THE MULTINATIONAL ENTERPRISE

Edited by
John H. Dunning

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Introduction

This book is concerned with the impact of the multinational enterprise on the transfer of goods and factor inputs across national boundaries and the implication of this transfer on the welfare of nation states or sectors of nation states. Each of the contributions is written by a leading research specialist or practitioner in the field; each surveys the existing state of knowledge and suggests lines for future research. A number of the essays embody results of original research; others are more concerned with political considerations or are speculative in approach.

As both Paul Streeten and Jack Behrman emphasize in their chapters, the welfare of nation states affected by multinational enterprises is a synthesis of the welfare of its component parts, not all of which will be affected by their operations in the same way. As with other environmental issues, problems arise as much from balancing or reconciling *sectoral* costs and benefits within nation states as from securing the maximum net benefit of the whole. Mr Lea's chapter is a good illustration of this point. Nevertheless, the Reading Conference from which this book originated was more concerned with the general repercussions of the growth of multinational enterprises in the world economy. The intention was that participants should take stock of thinking on the subject and should suggest lines for future research.

As will be seen from the contents of this volume – and particularly from David Robertson's summary in Chapter 13 – the Conference was not primarily concerned with the internal operations of multinational enterprises. Instead it concentrated its attention on the impact of this particular phenomenon on the economic environment of which it is part.

Broadly speaking, the chapters divide themselves into four main sections. The first consists of three chapters. In a background review, Professor Dunning sets out some of the economic and conceptual issues surrounding the multinational enterprise. What is this particular phenomenon? Why is it worthy of study? What distinctive economic problems or challenges does it raise? How can these best be dealt with?

This essay is followed by two on the multinational enterprise as an agent of the transfer of factor inputs across national boundaries. Professor Aliber discusses the extent to which the pattern of growth of the multinational enterprise can be explained by the demarcation of the world into various currency areas and the extent to which the operations of international companies – by their ability to move funds across national boundaries – affects the independence of monetary authorities in various currency areas. Mr Pavitt deals with the role played by foreign direct investment in transferring knowledge and technology, and draws upon the valuable data collected by the OECD in their 'Gaps in Technology' section. He also compares the role of the multinational enterprise in the transfer of technology to the less-developed areas with that to the developed countries.

The second series extends from Chapter 4 to 7 and is concerned with a selection of operational questions arising from international direct investment. Chapter 4 is a long contribution by Mr Steuer and Mr Gennard, and contains some of the results of an original piece of research undertaken by the authors and sponsored by the Board of Trade, into the effects of foreign direct investment in the UK. Mr Steuer has already published, or is about to publish, the rest of his findings – many of which are relevant to our theme. This contribution on industrial relations is especially welcome because it is one of the first pieces of work published on this aspect of the multinational enterprise. Later sections of the chapter also contain useful empirical material on the profitability and productivity of foreign enterprises in the UK.

This essay is followed by Mr Lea's chapter which, though perhaps somewhat less objective in its approach and orientation, fairly summarizes many of the concerns expressed by trade unions over the operation of multinational enterprises. Some commentators believe that many of the conflicts arising in the future will be in the area of labour/management relationships, particularly if, to meet the internationalization of business, the unions attempt to formulate global strategies. Such a bilateral monopoly could obviously have extremely wide implications which have not yet really been appreciated or worked out by the parties concerned – or received the attention they deserve from labour economists.

The following two chapters deal with the balance of payments and trade impact of foreign direct investment. Mr Robertson's is a comprehensive survey of the state of thinking on the subject, a field which is perhaps better documented than most and where economists have done the most empirical research. It is also one of the most hotly disputed subjects for, if nothing else, enquiries have revealed the difficulty of arriving at any sensible general conclusions, partly because of the wide differences between types of foreign investment and partly due to the difficulty of estimating what would have happened had the investment not been made. Mr Sudworth's contribution, although perhaps not as forthcoming in statistical data as one would have liked, is the more useful, because it does illustrate at an individual enterprise level how one large multinational firm considers its own investments have affected trade flows. Quite unintentionally, it also illustrates one of the difficulties one has in obtaining useful factual information from firms which, for very good reasons of their own, are reluctant to provide data on their operations in the way economists would like.

The third group of essays deals essentially with the relationship between the multinational enterprise and host nations of which their foreign operations are part. Professor Penrose and Mr Streeten are concerned with the reactions of less developed countries to inward foreign investment – Mrs Penrose concentrating on attitudinal and organizational questions and Mr Streeten on the costs and benefits of obtaining the ingredients of foreign investment by alternative means. Both essays suggest that, even from an economic viewpoint, it is very difficult to give any generalized answers to the problems under review, though Mr Hayes, in his comments, questions whether some of the alternatives Mr Streeten suggests are, in practice, feasible.

In his contribution, Mr Murray surveys some of the implications of the growth of international business for the system of national states as they are at present organized in developed countries and, in particular, the changes in political structures it may necessitate.

Professor Behrman's chapter is more concerned with the tensions which may arise, both between nation states and the multinational enterprise, and *within* nation states, as a result of the sharing out of the operations of multinational enterprises and, in particular, from the distribution of the costs and benefits they confer to host countries. In examining these, he lists a variety of alternative government policies which might be pursued. Professor Behrman has written extensively on this subject and is the author of a recently completed study, *National Interests and the Multi-National Enterprise.*[1]

The fourth section consists of a single paper. It stands on its own as it is concerned with a rather different problem. Mr Whitehead is a Research Fellow at the Centre of European Industrial Studies at Bath University of Technology and is working with Christopher Layton on the problem of multinational companies which are owned and controlled by economic agents in two or more countries.

[1] Englewood-Cliffs, New Jersey, 1970.

His chapter attempts both to distinguish this brand of operation from others and also to give a first insight into the effects of one of the most recently set up of their enterprises, Afga-Gevaert.

Most of the contributions at the Conference were introduced by a participant other than the author, and we include in the volume the comments of several of these discussants who, like the authors, have worked or are working in this particular field. The volume concludes with a summary of the discussion recorded by David Robertson and some concluding impressions by Professor Heath.

Obviously, not all areas of the subject matter under review were covered in the two-and-a-half days of debate. Some of these (e.g. industrial structure) had been touched upon at other conferences,[1] while others – e.g. the theory of direct investment – have been dealt with fairly extensively in the literature.[2] Neither did we attempt to review the existing research being done on the multinational enterprise. For an idea of the work being done in the UK and North America the reader should consult an excellent summary recently produced by the British–North American Research Association.[3]

We hope that the growing number of people interested in the multinational enterprise will find the contents of this volume stimulating and informative – and a catalyst to further thinking and research.

[1] Notably the Conference on Mergers and Restrictive Practices organized by the Board of Trade and held at Cambridge in September 1969.

[2] See, for example, C. P. Kindleberger, *The International Corporation*, Cambridge, M.I.T. Press, 1969.

