

American Business Abroad

Six Lectures on Direct Investment

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Lecture I

The Theory of Direct Investment

There is no single obvious principle for organizing a topic as complex as direct investment—sometimes also referred to as the international corporation or the multinational corporation. One organizational choice lies between theoretical analysis and empirical description; another, within description, between classification by industry—between, say, manufacturing and mining plus extraction—and by geographical area or level of development. In what follows we compromise. The first and last lectures are devoted to theory, the theory of direct investment and of the international corporation, respectively. Sandwiched between them are four treatments with an ostensibly geographic orientation. The second lecture is on the interests of the United States, which have been the source of many or most of the newer firms to the ranks of direct investors or international corporations, and enjoys or suffers the problems of the situs of the parent companies. Three subsequent lectures are focused primarily by regions—although many of the problems treated in each are general to all—Europe and Japan, the Dominions, and the less developed countries.

Direct Investment as a Capital Movement

Direct investment used to be thought of by economists as an international capital movement. Capital move-

ments take place in a variety of forms—through the issue of new securities, largely bonds; through purchases and sales of outstanding securities, both stocks and bonds, on security exchanges; through a variety of short-term credit instruments and forms; and through direct investment. Direct investment differed from other kinds of international capital movements in that it was accompanied by varying degrees of control, plus technology and management. But it was a capital movement.

For some purposes, and especially in the concerns of the United States, the capital movement features of direct investment remain paramount. Plagued by a balance-of-payments deficit, the United States imposed a set of voluntary controls on direct investment in February 1965 and converted them to mandatory restrictions in January 1968. More, much more, on this below. There is, in addition, renewed interest in the capital aspects of direct investment from a theoretical point of view, and particularly in the way national capital markets can be joined internationally through the markets for whole companies, in contrast with securities traded in organized markets. This subject will also occupy us later. But economists trying to interpret direct investment as a capital movement were struck by several peculiar phenomena. In the first place, investors often failed to take money with them when they went abroad to acquire control of a company; instead they would borrow in the local market. Capital movements would take place gross—the acquisition of an asset (an outflow) and the incurring of a liability (an inflow)—but not net. Or the investment would take place in kind, through the exchange of property—patents, technology, or machinery—against equity claims, without the normal transfer of funds through the foreign exchange associated with capital movements.

And direct investment would proceed by the reinvestment of profits, with the capital outflow matched by earnings on past investment, but again no movement of funds through the foreign-exchange market. On this showing the clue to direct investment lay in capital formation, not in capital movement.¹

In the second place, direct investment often takes place simultaneously in two directions. United States companies invest in Europe, and European companies invest in the United States. Such two-way movements occur to some degree in securities, as investors seek to diversify their portfolios on the one hand, or to escape taxation, confiscation, or other real or imagined evils on the other. Europe and Canada own a lot of United States corporate stocks. The contrast is rather with bonds, where, prior to the imposition of the Interest Equalization Tax in 1963 which cut off the flow, foreign debtors would issue bonds in New York, but United States debtors would not issue bonds abroad to raise funds for expenditure in this country.

Direct investment may thus be capital movement, but it is more than that.

Control

Direct investment has long been defined as a capital movement involving continuing control by the investor. Sometimes this is put in legal terms, depending upon whether the equity ownership amounts to 10, 25, 48, 51, 95, or 100 percent of the foreign subsidiary. The 1968 mandatory restrictions on foreign direct investment, for

1. Jack N. Behrman, "Promoting Free World Economic Development Through Direct Investment," *American Economic Review*, 50, No. 2 (May 1960), 271-81.

example, choose 10 percent as the criterion. To the economist, of course, the test is not the extent of ownership, but the locus of decision-making power. It is said that one 100 percent British-owned subsidiary of an American company has carried decentralized decision-making so far that it tells its parent, rather than asks it, even on the focal issues of dividends, capital budgeting, new products, research, and top personnel appointments, which decentralized corporations ordinarily reserve for centralized decision. If this is true, it is no different from an ordinary portfolio investment.

The economist, moreover, is interested in control only insofar as it affects behavior. In their study, *Canadian-United States Economic Relations*, Irving Brecher and S. S. Reisman are inclined to deprecate the importance of United States direct investment in Canada.² They argue that two companies, one foreign, one Canadian, operating in the same circumstances, both presumably rational and both seeking to maximize earnings, will operate in the same way. Things equal to the same thing are equal to each other. But a Canadian corporation and a foreign corporation in the same industry in Canada, even if both are unaffected by government, are not necessarily the same thing. If the Canadian corporation were an international firm of the same size and extent as the foreign, this might be so. For a company of a given volume and structure of assets and earnings it would make little difference economically whether the ownership were Canadian or United States. But assume that the Canadian is a national and the American an international corporation. They will scan different horizons in space, and possibly in time, and maximize different ob-

2. Ottawa, Queen's Printer, 1957.

jective functions. The international corporation may take depreciation allowances out of Canada to invest in a cheaper new source of output, whereas the Canadian firm's choice would be between expanding production in Canada or not expanding at all. Or in the event of world depression, the international corporation might cut back production in its various locations on the basis of the grief it foresaw from various national institutions—governments, unions, public opinion—rather than cutting back high-cost units first so as to equalize the marginal cost of production in each operation. With a narrower spatial and a shorter time horizon, the Canadian firm, because it is national and smaller, maximizes income in a Canadian context in the short run, the international firm in a world context in the long run. They may well then behave differently.

