

Multinational Corporations and the Erosion of State Sovereignty

One of the most important issues states face is the growing power of the multinational corporation (MNC) at the expense of state sovereignty. While anti-globalists often argue that MNCs are more a bane than a boon to states' economies, recent evidence shows that foreign direct investment from MNCs can help promote and sustain development in many countries. In fact, countries that choose not to encourage foreign direct investment from MNCs – or are not offered any – are often less developed. Therefore, states have become reliant on MNCs to integrate their economy into the global economy and to encourage development. This reliance, though, explains in large part why MNCs have gained so much power. MNCs have immense influence in the international system, participating in the majority of global economic activity and growth. This essay serves an inquiry into the nature of MNCs in an attempt to explain how MNCs affect the international system, and are, in turn, affected by the international system. In addition, this essay also aims to point out that while states still have power *de jure* in the international system, and within their own country, MNCs have power *de facto* both in the international system and in individual states.

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One of the most important issues states face is the growing power of the multinational corporation (MNC) at the expense of state sovereignty. MNCs have immense influence in the international system, participating in the majority of economic activity and growth. It is therefore important to understand the effect that MNCs have on international relations in order to correctly identify why particular events happen. If public policy is made without an accurate understanding of the international system then chances are that it will cause more harm than good.

This essay serves an inquiry into the nature of MNCs in an attempt to explain how MNCs affect the international system, and are, in turn, affected by the international system. In addition, this essay also aims to point out that while states still have power *de jure* in the international system, and within their own country, MNCs have power *de facto* both in the international system and in individual states.

MNCs do not just possess knowledge of production; they also have an increasingly complex understanding of how to take advantage of changing political situations in the international system as well as how to influence state policy in order to gain legitimacy. Of course, all of this is done in the name of efficiency and profits. By gaining access to more markets corporations are able to take advantage of uncertainty in world events and enhance wealth acquisition. A change in costs shifts production from high cost states to low cost states, usually to the consternation of the latter. MNCs are then able to play states off of each other, forcing states to compete with each other in order to secure investment which brings jobs and tax revenue. This clearly gives MNCs significant power as it allows MNCs to dictate to countries what they want, and if a country does not respond favorably a corporation can simply pull out and invest in the state with the next lowest opportunity cost.

This essay seeks to investigate how MNCs are eroding state power through an exploration of why states are so dependent on MNCs. First, I explain why MNCs play a significant role in all developed and developing states' economies. Second, I look at the international system and how MNCs developed in it. Third, I explore different theories on the nature of the firm – all of which seek to explain why MNCs are so efficient in allocating scarce resources in the name of maximizing profits or returns to shareholders. Fourth, I consider what avenues of recourse states have to control MNCs. Finally, I suggest several policy options that states could exercise to regulate and mitigate the growing power of MNCs.

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Two Paths to Development: Official Development Aid and Foreign Direct Investment

For states trying to either develop or maintain a healthy economy the power that MNCs wield presents a considerable problem. However, developed countries will find that the severity of problem is not as bad as it is for developing countries because they usually have better governance systems and are not as dependent on foreign direct investment. To fully understand the problem MNCs present, I show that states must rely on foreign direct investment from MNCs in order to promote or sustain development.

Naturally, most governments want to promote or sustain development within their country. Development usually leads to increased tax revenue that allows the government to expand and pursue different policies and programs. Additionally, developed countries and countries that are on a promising road to development usually are politically stable, which almost all governments want. For instance, the health of the economy in fledgling democracies is especially important as evidence shows that new democracies with a floundering economies are at a higher risk of failure than ones that have strong or growing economies (Carothers 1997, 11-18, Diamond 1992, 25-46).

Economically developed countries rely on domestic investment, to some extent, to help sustain development. However, economically developed countries which fail to integrate into the international market will most likely stagnate or fall behind other developed countries. Integration into the international market allows goods, services and ideas to flow freely between countries promoting and sustaining development in all participating countries. For developed countries, then, it is crucial that they retain open borders and allow foreign direct investment into their economy in order to perpetuate competitiveness.

Immature economies usually have two options when considering how to develop. They can seek out official development aid or they can seek out foreign direct investment to help supplement often weak domestic investment. The benefits of official development aid (ODA), though, are increasingly being called into question by economists and other development analysts. Economic analysis shows marginal growth rates in many targeted developing countries, and in those targeted countries ODA produces decreasing marginal returns. Lant Pritchett, a World Bank economist, reports that for the most part development aid does not promote sustained development. Out of the 108 countries that he studied only eleven had a strong GDP per capita growth rate. Forty countries had a GDP per capita growth rate of less than one percent and twenty-eight countries had a GDP per capita growth rate of less than .5 percent. Sixteen countries actually had a negative per capita GDP growth rate (Pritchett 1997, 3-17). Pritchett's study suggests that development aid is not being used effectively to create development. In fact, it shows that ODA has an almost insignificant effect on the GDP per capita growth rate in many countries, and in other countries ODA may actually contribute to a decline in GDP per capita growth rate.

One of the problems that ODA causes is that it may make developing countries skip important steps in development which creates problems in the future. Usually, governments develop over long periods of time and during this time accountability mechanisms and trust are established between the government and society. Some degree of transparency also occurs, allowing citizens enough insight into government functions to reassure them that the government is not completely corrupt. Additionally, the government learns how to manage its budget and create sound development projects that will contribute to the country's long-term growth. Official development aid may reduce the government's accountability to citizens because they are no longer dependent on tax revenue to finance projects which can lead to decreased transparency and increased corruption (Alesina and Weder 2002, 1126-1137, Knack 2001, 310-329). The government's lack of tax dependence also reduces governments' desire to institute good policies, or for that matter, do anything at all which can lead to inefficient policies and a deficiency in the necessary infrastructure required to attract private capital (Knack 2001, 310-329). Further, ODA is believed to weaken countries by "siphoning away scarce talent from the civil service, as donor organizations often hire away the most skilled public officials at salaries many times greater than those offered by the recipient-nation government" (Knack 2001, 310-329).