[3] *Research on the Multinational Enterprise*, by S. Webley and S. Lea.

PART ONE. THE MULTINATIONAL ENTERPRISE: SOME GENERAL CONSIDERATIONS

Chapter 1

THE MULTINATIONAL ENTERPRISE: THE BACKGROUND

JOHN H. DUNNING

INTRODUCTION

Economic agents have long traded with each other across national boundaries; to this extent, the internationally-oriented enterprise is no new phenomenon. Similarly, the economic prosperity of nations has always been influenced by the terms on which they have exchanged goods and services among themselves. Since the early nineteenth century, an active international capital market has existed, while the international flow of knowledge has an even longer pedigree – dating back to the exodus of the Huguenots in the seventeenth century and the smuggling of drawings, designs and machinery out of Britain to the American colonies more than one hundred years later.

These observations underline the very familiar point that world trade in goods and factor inputs has always affected the economic welfare of participating nations, and that several countries owe the timing of their take-off in development directly to the inflow of foreign capital and expertise.[1] But until fairly recently, most international transactions had two things in common. First, each was generally undertaken independently of the other and by different economic agents. Admittedly, in the nineteenth century, trade often followed investment, and labour and capital sometimes migrated together, but these movements were usually separately initiated and diversely motivated.[2] Second, most transactions were between

[1] W. W. Rostow, *The Stages of Economic Growth*, London, Cambridge University Press, 1961.

[2] R. Nurkse, 'International Investment Today in the light of Nineteenth Century Experiences', *Economic Journal*, Vol. LXIV, March 1954.

unassociated buyers and sellers, and were concluded at market or 'arm's length' prices.

During the last half century, and particularly in the last twenty years, a new and separately identifiable vehicle of international economic activity has emerged as a result of the internationalization of the productive activities of many enterprises.[1] and its concomitant – the rapid expansion of foreign direct investment.

The distinctive features of foreign direct investment are twofold. First it embraces, usually under the control of a single institution, the international transfer of separate, but complementary, factor inputs, viz. equity capital, knowledge and entrepreneurship – and sometimes of goods as well. Nowadays direct investment accounts for 75% of the private capital outflows of the leading industrial nations,[2] compared with less than 10% in 1914. Payments for proprietary knowledge, e.g. royalties, technical service fees, etc. between related institutions, accounted for 54% of all such payments made across national boundaries by British enterprises in 1968,[3] and in the same year, about a quarter of their manufactured exports were sent directly to their foreign subsidiaries.[4]

The second unique quality of direct investment is that the resources which are transferred between countries are *not traded,* they are simply moved from one part of the investing enterprise to another; no market transactions are involved. Such prices as are charged may differ from arm's-length prices wherever, *inter alia,* it pays the investing enterprise to earn its taxable income in one country rather than another.

This, then, may be taken as a starting point to the concept of the international or multinational* producing enterprise (MPE), which we shall define simply as an enterprise which owns or controls producing facilities (i.e. factories, mines, oil refineries, distribution outlets, offices, etc.) in more than one country.† We distinguish

[1] J. Polk, 'The New World Economy', *Columbia Journal of World Business,* January/February 1968.

[2] International Monetary Fund, *Balance of Payments Yearbook.* Vol. 21, 1970.

[3] Board of Trade, 'Overseas Royalty Transactions in 1968', *Board of Trade Journal,* March 25, 1970.

[4] *Board of Trade Journal,* August 16, 1968.

* For the purpose of this paper we regard the terms international and multinational as synonymous.

† A special case of multinational enterprise is the bi-national enterprise which is only involved (in some way or the other) with two countries. We might also classify nationally-oriented enterprises in similar ways (NPE, NTE, NOE, NCE).

such an enterprise from one solely engaged in international trade (MTE), which sells its domestically-produced output directly to other enterprises or individuals in other countries; and also from an internationally owned and/or (financially) controlled enterprise (MOE and MCE), the capital of which is owned or controlled by economic agents of more than one nationality. Most large enterprises are, to some extent, MOEs: only a very few, e.g. Unilever, Royal Dutch Shell, Agfa-Gevaert, are MCEs. These latter are also sometimes referred to as transnational enterprises.*[1]

It is, of course, possible for an enterprise to be multinational in more than one, or indeed in all, of the above senses, though in this paper we shall be mainly concerned with the economic issues surrounding the multinational producing enterprise (MPE), which is financially controlled by residents of one country.

From most standpoints, the distinction between foreign direct investment and the operations of the MPE is not an easy one to draw.[2] Nevertheless, there are some obvious differences. First, direct investment can be made by economic agents other than enterprises, though in practice the amounts involved are very small. Second, it incorporates foreign investment by all firms, irrespective of the *extent* to which they are involved in foreign activities - or indeed in domestic activities.[3] Third - and most important - while the value of direct investment only includes the capital of the foreign company actually *owned* by the investing enterprise, the economic role of the MPE is better expressed in terms of *all* resources under its *control*, including those of local origin.

Other writers have attempted more precise definitions of the MPE[4] but usually these either emphasize particular characteristics which may or may not be possessed by it, or treat the phenomenon from a specific viewpoint. The *producing enterprise*, for example, is likely to evaluate its degree of multinationalism in terms of the proportion its total employment, assets, sales or profits derived from

* To complete the picture there are a few multinational companies, e.g. Deltec and Adela, which are MOEs but where no substantial proportion of their capital is owned by any one shareholder in any one country.

[1] See also Chapter 12 in this volume.

[2] R. E. Caves, 'International Corporations: the Industrial Economics of Foreign Investment' in *Economica*, Vol. 38, February 1971.

[3] For example, many British-based companies in extractive industries do not operate production units in the UK at all.

[4] Some of these are summarized in the Committee on Invisible Exports, *The Role of International Companies and how their Management Affects Britain's Invisible Earnings*, London, 1970.

foreign operations.[1] Looked at from the angle of recipient *nation states*, or sectors within nation states, a more appropriate criteria might be the contribution of subsidiaries of foreign owned MPEs to domestic output or capital formation, or the impact of the foreign operations of domestically-owned MPEs on the balance of payments. A third and more functional approach is to look at the MPE according to the extent to which its constituent firms are subject to a common *management or operational strategy*.[2] Professor Perlmutter, for example, argues that only those enterprises which fully integrate their global activities and have a geocentric outlook can be considered as truly multinational.[3] On this definition, only a handful of the world's enterprises would currently qualify as MPEs; on the other hand, the numbers are growing and it is this particular form of the MPE which is attracting the most attention of nation states.[4]

In view of these diverse ideas about the nature of the MPE it may be questioned whether we can say anything useful about it. I think one can, for two reasons. First, as we have already observed, there are certain common features to all enterprises that produce in more than one country and, second, compared with nationally producing enterprises (NPEs), there are sufficient differences both in their behaviour and their economic impact to make this particular institution worth studying.

