institution with power of ensuring "level playing fields" in the overall area of transnational activities. Such an agency could deal not only with the issue of grants and subsidies, but also - among others - with the issue of international mergers and acquisition, collaborative agreements across countries, transfer pricing issues. Such an agency - modelled on GATT - should get involved in policy reviews. Ideally various player and agents would be involved in the formulation and review of policies or at least their interests should be taken into account by the relevant governments (large TNCs, smaller companies, consumers, labour).

The agency in charge of developing, disseminating facts and promoting strategies and locations should not be the same as the one in charge of reviewing policies in order to maintain the objectivity of "facts" vis-á-vis policies.

7. Conclusions

The overall national and international macro environment has become more favourable to TNCs activities. Ideologically the era of suspicion and distrust towards TNCs seems to be over. Various elements have contributed to this change from the sheer size of activities to more cooperative international relations among developed countries to the acceptance of theories that see large firms and TNCs as efficiency driven organizations.

This paper has set up the new framework of TNCs operations worldwide in terms of trends and patterns of activities. It has analysed their new framework in terms of the integrating nature - at the international level - of the various activities and trends. It has then considered the implications of the new framework for developing countries and in particular the actual and potential tensions and conflicts it generates for these countries and between developed and developing countries. Some tentative policies and strategies for developing countries have also been suggested.

Notes

1. I would like to thank R. Burnley and D.A. Gillies for useful comments on an draft of this paper.

2. Companies behaviour vis-á-vis foreign investment in oligopolistic markets is analysed in Knickerbocker (1973) and in Cowling and Sudgen (1978b). A summary and comments on these theories as well as many other theories of international production is in Ietto-Gillies (1992 Part II).

3. The UN Transnational Corporations and Management Division (1992, p. 287) gives the following evidence for the less antagonistic relations between TNCs and host countries: the number of expropiation acts have fallen "..... from a peak of 83 in 1975 to 1 in 1985; since then barely any nationalizations have taken place".

4. Details of the trends touched on here are in Ietto-Gillies (1992: ch.2), UNCTC (1988, 1989, 1991).

5. A critical approach to the internalization theory is in Ietto-Gillies (1992, ch. 14), Cowling and Sugden (1987a) Yamin and Nixson (1988) Sugden (1991) Pitelis (1991), Dunning (1991).

6. On the opportunities and risks of FDI in the eastern bloc cf. Radice (1993)

7. Vernon (1979) gives evidence on the increased network of operations of the largest US and European companies. Current research by this author on the UK largest TNCs points to considerable and increasing geographical spread of activities.

8. An interesting analysis of the links between different stages of development and the demand for raw materials is in Rowthorn and Wells (1987). The authors argue convincingly that as economies develop, the demand for raw materials declines for two reasons: firstly because of a substitution effect due to the development of manufactured materials; secondly because of the development of productive processes that economize on raw materials.

9. Cowling and Sugden (1987) consider the economic significance and power of the "new firms" controlling smaller enterprises through subcontracting and similar arrangements.

10. On this point see Frobel et.el (1982)

11. Cf. Ietto-Gillies (1993)

12. Cf. UNCTC (1991 ch. IV) on this point.

13. On this issue see also cf. Reich (1990 and 1991). Reich refers to the US situation not to developing countries.

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