Other problems stem from how ODA is used by governments. Many economists argue that ODA is not effective in creating growth because most of it is consumed by the recipient government in administrative overhead instead of being invested in the country. Even when economists such as Victor Levy report that most ODA is in fact invested rather than consumed, they still report that the increased ODA investment does little for development (Levy 1987, 152-156). During the time periods that Levy studies the average growth rate went from 3.7 percent in 1968-73 to 4.1 percent in 1974-80, an increase of four tenths of one percent. Even more discouraging is that African countries actually experienced a small decline in the average growth rate, from 3.3 percent in 1968-73 to 3.0 percent in 1974-80, a decrease of three tenths of one percent (Levy 1987, 152-156). Other economists argue that even when aid is used in good policy environments it spurs development through increased investment, it shows diminishing returns – thus the more aid a country receives the smaller the impact of each additional dollar (Easterly 2001, 94, Cull 2001, 269-290).

Some research suggests that it is necessary to discriminate between the two main types of ODA (bilateral and multilateral) in order to understand the overall effect of aid on development. According to Craig Burnside and David Dollar bilateral aid does not promote development because bilateral aid is "not [necessarily] given only for developmental purposes; it may serve the strategic or commercial interests of donors" (Burnside and Dollar 2000, 847-868). They conclude that multilateral aid could promote development, most likely due to the fact that multilateral donors only have an interest in developing countries. Burnside and Dollar find that the World Bank, for example, is very sensitive to policy environments and gives the most aid to governments that institute good policies (Burnside and Dollar 2000, 847-868). They suggest that aid given to governments which institute good policies actually cultivates development. Despite the fact that multilateral aid seems to have a positive affect on growth, Burnside and Dollar

fail to find a dramatic increase in growth (Burnside and Dollar 2000, 847-868). Further research by William Easterly shows that when the dataset used by Burnside and Dollar is expanded and the same regression used by Burnside and Dollar is run on the new dataset the results show no correlation between ODA and growth (Easterly 2003, 23-48). Easterly's findings contradict all the recent enthusiasm about the possible gains from ODA and force policy makers to reconsider the usefulness of ODA when creating development strategies.

Official development aid, for the most part, then, fails to act as a catalyst for development. For a few countries already disposed to creating development it can help to spur development, but for the majority of countries its effects are negligible, and for some countries ODA appears detrimental. Additionally, sustained amounts of aid can make countries cripplingly dependent on aid, seriously undermining the "quality of governance and public sector institutions by weakening accountability, encouraging rent-seeking and corruption, fomenting conflict over control of aid funds, siphoning off scarce talent from the bureaucracy, and alleviating pressures to reform inefficient policies and institutions" (Knack 2001, 310-329). Conditional aid only seems to work marginally better, inducing relatively few countries to reform in order to receive aid. Countries with good policies will most likely already be developed to a certain extent so that each dollar of aid faces diminishing marginal returns. Those countries that could benefit the most from aid because they lack any real development have a tendency to waste aid on government consumption and corruption.

For many developing countries full development will most likely come about by focusing on creating environments that attract private investment which then directly creates economic growth and indirectly promotes social development. Governments are beginning to realize just how important private investment is when it comes to trying to develop their countries. Naturally, domestic investment is preferred to foreign investment, but usually domestic investors in developing countries lack the funds, managerial know-how, and technology to create a successful business. Governments, then, turn to foreign direct investment to act as a catalyst for development within their country and to supplement private domestic investment (Rozental 1957, 277-285).

Foreign Direct Investment

Most host countries of foreign direct investment (FDI) from MNCs regard FDI as a "significant opportunity for integrating their economies into the global market and promoting their economic development" (Long 2005, 315-336). These countries find that FDI cultivates development through a variety of ways, from providing more health coverage than domestic firms to increasing research and development within the country (Erdilek 2005, 108-133, Moss, Ramachandran and Shah 2005, 340-362). For many developing countries FDI plays a crucial role in development, and for developed countries FDI helps to integrate their country's market into the global market and help it stay competitive.

Any research studying economic growth must control for a variety of variables that may exogenously or endogenously cause growth. Studies must control for possible spurious relationships between FDI and growth. It is also hard to determine whether FDI spurred economic growth or if something else that coincided with the investment spurred economic growth. This is why determining whether FDI promotes economic growth is so hard to determine.

While it may be hard to track all the causal mechanisms for economic growth, FDI certainly plays a key role in every country's economy. In developed countries with large economies it is almost impossible to understand how the economy responds to public policies, FDI, or domestic investment. However, in developing countries it is possible to find many connections between FDI and economic growth. Indeed, it is important to separate developing countries from developed countries in order to discover any positive affects of FDI on economic growth (Blonigen and Wang 2005, 221-241).

When useful controls and measures are used and when the data is divided into appropriate samples, empirical evidence shows that FDI does, in fact, promote economic growth, which in turn helps spur development in a broader sense. Researchers find that under the right policies and conditions an array of different positive spillovers can come from FDI. These include wage spillovers, production spillovers, technological spillovers, generally lower prices, higher quality domestic suppliers, and increased research and development. Not only does FDI produce positive spillovers, but for some countries it "may mean the difference between development and stagnation, in others, it may be a precondition of higher living standards" (Rozenal 1957, 277-285).