This chapter will seek to answer four groups of questions:

(a) What is the economic significance of the MPE? In what ways does its pattern of behaviour (or that of its constituent parts) differ from that of a NPE? To what extent is it a distinctive decision-taking unit? What determines the level and pattern of the activities of MPEs in the world today?

(b) What is the contribution of foreign and home-owned MPEs (or their subsidiaries) on the national economies of which they are part?

(c) What are the costs and benefits of these businesses (or their subsidiaries) from the viewpoint of investing and recipient countries? What is the nature and significance of the conflict of *objectives* between the MPE and nation states? – or sectors within

[1] N. K. Bruck and F. A. Lees, 'Foreign Investment Capital Controls and the Balance of Payments', New York University, Graduate School of Business Administration, *Institute of Finance Bulletin* No. 48/49, April 1968.

[2] R. Vernon, 'Multinational Enterprise and National Sovereignty', *Harvard Business Review*, March/April 1967.

[3] H. V. Perlmutter, 'The Tortuous Evolution of the Multinational Company', *Columbia Journal of World Business*, January/February 1969.

[4] See especially Chapter 11.

nation states? How, if at all, can conflicts of *interest* be resolved?

(d) What should government policy be towards the MPE (or its subsidiaries)? Is there a case for establishing supra-national institutions to deal with the international conflicts of interest between the various interested parties?

THE GROWTH OF THE MULTINATIONAL ENTERPRISE

The increase in the contribution of MPEs to world industrial output is one of the most impressive economic features of the last two decades. Though about three-quarters of this growth has originated from US and UK owned and controlled enterprises, the greatest percentage increases have been recorded by Continental, European and Japanese firms,[1] which seem almost certain to increase their share still further. A number of recent publications have analysed these trends in some detail.[2] In this chapter we shall just highlight one or two of the more outstanding facts.

First, the current position, in so far as one can estimate it. In 1968, the book value of total assets owned by MPEs outside the country in which they were first incorporated was about $94 billion, and their total foreign sales (both exports and local output) were reckoned to exceed in value the gross national product of any country except the US and the USSR.[3] About 55% of these international assets were owned by US enterprises, 20% by UK firms and the rest largely by European and Japanese companies. About one-half of the American companies with world-wide sales of more than $1 billion in 1966 owned at least a quarter of their assets or derived at least one-quarter of their sales outside the US.[4]

Second, the foreign output of MPEs is currently expanding at the rate of 10% per annum, twice the rate of growth of world gross national product and 40% faster than world exports. Moreover, since the MPEs are concentrated in the technologically-advanced and faster-growing industries, their share of the world output is almost certain to rise in the future. This, coupled with the economies of scale such enterprises enjoy over NPEs, has prompted

[1] J. H. Dunning and R. D. Pearce, 'The World's Largest Firms: A Statistical Profile', *Business Ratios*, No. 3, 1969; S. Hymer and R. Rowthorn, 'Multinational Corporations and International Oligopoly: the non-American Challenge' in C. Kindleberger (ed.), *The International Coporation*, M.I.T. Press, 1970.

[2] S. Rolfe, *The International Corporation*, International Chamber of Commerce, 1969; J. Behrman, *Some Patterns in the Rise of the Multinational Enterprise*, University of North Carolina research paper, 1969; Economist Intelligence Unit, *The Growth and Spread of the Multinational Company*, London, 1971.

[3] J. Polk, *op. cit.* [4] N. K. Bruck and F. A. Lees, *op. cit.*

some observers to make predictions that by the turn of the century the largest 200 or 300 MPEs will account for one-half of the world's output.[1] Whatever one's view of this prediction might be it would appear that, in recent years, the leading American MPEs have been growing appreciably faster than their more domestically-oriented counterparts. Of the largest 500 US industrial enterprises in 1967, those whose foreign sales and/or assets accounted for 25% or more of their total sales and/or assets grew by 64% during the preceding five years, while those whose overseas sales and/or assets were less than 25% recorded only a 53% rate of growth.[2]

The third point concerns the industrial concentration of MPEs. In 1967, 21% of the plant and equipment expenditure by US manufacturing enterprises was undertaken by their overseas subsidiaries.[3] But 85% of this was in four main sectors: vehicles, chemicals, mechanical engineering and electrical engineering. While certain industries throughout the world, e.g. rubber tyres, oil, tobacco, pharmaceuticals and motor vehicles are almost completely dominated by MPEs, in others, e.g. cotton, textiles, iron and steel, and aircraft they are largely absent. Why? This concentration has important implications for the theory of industrial organization, which we shall take up later.

Geographically, too, the impact of the MPE varies considerably. Of the developed countries most dependent on inward direct investment, Canada stands supreme. Some 55% of her industrial capital assets are owned by US or UK firms.[4] Of the 100 largest companies, 75 are foreign controlled. Australia is another example: 40% of her manufacturing and mining output is supplied by US firms, compared with less than 10% in Western Europe. MPEs are also active in many of the LDCs, particularly in the resource exploitation and intermediate technology fields.[5] Of the leading capital exporters, Switzerland, the Netherlands and the United Kingdom each derive more than 1% of their gross national product from income earned on foreign direct investment.[6]

Some countries are two-way investors. Britain is unrivalled here. While more than 30% of the profits of British owned enterprises are

[1] J. Polk, *op. cit.* [2] J. H. Dunning and R. D. Pearce, *op. cit.*

[3] US Department of Commerce, *Survey of Current Business*, August 1968.

[4] M. Watkins, *Foreign Ownership and the Structure of Canadian Industry*, Report of the Task Force on the Structure of Canadian Industry, Ottawa, 1968.

[5] J. H. Dunning and R. D. Pearce, *Foreign Direct Investment in the Less-Developed Countries* (to be published as a PEP broadsheet 1971).

[6] J. H. Dunning, *Studies in International Investment*, London, Allen & Unwin, 1970.

derived from their overseas operations, foreign MPEs in the UK account for about 25% of manufacturing exports and, on present trends, are likely to supply the same proportion of manufacturing output by 1980.[1] The Netherlands, France, Sweden and, more recently, Germany and Japan also fall into this category.[2]

How can one explain these facts? Why do MPEs dominate certain industrial sectors? Why are they mainly of US and European origin? Why has the post-war growth of certain European economies been strongly influenced by American investment, while that of the Japanese economy has been largely independent of it?

We have already hinted at why, relative to other ways of conducting international business, foreign direct investment has become more attractive to enterprises, and particularly those in the technologically-advanced industries.[3] Basically this has to do, on the one hand, with the economics of the production of knowledge and its transmission across national boundaries and, on the other, with the conditions of international marketing. Increasingly, for one reason or another, enterprises have chosen to transmit abroad the knowledge of how to produce goods rather than the goods themselves, and to do this by setting up their own producing facilities rather than licensing foreign firms.