An important caveat to note in the relationship between FDI and growth is that FDI has a different impact on different types of domestic corporations. Foreign direct investment often has a negative short-run effect on domestic competitors. Most research shows that there are few horizontal spillovers, which is why domestic competitors are crowded out in the short-run. However, foreign direct investment does have a positive short-run impact on domestic suppliers (vertical spillovers) who provide MNCs with the necessary inputs for production. In the long-run FDI has a positive affect on both domestic competitors and suppliers and, to some extent, the longer an MNC is in a country the larger the positive impact of FDI will be in the domestic market (Moran, Gramham and Blomstrom 2005, 375-393). While the positive externalities that come from FDI will most likely occur at the local level because of the close knit ties that MNCs form with geographically close domestic suppliers, the positive externalities may also spillover into other neighboring countries as former employees move and as the MNCs technology slowly diffuses throughout the market, thus increasing the development within whole regions of the world (Gorg and Strobl 2005, 137-155, Lipsey and Sjöholm 2005, 36-41). To understand how FDI affects growth one must first disentangle how FDI affects domestic markets.

One of the most important effects that come from FDI is the competition effect. From the greater competition within a country's markets come incentives to pay higher wages to attract workers, invest more in research and development to stay ahead of

competition, increase productivity which then lower costs for both domestic suppliers and domestic competition, and increase quality standards for domestic suppliers. According to Guoqiang Long, FDI created competition in China's Pearl River Delta and Yangtze River Delta that helped motivate domestic suppliers and domestic competitors to improve their respective industries. As a result, the Pearl River Delta and Yangtze River Delta have become world-class information technology regions (Long 2005, 315-336).

Domestic suppliers immediately feel the effects of foreign direct investment as MNCs demand inputs in order to produce their products. Additionally, downstream suppliers may feel the effect of FDI as MNCs demand packaging services so that they can send their finished products into the market. Many MNCs do, in fact, rely on domestic suppliers for inputs, but how much they rely on domestic suppliers usually depends on the quality of products domestic suppliers can produce (Moran 2005, 283-309). MNCs often will help potential domestic suppliers meet quality requirements, such as the ISO 9000, in order to increase efficiency and profits. Many MNCs will still help domestic suppliers even if it benefits domestic competition by helping domestic suppliers achieve economies of scale. By achieving economies of scale domestic suppliers can produce quality products at a low cost which benefits both MNCs and domestic competition (Moran, Gramham and Blomstrom 2005, 375-393). Examples of this can be found in the automotive and electronics sectors. For example, QDOS Microcircuits, a Malaysian company was able to expand into the international market and become a supplier to many corporations after Motorola helped improve quality standards, thus increasing demand for their products (Moran 2005, 283-309).

As demand for inputs from domestic suppliers increases the productivity and profitability of the supply sector, the supply sector will grow resulting in increased competition as new firm enter the market. Thus, as a result of FDI the supply sector is able to grow and encourage economic development.

Wages will also increase as a result of FDI for three reasons. First, MNCs will enter the market and offer higher wages than the domestic competition in order to attract skilled workers. Second, as the demand for inputs from domestic suppliers increases domestic suppliers will start to demand more skilled laborers which will also increase the wage rate. Third, as domestic suppliers reach economies of scale the price of inputs will drop, the quality of inputs will up, and profitability will increase which will cause domestic competitors to enter the market resulting in additional demands on the labor market.

MNCs also help countries stay out of recessions and depressions by shifting production from areas of high cost to areas of low cost. As the cost of investing in a particular country decreases due to an economic recession MNCs will weigh production costs in other countries compared to production costs in that country. One of the characteristics of adept MNCs is their ability to quickly shift production from areas of high cost to areas of low cost. Investments in the country with an economic recession will rise as MNCs invests in that country and demand for labor and capital will increase. MNCs can also help to decrease the severity of a recession or depression within a country

that it is invested. In depressions the costs of investing for foreign firms dramatically decreases, which then increases the desire of foreign firms to invest in that country (Rozenal 1957, 277-285). The increased investment then stimulates the economy and lifts it back out of the recession. Additionally, in a recession subsidiaries of foreign firms that want to invest can gain access to credit through foreign firms while domestic firms are unable to gain access from domestic banks (Blalock and Gertler 2005, 73-104).

When an MNC invest in a country they must train new workers so that the workers can utilize the MNC's technological and managerial know-how. When these workers leave they start up their own companies or domestic competitors pick them up by offering higher salaries. Additionally, MNCs will help domestic suppliers take advantage of the MNC's technological and managerial know-how so that the domestic suppliers will efficiently produce quality products. Domestic competitors are then able to absorb technological and managerial know-how from domestic suppliers as well. Over time, then, MNCs' technological and managerial know-how is slowly diffused throughout the market (Krause 1972, 93-103).

In order to stay ahead of the competition, MNCs and domestic competitors will invest in research and development (R&D) (Krause 1972, 93-103). Usually MNCs locate R&D centers in developed countries where there is a large skilled worker pool, but as intellectual property rights, favorable investment policies, infrastructure and the number of skilled workers increases in developing countries MNCs will shift R&D to areas of low cost (Erdilek 2005, 108-133). Countries that choose to continue to force MNCs to participate in joint ventures or that have weak intellectual property laws will find that MNCs will not invest in R&D or use the most technologically advanced production techniques within the country (Krause 1972, 93-103).

Some countries have a valid concern that foreign direct investment will crowd out domestic competition, resulting in a loss of economic development and independence. In the short-run it appears that it is true that domestic competitors are crowded out of the market. MNCs usually have advanced technology and better managerial know-how than domestic competitors allowing them to produce better products at a lower cost. Additionally, MNCs may overwhelm domestic suppliers with orders so that domestic competitors are unable to get the necessary inputs for production. However, in the long-run domestic competitors will enter as domestic suppliers are able to reach economies of scale and thereby produce quality inputs at a low price, thus cutting the cost of production (Blonigen and Wang 2005, 221-241). As technological and managerial diffuses throughout the market domestic competitors will be able to capitalize on the MNC's know-how. For many countries, such as China, the positive spillovers derived from FDI outweigh the initial negative crowding-out effects (Long 2005, 315-336).