The above thesis essentially applies to MPEs in manufacturing industry but, equally important, are the activities of such enterprises in resource exploitation and tertiary industries. At this point it may be useful to distinguish between three types of MPE, the activities of which may be prompted by quite different considerations:

1 *Backward Vertical (or Cost Oriented) Operations*

These are of two varieties. The first represents the extension of the *purchasing* function of the investing firm and is undertaken to obtain cheaper or more reliable supplies of raw materials or processed goods for the investing company. The second type is undertaken, chiefly by firms in extractive industries, with the aim of supplying their output to world markets. Most operations of UK firms are now of this latter kind.[4]

[1] J. H. Dunning, *The Role of American Investment in the British Economy*, PEP Broadsheet No. 507, February 1969.

[2] International Monetary Fund, *op. cit.*

[3] W. Gruber, D. Mehta and R. Vernon, 'The Research and Development Factor in International Trade and Investment of US Industries', *Journal of Political Ecnomy*, Vol. LXXV, February 1967.

[4] W. B. Reddaway *et al.*, *Effects of UK Direct Overseas Investment*, London, Cambridge University Press, 1967 and 1968.

2 *Forward Vertical (or Market-Oriented) Operations*

These activities represent the extension of the *sales* function of the investing firm, the main purpose of which is to advance or protect its markets and facilitate *domestic* production. They do not usually account for large amounts of foreign capital, though quite a lot of the exports of the MPEs are channelled through them.

The factors influencing both these types of MPEs are fairly clear-cut as is their economic impact on host and investing countries.

3 *Horizontal Operations*

These largely comprise foreign manufacturing activities of MPEs which may or may not be harmonized with each other or with domestic activities. It is this type of operation which is currently attracting the greatest interest of both host and investing nations. These too may be variously classified, but perhaps the most useful division is between (*a*) high technology and (*b*) intermediate technology investments.

It now seems generally accepted that the explanation of the level and pattern of this kind of international activity is to be found in the theory of market behaviour and imperfect competition.[1] An enterprise develops foreign interests to exploit or protect a particular economic advantage it has over its competitors – or potential competitors.[2] In many cases this advantage can best be exploited by setting up a foreign operating subsidiary, rather than by any alternative route. In a static world of perfect competition and the free movement of capital there would be little or no incentive for direct investment. Imperfect competition, product differentiation and barriers to trade explain why the MPE exists at all.

Both Stephen Hymer and, more recently, Richard Caves have sought to explain foreign direct investment in these terms.[3] And, indeed, a quick look at the product and market structure of the leading MPEs in manufacturing industry shows that they tend to be concentrated in oligopolistic industries supplying branded or differentiated products. This is especially noticeable in the high technology industries, but it is also pronounced in some intermediate technology industries where, by today's standards, a fairly uncomplicated and easily learned process of production is involved.

[1] C. P. Kindleberger, *American Business Abroad*, New Haven, Yale University Press, 1969.

[2] *Ibid.*

[3] S. Hymer, *The International Operation of National Firms: a Study of Direct Investment* (Ph.D. dissertation, M.I.T., 1960); R. E. Caves, *op. cit.*

Typical of these are cement, textiles, tobacco and soap. Here, the competitive imperfections mainly arise from import restrictions and/or high transport costs, and from the economies of experience and/or scale possessed by the investing company over its local competitors. Sometimes, because of its initial lead as an innovator and exporter, a foreign firm is able to retain its initial lead in local markets – particularly if the cost of indigenous competitors entering the market is a high one.

In the high technology industries it is the technology itself – or, perhaps, more correctly, the economic and institutional environment which generates this technology – which gives the foreign MPE an edge over its local competitors. The transatlantic technological gap is a very real phenomenon – however much one might believe its origins are, essentially, non-technological.

A particularly interesting feature about many MPEs in high technology industries is their attempt to closely integrate their world operating facilities. In the intermediate technology trades, each operating subsidiary in each country is more likely to produce similar products from start to finish, and there is comparatively little trade – either vertical or horizontal – between them.[1] By contrast, there appears to be much more international division of labour in the high technology industries. Sometimes this is vertical, with each subsidiary undertaking a particular process of production or supplying a range of components and parts of a particular product (or groups of products); sometimes it is horizontal, and subsidiaries trade finished products with each other; sometimes, in the case of some of the larger MPEs, e.g. IBM and Ford, it is a mixture of the two.

Such intra-enterprise product or process specialization, which appear to be increasing, has extremely important economic implications both for investing and host countries. This is partly because the operating strategy of each subsidiary is likely to be determined by the parent company (which is usually in the investing country) with the global interests of the enterprise in mind; partly because of the impact of such investment on trade flows; and partly because it is in this kind of MPE where the greatest opportunity for the manipulation of transfer prices occurs. For these reasons it is here where a conflict of interest between the MPE and the nation states in which it operates is most likely to arise. It is here too where national trades unions facing MPEs are most conscious of their weaknesses.[2]

[1] *Board of Trade Journal*, August 16, 1968; *Survey of Current Business*, May 1969. [2] See Chapter 5 of this volume.

We conclude. The level and growth of international direct investment reflects the costs and opportunities for investing firms to best organize their foreign operations in this particular way. The industrial pattern of such investment reflects the extent to which, for one reason or another, international competition is imperfect between firms in particular industries, and the attractiveness of foreign production as a means of overcoming these barriers to entry. The more significant the economies of scale and intra-enterprise integration; the more important enterprise-specific knowledge which cannot be transmitted on paper, the greater the need for product differentiation and the desire of the investing company to grow; then the more attractive international direct investment will be as a vehicle for international business.

Substantially the same approach may be used to explain the *geographical* origin and distribution of international direct investment, although here additional factors, e.g. risks associated with operating in a multi-currency world and political instability, are involved.[1] Just as the leading MPEs possess common features, so do the countries which invest the most outside their boundaries. These mainly fall into one (or more) of three types:

(a) Those countries which engage in foreign investment primarily to exploit market potentialities. Faced with a limited domestic market, enterprises within these countries seek to grow by diversifying their territorial interests. Switzerland and Holland are the classic examples here. Only four of Nestlés 189 plants – which account for 3% of its total sales – are in Switzerland, while Philips of Eindhoven derives more than 80% of its profits from its foreign operations.

(*b*) Those countries which invest mainly to secure materials for their manufacturing industries. This was the traditional *raison d'être* for UK firms venturing abroad in the nineteenth century, and it is still a very powerful inducement for many advanced industrial nations today. In 1968 the US obtained one-third of its imports of raw materials from its foreign subsidiaries, mostly in Canada and the developing countries.

(*c*) Those countries which invest primarily to exploit a comparative advantage which they have, or have acquired, in the ownership of certain kinds of resources – and hence in the production and/or marketing of certain types of products. This kind of capital export is mainly *horizontal* within secondary industry, although

[1] See Chapter 2 of this volume.

the law of comparative costs holds no less for processes of production. Moreover, it is often two-way in character. While most post-war US investment in Europe, for example, reflects her comparative advantage in the innovation of research intensive products,[1] European investment in the US reflects her relative abundance of certain types of labour, and her more heterogeneous markets. The process by which this types of investment takes place has been traced by Raymond Vernon, Gary Hufbauer and others in their analysis of the *product cycle* and *technological gap* theories of trade.[2]

Little empirical research has been done in testing this more macro-approach to the theory of imperfect competition, though the general direction and composition of sales of MPEs of different nationalities would lend support to it.[3] Such macro-work so far published has tended to address itself to a rather different question, viz. what determines the flow of capital across national boundaries. The writings of Guy von Stevens, Alan Severn, R. d'Arge and others[4] have been mainly concerned with 'internationalizing' the theory of domestic investment, and specifying the relationship between foreign investment, profitability and other variables.[5]

This research, though providing us with a useful insight into the determinants of foreign direct investment, has generally much less to do with predicting the behaviour of MPEs. This is because the foreign capital owned by MPEs (which is usually taken as the dependent variable) is a poor proxy for the resources under its *control*. Since 1967, for example, the direct outflow of capital from US to finance the growth of American companies in Europe has been reduced, but the rate of expansion of assets *controlled* by US-affiliated companies has been maintained, as an increasing propor-

[1] W. Gruber, D. Mehta and R. Vernon, *op. cit.*

[2] For a summary of these and other modern trade theories, see G. Hufbauer, 'Theories of International Trade and Technological Progress', in R. Vernon (ed.), *Technological and International Trade*, National Bureau Committee for Economic Research, 1970.

[3] J. H. Dunning and R. D. Pearce, *Business Ratios*, *op. cit.*

[4] See particularly G. V. G. Stevens, 'Capital Mobility and the International Firm', and A. K. Severn, 'Investment and Financial Behaviour of American Direct Investors in Manufacturing': both papers presented at the Conference on International Mobility and Movement of Capital organized by the National Bureau of Economic Research, New York, January/February 1970.

[5] See also A. E. Scaperlanda and L. J. Mauer, 'The Determinants of US Direct Investments in the EEC', *American Economic Review*, September 1969, Vol. LIX, No. 4, Part 1.

tion of the resources used have been recruited locally or from the Euro-dollar market.[1] Probably not more than one-third of the growth of American subsidiaries since 1967 has been financed by new capital from the US and reinvested profits. Indeed, as has been frequently emphasized, the object of many MPEs appears to be to invest a minimum amount of equity in their foreign operations and to use this capital as a catalyst to obtain most of their resources locally. Obviously, this kind of 'geographical' gearing of capital has important implications for the balance of payments of the host and investing countries.

THE ECONOMIC IMPACT OF THE MPE

We now turn to consider the contribution of MPEs or their subsidiaries on the economies of which they are a part, be they host or investing countries.

There are three sorts of data available for us to draw upon. First, at a macro-economic level, there is information, of varied quality and coverage, of the total foreign capital *stock* (both inward and outward), direct investment *flows* and/or earnings of most of the leading investing and recipient countries.[2] Even though it may still not be possible to derive anything like a complete matrix of international flows between countries,[3] one can estimate, with a reasonable degree of accuracy, the contribution of inward or outward investment to such magnitudes as gross national output, capital formation, and the balance of payments. Quite a lot of data has also been collected by private investigators on the role of foreign investment in particular sectors of host and investing economies[4] although, as one might expect, the further one moves from the macro to the micro level, the less comprehensive and reliable data becomes.

[1] See Chapter 3.

[2] Notably that published by US Department of Commerce, UK Board of Trade, Dominion Bureau of Statistics (Canada), Reserve Bank of India, Ministry of International Trade and Industry Materials (Japan), Commonwealth Bureau of Census and Statistics (Australia).

[3] S. Rolfe, *op. cit*; J. Behrman, *op. cit*; S. H. Robock and K. Simmonds, 'How Big is it: the Missing Dimensions', *Columbia Journal of World Business*, May/June 1970.

[4] For example, D. Brash, *American Investment in Australian Industry*, London, Cass, 1967; A. Safarian, *Foreign Ownership in Canadian Industry*, McGraw Hill, 1966; F. Stubenitsky, *American Direct Investment in the Netherlands Industry*, Rotterdam University Press, 1970; R. B. Dickie, *Foreign Investment in France: a Case Study*, Oceana Publications Inc., 1970.

From the viewpoint of the total activities of international firms, one is faced with a much less satisfactory situation, simply because the data of the kind required are not often separately collected. The most obvious starting point is the financial accounts of the firms. Unfortunately, even when these are available they are subject to a great deal of interpretative difficulty. Statistics of the output, employment, sales and exports of foreign or native owned MPEs are collected by even fewer countries, and these only infrequently. Only in 1970 was the Board of Trade able to produce for the first time an estimate (based on data collected in the 1963 Census of Production) on the contribution of foreign-owned enterprises to industrial output.[1] There are no comparable statistics for the US, although the US Department of Commerce regularly publishes fairly detailed analyses of the sales and trading patterns of its foreign subsidiaries. But the problem of reconciling data derived from widely different sources is a very real one, as anyone who has tried to relate the US Department of Commerce data to the production, sales and exports of indigenous firms will have found.

Thirdly, specially commissioned surveys, e.g. the Reddaway enquiry in the UK and the Hufbauer/Adler study in the US,[2] together with an increasing number of private research projects, are considerably adding to our knowledge of the role of international firms in particular industries or regions of various economies, and also of their size, age and market structure.[3] A good deal of preliminary work is also being done on the relationship between MPEs and employees' organizations in the countries in which they operate.[4]

From these sources of data, it is possible to classify countries (or sectors within countries) in one of four ways:

(*a*) Those which are substantial *net colonizers* of multinational operations, i.e. where the sales of the foreign subsidiaries of its domestic companies exceed, by a substantial margin, those of the foreign enterprises operating in it. Switzerland and the US are two countries which are in this category. Sometimes the *absolute* amount of net outward investment is large, while *relative* to domestic operations the foreign contribution is not of major importance, as in the US: sometimes the reverse is the case, as in

[1] Board of Trade, *Summary Tables*, 1963, Vol. 132. *Census of Production*, HMSO, 1970.

[2] G. Hufbauer and M. Adler, *Overseas Manufacturing Investments and the Balance of Payments*, US Treasury Dept., Washington, 1968.

[3] *Ibid.*, W. B. Reddaway *et al.*, *op. cit.*

[4] Trades Union Congress, *International Companies*, 1971.

Switzerland. In the UK the food, drink, tobacco and textile industries are among the leading net colonizers of multinational activity.

(*b*) Those which are both *colonizers* and are *colonized* by MPEs, i.e. which are important both as capital exporters and capital importers. The UK and Holland are the most long-standing examples of countries which are cross-hauliers of capital. Other European countries, e.g. Sweden and Germany, are more recent illustrations. The rubber-tyre industry of France, the pharmaceutical industry of Switzerland and the tobacco industry of the US are among sectors in which there is inward investment and which themselves operate overseas.