It is necessary to note, though, that FDI has the biggest positive effect in open markets. Countries with distorted economies will fail to initiate robust economic growth through foreign direct investment (Lawrence 2005, 368-373). The consequences of this are quite profound and are part of the reason why MNCs have gained so much power. MNCs will continue to gain more power as countries begin to institute liberal economic

policies in order to integrate their economies into the international market. The incentive to integrate into the international market is great because of the many potential benefits that come from FDI, including the transfer of technological and managerial know-how (Feinberg and Keane 2005, 245-277). MNCs are also increasingly demanding to be allowed to operate wholly owned facilities, so countries that refuse to open up their markets to the demands of MNCs will find that they remain undeveloped. Indeed, those countries which compel MNCs to invest in national joint ventures and share technology in order to spur development have failed to see any economic improvements (Moran 2005, 283-309). In fact, when there a country has a closed market FDI tends to have a negative affect on the host country's economy (Moran, Gramham and Blomstrom 2005, 375-393). It is necessary, then, for countries to open up their markets to MNCs in order to initiate or sustain economic development.

In pursuit of integration into the international market and economic efficiency developing states must let MNCs freely mobilize and deploy resources "according to the most efficient pattern" through liberal trade practices and open borders in order to broaden their economic horizons (Ball 1968, 163-170). However, some countries seem to be are catering too much to the needs and wants of MNCs. These countries not only open up their markets to MNC investment, but they also provide tax breaks, subsidies and free land in order to encourage MNCs to invest in their country (Moran 2005, 283-309). The power that this gives MNCs in that state is tremendous. In order to understand the kinds of power MNCs gain from operating in a system such as this it is necessary to first understand the nature of the MNC and the international system in which MNCs operate.

MNCs in the International System

The international system in which MNCs were created was originally state dominated. The first MNCs were state sponsored, like the 18th century British East India Company, which was granted exclusive trading rights between England and the East Indies. As the MNC evolved it became less reliant on states to open up trade with other countries. These corporations eventually grew large enough that they could initiate trade talks with other countries on their own. At first, MNCs had a technological advantage over domestic firms which allowed MNCs to dominate local markets and reap considerable profits. Low wages and weak labor and environmental laws in developing countries also allowed MNCs to make considerable profits. Over time the MNC continued to evolve until now some MNCs specialize just in efficiently coordinating production within the international market.

The international system which spawned MNCs has made MNCs time sensitive, profit motivated and incredibly adaptive, which is why MNCs are so efficient at coordinating production in the international system (Perlmutter 1972, 139-152). These characteristics are why power is shifting from states to market entities (Kobrin 1998, 97-109). Despite the fact that evidence shows MNCs are "independent actors operating in the interstices of state-to-state relations," the notion that MNCs are instruments of home states' foreign policy still persists (Walters 1972, 127-138).

Developing countries often view the latter argument as correct, which is one reason why they tend to be more wary of MNCs than developed countries. MNCs are sometimes seen as instruments of a predator state through which the predator can achieve its self-interested ambitions by penetrating and securing “effective economic and political dominance” over the less developed state (Walters 1972, 127-138). While MNCs operate transnationally they are still nationally based, so to many developing countries MNCs appear to be just ethnocentric corporations perpetuating developed states’ dominance over developing states in the international system (Papandreou and Bergsten 1973, 455-462). Therefore, free trade and other similar economic ideas do not level the playing field; instead “free trade” just helps MNCs rob developing states of valuable resources for their own benefit, even if all states are better off in the end (Walters 1972, 127-138).

However, as shown in the previous section on foreign direct investment, MNCs can actually help developing countries develop, provided developing countries do not have distorted markets. Additionally, investments abroad by MNCs do not always benefit the home country, which suggests that MNCs operate without considering the home state’s interests (Papandreou and Bergsten 1973, 455-462). After all, the primary objective for MNCs is how to maximize profits, and what may be good for an MNC may be absolutely terrible for the home country (Papandreou and Bergsten 1973, 455-462). For instance, MNCs often place “higher priority on the innovation process – regardless of where that process is centered – then on outdated notion of home country” (Stopford 1998-1999, 12-24). MNCs may also conduct paradiplomacy with other states independent of the host or home state, thus frustrating states’ attempts to carry out foreign policy. Additionally, MNCs are becoming more international in scope, and thus truly “stateless,” because shareholders are becoming more globally dispersed (Stopford 1998-1999, 12-24). MNCs, then, do not necessarily reflect the interests of the home country, but reflect the interests of shareholders. Therefore, to argue that MNCs are just an extension of a state’s foreign policy is a misunderstanding of the nature of the firm and its relationship with the state.

MNCs, then, must operate independently of states and state policies. This argument, though, suggests that MNCs pose “significant challenges to the sovereignty of all states” because they are independent of states and have a considerable amount of power (Walters 1972, 127-138). For example, states should be concerned with the power that MNCs have because of their ability to determine employment and, ultimately, the prosperity of the state (Ball 1968, 163-170). The power and influence of MNCs on the global and national economies, though, is greater than many policymakers may realize for four reasons. First, MNCs often export goods within the corporation across national borders, and these transactions are often not tracked under the traditional concept of international trade (Hadari 1973, 729-806). Second, foreign direct investment is not always correctly estimated or determined. Third, the way “in which the ‘boundary’ of a firm is defined” does not account for the total impact that a MNC has on the economy (Stopford 1998-1999, 12-24). Finally, MNCs are incredibly efficient, adaptive and resourceful entities. These reasons suggest why many policy makers fail to understand the full impact of MNC investment on a country’s economy. In order to fully understand the power that MNCs have it is necessary to look at the nature of the MNC.