(*c*) Those which are *net colonized* by foreign-owned MPEs. Countries falling into this group are of two kinds. First, the high income but low-populated countries, e.g. Canada and Australia where, in spite of substantial indigenous resources and a highly-skilled workforce, small markets make it difficult for certain industrial sectors to operate on the scale necessary to exploit their full potential, or adequately finance research and development. Second, the less-developed countries, where the investment is in intermediate technology industries and in resource exploitation. As far as colonized sectors within an economy are concerned, the UK motor vehicles industry is a good example: in 1965, the (book) value of the foreign capital stake in the sector was £3,045 million, while British motor car companies owned about £150 million of assets abroad.

(*d*) Those countries and sectors may be added which, for one reason or another, neither attract inward investment nor invest themselves overseas. The countries include some LDCs, most communist countries and, until recently, Japan; the sectors (in most countries) include shipbuilding, woollen textiles and clothing, and aircraft.

Is it possible to explain why a country or sector should fall into one of these four categories? An analogy with the behaviour of firms may help. An enterprise is most likely to be colonized (i.e. taken over) by another firm whenever its assets are undervalued and/or whenever the buying enterprise believes it can use its resources and/or markets more profitably. The entry of national companies into overseas markets can be interpreted in similar terms, whether an existing foreign firm is purchased or a new enterprise set up. Since both the incentive and the ability of firms to be colonizers will vary between countries and industries, the level and pattern of activity by MPEs of different nationality will tend to differ. We have already explained the importance of knowledge as an agent of production, and the fact that it is expensive to produce. Yet, once produced, knowledge has a low marginal cost of exploitation. Rather than export the products of its knowledge or sell its knowledge to a foreign firm, the innovating firm may find it more profitable to exploit its advantage by colonization, particularly where the recipient country has a comparative cost advantage in the production or marketing of the goods in question. This sort of analysis certainly helps to explain why, for example, the motor vehicle and electronics industries in most countries of the world are *net colonized by* US firms. In other cases, particularly in the LDCs, the foreign penetration of an industry is better understood in terms of the marketing, financial or scale advantages of the colonizing firms.

There are, of course, a host of other factors – political, institutional and sociological – which might also influence the degree of colonization by MPEs, including the way the host economy is organized and the extent to which the benefits of particular MPEs can be obtained in other ways. The post-war experience of Japan is quite different from that of Germany. Its cultural background and strong nationalistic sentiments have largely determined its attitude towards foreign investment. There seems little doubt that had Japan followed the course of the UK and Germany in encouraging inward investment, several sectors of her economy would now be dominated by foreign (and particularly US) firms. The extent to which an importing country can absorb foreign capital is also influenced by its particular phase of growth (compare Australia now and before the war) and by the comparative efficiency of its firms *vis-à-vis* its international competitors.

Usually, of course, the comparative advantage of one nation over another does not apply across the board, nor is it necessarily maintained over time.[1] This helps to explain why two way currents in investment can and do occur. Canada is substantially a capital importer but in certain industries, viz. agricultural machinery, aluminium processing, etc. her own MPEs are among the largest in the world. Australia has substantial foreign investments in food processing and the Swiss in pharmaceuticals; Philips of Eindhoven is the fifth largest foreign company in the UK, while Japanese firms

[1] For the experience of British investment in the US, see T. C. Coram, *The Role of British Capital in the Development of the US 1600–1915*, M.Sc. (Soc. Science) thesis, University of Southampton, 1967.

are carving out an important share of the South American market in heavy iron and steel products. The UK insurance industry owns foreign assets considerably in excess of those possessed by other nationalities; at the same time, overseas banks in London account for 15% of all bank deposits in the UK.[1]

It is not, then, surprising that foreign investment tends to be concentrated in particular industrial sectors. Where the investment is also concentrated in the hands of a few firms, who use this capital as a catalyst to gain control over local resources, the impact of MPEs becomes that much greater and of more concern to host nations. And it is a fact that by far the larger part of international investment of all countries is undertaken by large firms competing under conditions of imperfect oligopoly.[2] Thus the impact of the MPE is considerably understated by the value of its foreign investment. The question now arises: to what extent is this impact different from that of a domestic firm of comparable size?

THE ECONOMIC ISSUES INVOLVED

In this section we shall try and pinpoint some of the *economic* consequences of the presence of foreign-owned MPEs to nation states. These, of course, are not the only issues; indeed sometimes they may be secondary to political, social and cultural ones.

One thing which many studies of the multinational enterprise fail to establish is the extent to which any differences in its behaviour, compared with that of a national company, are due specifically to its 'multinationalism'. It is, for example, perfectly possible for an American subsidiary in the UK to perform more (or less) efficiently than a UK competitor for reasons, e.g. of size, product structure or technical expertise which have nothing to do with the fact that it is a subsidiary of a foreign enterprise. On the other hand, it could be *because* it is part of a MPE that its behaviour and impact in certain situations is quite different.

What, then, are the distinctive features of multinational businesses? We examine three aspects of the problem. First, the ways in which the MPE is analytically or conceptually different from a NPE. Second, whether or not its behaviour is likely to be different. And third, the extent to which its consequences on economic welfare are likely to be different.

[1] 'Foreign Banks in London', *The Banker*, November 1970.

[2] S. Hymer and R. Rowthorn, 'Multinational Corporations and International Oligopoly', in Kindleberger, *op. cit.*

ANALYTICAL FEATURES

(1) *The Theory of the Firm*

As a firm widens its territorial horizons, it changes its character to a certain extent. An enterprise which graduates from supplying a regional market to supplying a national market finds itself in competition with new firms and is faced with new market structures. Similarly, a firm with plants in more than one part of the country will have more flexibility in the organization of its activities than that possessed by a single plant firm. Depending on the importance of these differences, a plant operating in a particular location which is part of a multi-plant firm may be organized and perform differently than its single plant competitors, and its impact on the local region may also be different.[1]

As a firm goes 'international' in its operations these same considerations apply but they are intensified. (Compare, for example, the production and market conditions for rubber tyres in different parts of the UK with that in Pakistan.) The fact that the environment to which the new foreign investor is accustomed is different from that of its local competitors may give it certain advantages. If, for example, the host economy is becoming generally more capital-intensive in its production methods then, obviously, enterprises from countries more experienced in these methods will have the edge over local firms. Indeed, one of the most important competitive advantages of MPEs arises because they can draw upon their operating experience in different economic environments. This advantage is not only confined to production techniques. Knowledge gained in marketing, industrial relations, investment appraisal and so on may be equally valuable. As long as the MPE has the opportunity to make use of this experience – and chooses to do so – then it both increases its own efficiency and, because it is free to transfer its knowledge within its organization, that of the world economy as well.

In addition, there are differences between countries of a legal, political or cultural character which may also influence not only the amount of foreign investment undertaken, but the behaviour of investing firms. For, like the uncertainty surrounding the exchange rate, they may add a risk premium to foreign operations which, allowing for differentials in rates of taxation, may affect the way a MPE chooses (or would prefer) to allocate its profits between

[1] In a survey of some of the issues involved, see H. W. Richardson, *Regional Economics*, London, Weidenfeld & Nicolson, 1969.

countries. None of these problems really face the multi-plant domestic firm. Within a country there is usually unrestricted (though not costless) mobility of factor inputs and goods; there is a single currency and rarely will there be any substantial differences in the rate of profits tax between the regions.

The effects of these distortions on the activities of businesses are, of course, not confined to international firms. But the MPE is in a better position to overcome them. In order to minimize its world tax burden it is able to manipulate (or, at least, attempt to manipulate) its intra-group prices, both of goods and services, so as to record as high a profit as it can in low tax countries at the expense of profits in high tax countries. Neither this opportunity, nor those which arise from the ability of the MPE to organize the movement of goods and resources between countries to take advantage of the most favourable prices, are as readily available to NPEs.

Conceptually, there is no real difficulty in incorporating these new dimensions into the theory of the firm. On the other hand, it is possible that the utility function of managers of multinational businesses is different from that of managers of national enterprises. The motivation of local management may be influenced by local customs and constraints: indeed, in order to pacify host governments and avoid any charge of exploitation, the firm may adopt a 'satisfying' rather than 'maximizing' approach to projects. These differences in objectives are likely to be intensified where the subsidiary of the MPE is partly owned by local interests, the objectives of whom may not be the same as the foreign shareholders.[1]

(2) *The Theory of International Trade*

Another area in which the activities of the multinational enterprise are different from that of the national enterprise is in the behaviour of trade flows. Almost all theories of international trade presuppose that trade is conducted between independent firms – the conditions and terms of which are determined by normal market forces – subject to macro-economic constraints.

The introduction of the MPE has affected trade flows in two ways. First, as we have seen, a substantial part of world trade, probably about one-eighth, is trade internal to MPEs. To be sure, some of this trade may well have taken place in any event – particularly the purchase of raw materials and sales of finished products; in other cases, the international spread of production facilities has been trade substituting. But a third type of trade which we might call cross-

[1] E. Kolde, *International Business Enterprise*, New York, Prentice-Hall, 1968.

horizontal trade is very much a product of the MPE and, in particular, of the way in which its world-wide operations are organized. To take one example, the world trade in electronic computers and related products is strongly influenced by the larger MPEs, which tend to be highly integrated in their operations and generate a considerable amount of *intra*-enterprise trade. The pattern of this trade would be quite different if each nation was self sufficient in its computer production and/or MPEs operated self-contained operating units in each country.

The second effect of the MPE on trade is much more difficult to assess. In spite of some quite sophisticated work by UK and US economists,[1] we still know very little about the extent to which the MPE affects *inter*-enterprise trade between countries. So much rests on the assumptions we make about the so-called 'alternative' position, i.e. what would have happened in the absence of the MPE. No generalization applicable to all situations seems possible,[2] although there is a strong presumption that MPEs have increased world trade since (*a*) international direct investment has almost certainly added to the level and quality of the world's real capital stock and hence world output, and (*b*) on average, the growth of world trade has kept pace with the growth of world output.

No one can doubt, however, that the geographical and industrial pattern of world trade has been very much affected by the operations of multinational enterprises. This can be seen *inter alia* by comparing the import and export performance of subsidiaries of MPEs with that of domestic companies.[3] It has been estimated, for example, that one-third of the increase in Europe's exports of technologically advanced products between 1955 and 1964 was accounted for by US-financed firms.[4] An even more dramatic impact is revealed by the composition of Canadian exports and some of those of the LDCs.[5] The full implications of these trends which partly reflect the

[1] W. B. Reddaway *et al.*, *op. cit.*; Hufbauer and Adler, *op. cit.*, and present research now being undertaken by the NBER.

[2] W. B. Reddaway, *op. cit.*

[3] For the UK experience, see *Board of Trade Journal*, August 16, 1968.

[4] J. H. Dunning, 'European and US Trade Patterns and US Foreign Investment', in C. P. Kindleberger and A. Shonfield (eds.), *North American and Western European Economic Policies*, Macmillan, 1971.

[5] A. E. Safarian, 'The Exports of American-Owned Exports in Canada', *Papers and Proceedings of the American Economic Association*, Vol. LIX, No. 3, May 1964 and L. Needlemam and others. Flow of provincial resources: balance of payments effects of private foreign investment. Case studies of Jamaica and Kenya UNCTAD document TD/B/C. 3/79. July 1970.

effect which MPEs have had on the comparative trading advantage of nations and partly the trading policies of MPEs (for example, since devaluation, the UK has become a more attractive base from which US firms can export to third markets) has not yet been worked out by international trade theorists, and there is a fruitful area for research here.[1]

There are various other branches of economic analysis which may need to be re-thought in the light of the growth of the international firm. The role of the MPE as a transmitter of factor inputs, particularly knowledge and entrepreneurship across national boundaries, and its impact on the economic development of host nations, is one of these; another is its implications for the theory of economic welfare of both investing and host nations; a third is the theory of wages and collective bargaining.

(3) *Policy*

In the last resort, policy towards the MPE cannot be better than the policy-maker's understanding of the causes and effects of its behaviour. There are five main steps in the policy-formulating process:

(*a*) The recognition of a problem, or a phenomenon to be explained, e.g. that MPEs supply an important part of the output of a particular industry, or are instrumental in changing the pattern of a country's trade.
(*b*) The identification of the character of the problem, e.g. an evaluation of the net benefits (or costs) resulting from the presence of MPEs compared, for example, with those which would have occurred had the resources been obtained in a different way.
(*c*) An understanding of the factors influencing the behaviour of the main decision-taking units involved, e.g. in what way does the behaviour of the MPE differ from that of the NPE?
(*d*) A cost/benefit analysis of alternative policies which might be pursued either to affect the behaviour of the MPE, or of other economic agents, as a result of its effects.
(*e*) The choice of policy which is thought most likely to satisfy the policy-makers' objectives.

So far, thinking on these problems has advanced little beyond the first stage – yet all too often the policy makers choose to introduce measures and programmes based on hunches and prejudice rather than on substantive evidence.

[1] See also Chapter 6 in this volume.

Assume that there is something to be explained. How can one identify the characteristics of the problem? In what way are the economic objectives of governments advanced or hindered by the presence of foreign-owned firms. We have already suggested that only by comparing the actual behaviour and performance of MPEs with some alternative pattern of resource allocation can this question be properly answered. As a first shot let us make some very simple assumptions. The first is that governments of both host and investing countries pursue neutral policies towards the foreign operation of their MPEs; second, that corporate tax rates are identical for all countries and that there are zero risks associated with political instability or changes in the exchange rate. Third, that the utility functions of international firms (and their subsidiaries) are the same as those of NPEs.