The Nature of MNCs

MNCs are independent actors that are “sensitive to global opportunities” (Walters 1972, 127-138). Indeed, MNCs’ sensitivity to global activities makes them adaptive to new policy environments (Perlmutter 1972, 139-152). MNCs are also uniquely equipped by their “global strategies, management practices, and organizations” to take advantage of opportunities created by differences in states’ policies, such as different labor costs, labor laws, environmental laws, business laws, and taxes (Perlmutter 1972, 139-152, Walters 1972, 127-138). For example, when faced with unfavorable conditions in a host country MNCs can “threaten to shift production and future investment to plants in other states,” which forces states to create favorable investment policies (Walters 1972, 127-138). In this way MNCs have a tendency to frustrate state economic planning, threatening states’ ability to effectively pursue “national economic and political goals through such standard devices as fiscal policy, monetary policy, investment controls, and so forth” (Walters 1972, 127-138).

The nature of MNCs, that is, their ability to operate with global strategies to take advantage of changing state policies, also means that investment can be very fickle. In order to take advantage of changing state policies MNCs may quickly do an about-face, pulling out investment in one state and investing in another. In order to discern how FDI affects a state’s economy it is necessary to note, as John Stopford argues, that there are two kinds of investment. The first kind of investment, what Stopford calls “foreign portfolio investment (FPI),” which is extremely volatile and usually includes money or stocks. This paper does not address the affects that come from foreign portfolio investment as all FPI is not motivated by MNCs. In fact, most FPI is driven by money speculators and stock brokers. FDI though, only comes from MNCs and is what many states try to attract when promoting development and tends to be relatively permanent, usually in the form of capital, such as factories and heavy machinery (Stopford 1998-1999, 12-24).

In order to understand what motivates FDI it is necessary to first consider the nature of the firm. Firms, it is usually agreed, exist for the purpose of efficiently allocating scarce resources in pursuit of profit maximization, which is necessary for any firm to be successful in a competitive market. So, why do MNCs exist? MNCs exist because they can efficiently allocate scarce resources on a global scale. Kogut and Kulatilaka call this ability “operating flexibility,” and this adds value to a firm because it allows a firm to exercise a variety of different options due to three conditions: uncertainty, time dependence, and discretion (Kogut and Kulatilaka 1994, 123-141). MNCs capitalize on uncertainties, such as volatile exchange rates, take advantage of time dependence by investing in two plants in different geographical locations, and create managerial discretion by instituting beneficial managerial practices. Therefore, where an MNC decides to invest its FDI is motivated by how well the MNC can maximize profits in that location.

Stopford also notes that FDI is motivated by three different types of investment (Stopford 1998-1999, 12-24). First, there are resource-seeking MNCs that want access to either natural resources or human capital. Second, there are market-seeking MNCs that want access to larger markets. Third, there are efficiency-seeking MNCs that believe that by networking business across national boundaries they can lower the total cost of producing a product. Additionally, Kogut and Udo note that MNCs exist because they produce know-how that is not easily transferred to or replicated by other firms.

According to Kogut and Kulatilaka, by investing in foreign countries MNCs are presented with two kinds of options. The first option is what they call “within-country” growth, which is created by the establishment of a brand name in the foreign country (Kogut and Kulatilaka 1994, 123-141). Both foreign and domestic firms are able to exercise this option, and “as the firm grows in the foreign market, the value of these options to launch new products or to diversify within the country becomes the same as for a purely domestic corporation” (Kogut and Kulatilaka 1994, 123-141). The second option, or “across-country” option, is the ability to have operating flexibility, which comes from the fact that the firm is established in several different countries (Kogut and Kulatilaka 1994, 123-141). The advantage of being multinational, then, comes “not in being international, but in the ownership of options to coordinate flexibly multinational activities within a network ... [this is] valuable because it gives managerial discretion to respond profitably to the realization of uncertain events” (Kogut and Kulatilaka 1994, 123-141). Therefore, in order for MNCs take complete advantage of uncertain future events MNCs should invest in several different regions of the world and in “countries whose exchange rate is the most volatile” (Kogut and Kulatilaka 1994, 123-141).

As Kogut and Kulatilaka asserted, one of the options that arises from operating flexibility is managerial discretion. In order to fully utilize managerial discretion firms must have some kind of know-how that allows them to operate efficiently. Know-how, though, is not produced in a market because of the inability of the market to put a price on know-how, along with the problem of free-riding. Firms, then, produce and internalize know-how that is not easily transferred to or replicated by other firms in order to gain a competitive edge over other competing firms. By creating new knowledge, and coding it in a way that is easily replicated within the firm, firms are able to expand their market.

For many MNCs it is necessary to carry out operations in several countries, which requires that they not only have unique product know-how, but also unique management know-how. Know-how, though, is not limited to just the production of goods in an efficient manner; it can also refer to what Boddewyn calls “non-market” know-how. Non-market know-how is useful to MNCs in a variety of ways including “economic ones (such as monetary contributions to political agents), but also true political (power), social (solidarity) and cultural (status or respect) ones” (Boddewyn 1988, 341-363). The evidence for MNCs’ non-market knowledge is evidenced by the number of “risk assessors, advisors, door-openers, ‘5-percent men’, negotiators, public relations specialists, and the like” that MNCs hire in order to pursue foreign investment. Non-

market strategies are an alternative option that MNCs can pursue in an attempt to efficiently allocate resources (Boddewyn 1988, 341-363).

Through better political and market intelligence MNCs can pursue non-market political activities that help MNCs achieve their goals of efficiency (Boddewyn 1988, 341-363). Government decisions, then, are a factor in MNC investment and production decisions because they determine the profitability of an investment. MNCs are enticed to integrate political know-how into their strategies in order to achieve maximum efficiency. It is necessary to know as much as possible about the political, social, and cultural environment of a potential investment in order to guarantee a profitable return, and one way to ensure the profitability of an investment is to help persuade government to favor MNC investment.

Government persuasion can take the form of negotiations, lobbying, or even outright bribes, which are, of course, concealed in order to legitimize a MNC's investment in a state. Additionally, MNCs can target social groups in order to eliminate any opposition to investment. As Boddewyn argues, for many MNCs "political means must be chosen because they are superior or complementary to traditional economic ones" (Boddewyn 1988, 341-363).

States in many places regard such political influence, in fact, not as corruption, but as family values (Mallaby 2004, 480). For example, when Transparency International released its Corruptions Perception Index and rated Indonesia as less corrupt than China it made then President Suharto of Indonesia furious. Bribery is not something that is condemned in all parts of the world – in fact, it is expected by some governments, and for MNCs it becomes just another annoying cost of doing business. But MNCs do not have to offer out right bribers in order to influence government regulation and policy. MNCs can influence government through special interest groups and lobbyists, thereby keeping their influence within the legal realm.

Corporations are able to influence governments through special interest groups and lobbyists because they are often an important element in the legislative process. In order to create policies efficiently governments divide the workload among different agencies. These agencies then consult private advisors and panels in order to formulate policy. These private panels, though, are often special interest groups and lobbyists with their own agenda, so what are reflected in policy creation is not the interests of society but of the interest groups and lobbyists. Additionally, many governments rely on feedback from the same special interest groups and lobbyists they consulted to form legislation in order to determine how well the policies they instituted are working. The electorate, though, is usually never consulted during this process. It is therefore almost impossible to know if the representative body ever hears what the electorate wants because special interest groups and lobbyists who have a vested interest in creating policies that favor specific groups help formulate policy and determine whether a policy is working (Hammarlund 2005, 240).

Not only does the electorate have to compete with interest groups and lobbyists, but interest groups and lobbyists must compete among themselves in order to have the opportunity to formulate the most favorable policies. Politicians, after all, cannot promise to enact favorable policies to all groups. Firms, then, must compete to have the most influence in the legislative process. For example, this means that firms having a global vision, which want to operate in a borderless world, will have to compete with resource based firms, which tend to want state protection from foreign imports (Ball 1968, 163-170). Therefore, politicians will favor the special interest groups and lobbyists that offer the most benefits for themselves or for their country.

It is in the interest of the government, though, not to favor one specific firm, especially one that the government is reliant on for any reason, such as its products and services or for its benefit to the economy (Jay 1969, 244). A firm given monopoly control will eventually control the government because the government has no power over the firm. If the government tries to control the firm, the firm can simply restrict production or pull out investment, which will have a detrimental effect on the state. Therefore, states must be careful to only favor sectors of an economy and not specific firms.

The United States is an interesting case study of the lobbyist phenomenon. As early as 1949 Robert Lee observes that lobbyists and special interest groups have essentially created a tricameral body in the U.S. legislative branch of the government (Lane 1949, 154-162). Representatives are so reliant on special interest groups and lobbyists that it makes the geopolitical setup of representation meaningless. This suggests, then, that it may be more important for the electorate to be part of an interest group than to vote. Voters can only influence the legislature if they have considerable amounts resources that they can devote to lobbying, so, for the average voter they can only influence policy if they join an interest group and pool their resources together. Each interest group vies for power and influence in the legislature, and ultimately the interest groups with access to the largest amounts of resources usually win (Lane 1949, 154-162). Voters' interests, then, are represented by people that they do not elect, but generally trust because "unlike party or geographical representatives, their discretion is limited to mean; their ends are given" (Lane 1949, 154-162). This is similar to how shareholders in MNCs influence company policy. Stockholders do not really elect management, but they generally trust that the management will represent their interests, namely, to maximize profits (Lane 1949, 154-162). By relying so heavily on the third chamber the other two traditional chambers generously give up considerable power to the third chamber. It is the third chamber that is the source of many ideas and much policy, and it is the lobby that pushes for change, not the electorate or their representatives. It is of considerable interest, then, to know the motives of many interest groups and lobbyists, how ideas are filtered, and how policy and legislation is backed and enacted (Lane 1949, 154-162). The \$1.2 billion dollars spent by lobbyists in the United States during 2004 suggests just how important it is to influence legislation and to what lengths firms and other special interest groups will go in order to influence legislation (AllPolitics 2005). The third chamber certainly makes a travesty of representation (Lane 1949, 154-162).

An additionally intriguing aspect of the influence of special interest groups and lobbyists is the prevalence of megaprojects. Megaprojects, which are generally large infrastructure projects such as Boston's "Big Dig," are often pitched by interest groups to generously benefit everyone involved with the project – from the start to well after the project is finished. In reality, though, such optimistic predictions can hardly be supported because "megaproject planning and implementation is a highly stochastic one where things happen only with a certain probability and rarely turn out as originally intended" (Flyvbjerg 2003, 73). Usually there is an inadequate discussion about the risks involved with such projects because some powerful interest group is blocking all other views. This leads to lack of accountability in a project's decision-making process, which can lead to overly inflated appraisals and disastrous end results. Powerful interest groups often argue that investing in large infrastructure projects will help generate economic growth, but post-analysis of many megaprojects leads to a different conclusion. Cost overruns for megaprojects of "50 per cent to 100 per cent in real terms are common, and overruns above 100 per cent are not uncommon; Demand forecasts that are wrong by 20 per cent to 70 per cent compared with actual development are common; the key problem is lack of accountability, not lack of technical skills or data" (Flyvbjerg 2003, 44). The problem is that models used to predict demand and other economic benefits may seem objective, but in reality what is presented by one set of experts can easily be deconstructed and then reconstructed to show a very different conclusion (Flyvbjerg 2003, 218).