Given these assumptions, in what ways might the impact of a subsidiary of a foreign-owned MPE on the local economy be distinctive? There are several possibilities, the more important of which are as follows.

(*a*) Its operating efficiency may be affected by the knowledge available to it from the rest of the enterprise of which it is part.
(*b*) As a result of (*a*), its methods of production, labour policies, marketing and purchasing techniques, financial strategies and so on may be different.
(*c*) Both the composition of the output it supplies, and the degree to which its operations are (internationally) vertically or horizontally integrated may be different.
(*d*) The level and pattern of its imports and exports may be different.
(*e*) The share of its value added, remitted (or credited) to non-resident shareholders will be greater.
(*f*) The external or spill-over effects, associated with its operations, e.g. the dissemination of knowledge, competitive stimulus, etc. may be more or less.

Each of these differences may affect, for good or bad, the economic welfare of the host country. In the short run, this will show itself in the level and structure of the domestic output and distribution of national income; over a longer period it may have far-reaching effects on the host country's international competitive position, the pattern of its economic growth and its relationships with the investing country.

If we now introduce an element of government intervention into the situation, then this list of possible differences in the behaviour of the MPE is extended quite considerably.

First, if for whatever reason, the government of the investing company has the power, and uses the power, to influence the decision-taking of (or with respect to) the foreign subsidiaries of the MPE, then it is possible that the economic welfare of the host country may be affected. The favourite examples of extra-territorality usually quoted are the control of dividends policy and the constraints placed on US companies and their subsidiaries, on which countries they can trade with, and the extent to which they can associate with other firms. In each of these respects the policy of the US Government may not always be in accord with either the best interests of American subsidiaries or the policies of governments in host countries.[1]

Second, the fiscal, mainly taxation, policies pursued by governments of both investing and host countries will obviously influence the net profitability of the MPE and will cause it to arrange its intra-group trading in such a way as to earn profits where they are taxed the least. The *power* of companies to shift profits is the direct outcome of their multinational operations: the *incentive* to do so is due to the differential treatment by countries of income earned.

Third, because of these differences, multinational companies may well respond differently to the economic policies of host countries and, in some cases, may be able to avoid constraints on their conduct better than national firms. A credit squeeze in the UK may simply encourage US subsidiaries to obtain additional finance from their parent companies; the reactions of such firms to various incentives, e.g. investment allowances and the regional employment premium, may also differ from that of their native competitors.

THE NATION STATE CONTROVERSY

It is these differences in the behaviour of international companies and their effects on national economic welfare which sometimes prompts a rather cautious attitude on the part of host governments towards them. Without detailed empirical research, one can say very little about the precise effects of such companies on particular recipient countries. But we do, perhaps, know enough to suggest under what conditions they are most likely to lead to an increase in

[1] Such as the measures taken by President Johnson in January 1968 to reduce the flow of new US foreign investment, which helped to exacerbate the balance of payments difficulties of a number of recipient countries.

economic welfare, and what might be done to maximize their net social benefits.

At the start, I think it important to accept there is almost certain to be a conflict between the *objectives* of a subsidiary of a foreign-owned firm and those of the host nation. To a certain extent, such a conflict exists between a domestically-owned MPE or NPEs and the nation state of which they are part: only very indirectly, for example, are such companies concerned with broader economic and social objectives. But because some of the resources of the subsidiary of a foreign company are owned outside the country in which it operates, an additional conflict arises. Profits (and interest) earned by a national firm contribute to the country's net income: profits (and interest) earned and remitted by a subsidiary of a foreign-owned firm contribute to the income of the *investing* country. This means that while the host country is concerned with minimizing the profit component of any given output generated by the MPE (i.e. maximizing the local value added – *lva*), the MPE may reasonably wish to maximize this component.

While accepting that, in practice, profit maximization may not always be the objective of MPEs, let us assume for the moment that their behaviour is geared to this end. Now, clearly, there are various ways by which the host government can try and keep the profits of international firms to the minimum consistent with maintaining their presence. Much of its policy towards monopolies and restrictive practices, to which foreign firms are as much subject as are domestic firms, has this aim. But because the foreign-owned subsidiary is sometimes able to increase the earnings remitted to the investing country by various devices not open to the domestic firm, some observers have suggested that more discriminatory measures are needed to ensure it conforms to national objectives.

There is some *non sequitur* in this argument. It does not necessarily follow, even if there is a conflict of objectives between the international enterprise and the nation state, that the final economic impact of the MPE, in the absence of government interference, might not be in the nation state's best interests. This entirely depends on whether, in its absence, the resources it uses could have been better deployed elsewhere; not whether the subsidiary is producing at maximum efficiency or its *lva* is as high as it might be.

Let us try and elaborate this argument. Suppose the host country has a single objective – to maximize its gross national product (GNP), or rate of growth of GNP, from the resources available. The contribution of foreign subsidiaries to this target is the increase in net output (i.e. above that which occurred in their absence), less the share of income accruing to the investing company, i.e. *lva*. This contribution will depend on (*a*) the efficiency of the subsidiary of the MPE, and the extent to which, by one means or another, it increases or decreases the productivity of other companies in the economy, and (*b*) on the share of the total value added remitted to the investing company. This includes not only the recorded profits and interests on capital invested, but also 'disguised' profits contained in royalties and fees paid for services rendered. These may be thought of as the 'price' which has to be paid by the host country to the investing country for the investment.

We have suggested that one reason why the *lva* of a foreign subsidiary might be lower than it could be is that its market position allows it to earn above competitive profits. Policy here, as with domestic firms in a similar situation, must obviously direct itself to stimulating competition or, at least, curbing the abuses of monopoly power. The peculiar feature of much American foreign investment in high technology industries, however, is that the size of most domestic markets outside the US does not permit more than one or two firms to derive the fullest advantages from the economies of scale, and because of the economies of large-scale research, larger firms often have the edge on their smaller competitors. This means that to maintain effective competition against the American challenge some host countries may need to encourage the merger of enterprises, not only within their boundaries but across boundaries.

A second and related problem arises from the diffusion of knowledge first introduced by MPEs. Only in certain circumstances will it be in the enterprises' best interest to encourage this. Certainly, the vertical dissemination of knowledge by US subsidiaries to their British component suppliers and their customers has been one of their most valuable spillover effects.[1] And the type of knowledge which is specific to the enterprise, but which cannot be patented or put down on paper, e.g. much of managerial, marketing and organization know-how, permeates into the economy in other ways. Again, however, it is difficult to see what the host economy can do except create the type of environment most conducive to the spread of this knowledge.

The contribution of foreign firms to economic growth will also depend on the type of activity in which they engage, as this affects the productivity of local resources used. We have dealt with one

[1] J. H. Dunning, *American Investment in British Manufacturing Industry*, London, Allen & Unwin, 1958.