MNCs' political power, though, is not limited to lobbying for wasteful projects – MNCs also use their political power to become legitimate entities in a country. MNCs must ensure that both the parent company and the subsidiary company investing in a new state gain legitimacy in the law, society, and culture. If MNCs fail to accomplish this they will find it difficult to operate within the host state.

According to Kostova and Zaheer, there are three determinants of MNC legitimacy within a state (Kostova and Zaheer 1999, 64-81). First, MNCs must deal with the states' institutional structure and characteristics. Second, MNCs' organizational structure affects the legitimation process. Finally, the "legitimation process by which the environment builds its perceptions of the organization" affects the legitimation process (Kostova and Zaheer 1999, 64-81).

It is in the interest of MNCs to gain legitimacy in potentially profitable countries. When stiff resistance arises it is not surprising, then, that MNCs seize opportunities to influence government regulation and other policies that affect MNCs (Kostova and Zaheer 1999, 64-81). But, of course, legitimacy solely granted by the government is not enough to secure investment, which is why corporations also focus energy convincing the public of the worth of FDI. Only when MNCs convince the state as a whole can it truly secure investment that guarantees some degree of profitability.

MNCs, though, will have a harder time convincing the public of its worth than it will government because of the "liability of foreignness" (Kostova and Zaheer 1999, 64-81). This is due to the fact that the host country usually does not have much information

about the MNC in order to judge its intentions within the country. The result is delays in the legitimation process and considerable scrutiny from society and interest groups (Kostova and Zaheer 1999, 64-81). Foreign firms, Kostova and Zaheer argue, face societal stereotypes and different standards, which is harder for MNCs to break than for a domestic firm (Kostova and Zaheer 1999, 64-81). Additionally, larger and more visible MNCs will face even more scrutiny and delays in the legitimation process because they are “more vulnerable to attacks from interest groups” (Kostova and Zaheer 1999, 64-81).

Clearly, MNCs gain much of their power from their ability to efficiently operate, coordinate, and manage transactions between states. States, then, should be concerned with the power that MNCs have because of their ability to determine the prosperity of the state. After all, the only thing more alarming to a state than the presence of a MNC is its absence (Sampson 1973, 288).

Political action by MNCs also allows MNCs to minimize the extent to which governments can regulate MNCs by taking advantage of legislative processes that are often easily manipulated. For example, states create property rights for individuals and groups in order to protect parties from injuring each other’s property. Individuals and groups (including foreign and domestic firms) constantly vie for more protection and freer access to resources. Successful firms, as Boddewyn notes, are then able to manipulate legislation, raising the “transaction costs of others” which allows them to “exploit the ensuing rents” (Boddewyn 1988, 341-363). Government, then, is not really determined by the electorate, but rather by those with power, namely, firms (Kaplan 1997, 55-80).

The rise of the MNC has also created, in effect, an international organization that can have an immense effect on not only the economy, but on a state’s government as well. Corporations not only have the political power to influence states, but also the economic clout to devastatingly affect a state’s economy should the state try to oppose a MNC. It is always interesting to note, for example, that fifty-one of the world’s hundred largest economic entities are corporations and not countries, or that “the 500 largest corporations account for 70 percent of world trade” (Kaplan 1997, 55-80). It is not surprising, then, that states feel unable to formulate effective economic strategies or to plan for the future (Walters 1972, 127-138).

Powers of the State

States, though, should not feel completely useless or ineffective; after all, states provide basic rights that no corporation can provide. Additionally, states create a sense of loyalty, pride, and self-identity that no corporation could ever create. It is government, then, that is essential in providing a place to live that individuals can call home (Sampson 1973, 288). In fact, due to the increasing power of MNCs, individuals may increasingly turn to the state as the “only available countervailing force” (Alger 1972, 104-115).

Despite the erosion of state power by MNCs, states still have some power over MNCs. MNCs may be able to act independently of states – to avoid taxes, shift

production without notice, and engage in private diplomacy with other states – but states still retain some power over the corporation. After all, states still have the right to give legitimacy and to take it away (Sampson 1973, 288). For example, a MNC may continually demand free trade in the name of efficiency and threaten to not invest in states that do not agree to the terms of the MNC, but once the MNC begins to invest in a state its most valuable bargaining chip is gone. Indeed, once invested MNCs are locked into a state to some degree (Stopford 1998-1999, 12-24). It is therefore necessary that states remind MNCs of this power, forcing MNCs to constantly stand on hostile ground (Ball 1968, 163-170).

However, the power of the state is limited and the fact remains that MNCs are eroding states' sovereignty. Those states that institute protectionist policies to protect the domestic firms from MNCs will likely find that their economy stagnates. Additionally, if few MNCs are allowed to invest in the country they will institute inefficient practices which hamper the state's growth. For example, Chinese joint venture requirements with domestic firms during the 1990s caused MNCs to institute production processes that were about ten years behind the best production processes. MNCs were unwilling to use the most up-to-date production techniques because they were afraid that the local firm would expropriate the production technology (Moran 2005, 283-309). MNCs may also lobby and manipulate the government to keep the protectionist measures in place so that they can reap the profits from a distorted market. For example, though Chrysler used outdated and inefficient practices in Mexico it fought to keep the protectionist policies in place "in order to preserve what its managers described as a 'cash cow'" (Moran 2005, 283-309). Hewlett-Packard, Compaq, Apple, and other high-tech foreign investors also fought to keep Mexico's protectionist policies in place. Mexico's protectionist policies kept competitors out of the market allowing the MNCs to sell two- to three-years-old computer technology in the local market at prices "130-170 percent of the external price" (Moran 2005, 283-309). As previously stated, MNCs are profit maximizing entities. It may not always be the case that using the most up-to-date technology and production techniques maximizes profits, which is why states that institute protectionist measures will stagnate and decline. Those states that open up their markets but do not agree to bilateral or multilateral trade agreements with other countries will find that MNCs can play states off each other forcing them to compete for investment. Thus, the MNC rather than the state wins in the end. Those states that open up their markets and do agree to bilateral or multilateral trade agreements must give up some sovereignty in order to create an effective and legitimate international organization. At least by opening up their markets and joining an international organization states can promote development and mitigate some of the negative externalities that come from MNCs (Walters 1972, 127-138).

Conclusions and Implications: Mitigating the Power of MNCs

This essay has argued that MNCs do, in fact, help many countries promote and sustain development. Indeed, those countries that cannot attract FDI – or are not offered any – tend to be less developed. However, MNCs can also devastatingly affect states' economies and manipulate states' governments. Notable instances of powerful MNCs

devastating national economies and generally running amok seem to help support critics. In the past MNCs such as the London and Rhodesian Mining Company, or Lonrho, and ITT have plundered states' economies and manipulated governments. Recent accounting scandals involving Enron, Adelphia and Parmalat, and Wal-Mart's deplorable labor practices also seem to suggest that MNCs do not encourage development, but rather seek to corrupt governments and destroy domestic economies all in the name of maximizing profits. It is important to note, though, that while MNCs are driven to maximize profits, such corporate greed is not the norm. MNCs like those previously mentioned are aberrations; they do not describe the nature of the majority of MNCs. However, important lessons can be learned from them. First, when governments allow MNCs to have considerable influence in the legislative process MNCs tend to corrupt governments. Second, governments do have the power to prosecute scheming executives and create effective legislation to prevent extreme corporate greed. Third, non-governmental organizations (NGOs) and other interest groups can influence not only government policy, but also MNC policy.

Most MNCs are not trying to corrupt governments in order to increase profits. In fact, most MNCs operate well within the bounds of the law. However, they still lobby governments to change policies and legislation in order to increase profits. Indeed, as MNCs become more adept at coordinating international activities in order to take advantage of threats and opportunities they will become an increasing threat to states' sovereignty.

States could rely on NGOs to constrain powerful MNCs. In fact, the recent trend to become certified by NGOs (such as "fair and free trade" certification) suggests that NGOs may be able to do what most governments cannot – affect how powerful MNCs conduct their business. The influence of NGOs in the forestry and apparel sectors demonstrates the power of NGOs. NGOs were able to quickly delegitimize the "weak standards and inadequate enforcement mechanisms" in these sectors and effectively mobilized enough people to force MNCs to change their practices (Gereffi, Garcia-Johnson and Sasser 2001, 56-65). The evidence, then, suggests that consumers and NGOs can affect how MNCs operate (Drezner 2000, 64-70). Indeed, as citizens integrate themselves in the global society they will become increasingly more aware of MNCs' operations, and thus more influential. Under such scrutiny MNCs will have to conduct quality operations or sacrifice their brand name. However, consumers and NGOs cannot effectively regulate MNCs. States are the only entities that have the authority to grant and revoke legitimacy and therefore are the only entities that can regulate and mitigate MNCs. States though, are unable to regulate and mitigate MNCs because MNCs are international in scope and operation. If a state revokes an MNC's legitimacy the corporation can invest in another state, but the lack of FDI in the state's economy will be detrimental. The state, rather than the MNC, then, is affected negatively. Therefore, states must create and join an international organization in order to effectively regulate and mitigate MNCs.

States will have to give up some sovereignty in order to create a legitimate, effective international organization such as the World Trade Organization or the

International Criminal Court. The consequences of joining such organizations will mean that states cannot exercise every power usually associated with sovereign entities. It will be important that all states act together and that states punish other states that choose to act independently. MNCs are adept at taking advantage of and manipulating weak organizations – it is how they often make huge profits. Therefore, states must present a united front in order to regulate and mitigate the power MNCs.

States that give aid could also reconsider what types of aid they give aid. Official development aid could be refocused and targeted at regulating and mitigating the negative externalities and encouraging the positive externalities that come from FDI in developing countries. For example, ODA could help strengthen government institutions, increase transparency and accountability, and develop the necessary infrastructure that investors look for when deciding where to locate. ODA could also be used to address some of the social concerns that researchers worry will come from many countries' growing reliance on FDI. For example, some researchers fear that reliance on FDI will make many countries, especially developing countries, unable to create effective programs to protect people that FDI will affect negatively (Tanzi 2001, 78-79). ODA could fill this funding deficiency, allowing countries to reduce taxes in order to attract FDI while at the same time create social safety nets to protect citizens that will be negatively affect by FDI. Additionally, ODA could be aimed at creating an educated workforce so that technological spillovers can occur within that country. As the economy grows and social environment develops citizens will be able to enjoy higher standards of living.

Addressing the power that MNCs wield in the international system will become increasingly important as more states rely on FDI to spur or sustain economic growth. The arguments presented in this paper suggest that MNCs do have considerable influence in the international system because they participate in the majority of states' economic activity and growth. It is therefore important to understand and address the effects that MNCs have on international relations in order to create an effective international organization that can mitigate and regulate the power of MNCs.

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