The control aspect of direct investment, which economists have been inclined to dismiss, is increasingly assuming political significance. In part this is the result of an unresolved conflict in international law; in part the result of what we may loosely characterize as pure nationalism. On the first score, for example, the United States assumes that it has the right to require parent companies to direct the operations of their subsidiaries in ways that conform to American purposes, while foreign governments, sovereign over the territory where these subsidiaries are located, deny the existence of such a right. What I have called pure nationalism is the uneasiness that many people instinctively have when they contemplate the fact that the activities of institutions within their economy and polity are "controlled" from outside the political unit. I shall argue that this feeling, like so many of the instincts direct investment or the international corporation arouses over the globe, is not to be

trusted. The international corporation should be judged by how it operates, not for what it is. Scratch any of us deeply enough and you will find instincts of nationalism or xenophobia, overlain though they may be with layers of civilizing repression, and equally, instincts of peasant attachment to the soil; also populist fear of outside capital, mercantilist pleasure in expanding exports, on which I expatiate below, and perhaps others. The reactions are understandable, but they are not on that account to be approved.

The political, as distinct from the economic and legal, issue of control is thus made up of two elements, one involving attempts by governments to achieve national purposes through international corporations with headquarters in their jurisdictions and of other countries to resist them, and one of what I have called pure nationalism. It will be difficult to keep them distinct.

Growth of the Firm

There is a variety of theories about the firm, but the essence, at least in a number of theories, is growth. Firms manage and allocate resources; they innovate in new products; they are legal people; but primarily they grow. In growing they may well go abroad; in going abroad, they grow abroad.

In one formulation associated with the reinvestment of earnings, this comes close to a gambling theory of foreign investment. It has been observed that roughly half the earnings on foreign investment are reinvested abroad. From this a decision rule is deduced that firms bring home half their winnings and plow back the other half.³

3. E. R. Barlow and J. T. Wender, *Foreign Investment and Taxation* (Englewood Cliffs, N.J., Prentice-Hall, 1955).

The fact that there is an average reinvestment of half of their foreign earnings by United States companies cannot be doubted, but the existence of a rule of thumb that ascribes such conduct to individual corporations can be. A rule of thumb makes sense only when the benefits from its adoption in the reduction of costs of decision-making exceed the possible losses in poor investment choice. It is hard to believe that any firm is so irrational as to invest abroad by rule of thumb.⁴

Reinvest they do, when they have both profits and prospects for further profits.⁵ The rate of reinvestment evidently depends on both profits and profitability. Nor is there any basis for suggesting that new investment is limited, after the initial start, to profits on past investment, on some sort of compound-interest formula. Investment goes forward on the basis of past earnings, new funds from the parent company, and new borrowings at home and especially abroad.

Within the total view that direct investment is a function of the growth of the firm are two strands, one emphasizing the market, the other the internal source of finance. The first is very much in vogue among business men. Direct investment, they say, is stimulated not by profits but by markets. Not only separate business spokesmen, like Mr. Richard Fenton formerly of Pfizer Inter-

4. For another rule of thumb, see Jean-Jacques Servan-Schreiber, who quotes a survey by a company named Donaldson and Lufkin which says that United States business considers it normal to invest 20 to 30 percent of its assets in Europe (*The American Challenge* [New York, Atheneum, 1968], p. 11). But the variance around such numbers, even if they should be valid averages, is so wide as to make the statement of little interest.

5. E. T. Pervose, "Foreign Investment and the Growth of the Firm," *Economic Journal*, 66 (June 1956), 220-35.

national, but the business community as a whole, as recorded in the questionnaires of the National Industrial Conference Board, insist that business investments seek markets.⁶ From markets a firm can imply a market share, a volume of sales, and an earnings-to-sales ratio. A senior executive is quoted as saying: "If we can look forward to a certain *level of sales* we won't hesitate to invest, for our profit will justify any amount of investment needed to support an operation."⁷ It is easy, of course, to find counterexamples, where companies have a large foreign market supplied by exports, and with investment limited to distribution facilities and inventories, if any investment is needed at all. An outstanding example is the Volkswagen company which enjoys substantial sales in the United States, but deliberately refrains from domestic manufacture, having in fact first bought and then sold a former Studebaker plant at Linden, New Jersey. But the explanations which businessmen give of their thought processes must not be taken with literal seriousness. Like Monsieur Jourdain in Molière's *Le Bourgeois Gentilhomme* who spoke prose all his life without having been aware of it, they doubtless maximize profits rather than merely follow markets.

One factor accounting for the gap between business behavior and business perception of it may be the initial lag between investment and profits, resulting from "breaking-in" or "teething" troubles. A chemical firm established overseas for forty years found that its pre-

6. Judd Polk, Irene W. Meister, and Lawrence A. Veit, *U.S. Production Abroad and the Balance of Payments: A Survey of Corporate Investment Experience* (New York, National Industrial Conference Board, 1966), Chapter 4.

7. *Ibid.*, p. 67. Italics in original.

World War II investment, which accounted for 42.5 percent of overseas assets, produced 53.5 percent of total earnings and 82 percent of dividends.⁸ Subsequent investments are putatively as profitable as the earlier, with a time profile for earnings which starts low, or even negative, and rises to a normal long-run rate after a considerable interval. But the terrible possibility must be considered that businessmen actually do as they say they do and invest where markets are, without sufficiently considering long-run profits margins. The troubles of Chrysler with Rootes and Simca and of General Electric with Machines Bull in French computers raise the specter of such an outcome. But the returns are far from in.

Linking direct investment to markets and market position leads to an organic view of the process, as opposed to what we might call a mechanical one. The issue arises in connection with balance-of-payments restrictions, discussed in the next lecture. But the theory is clear. Direct investment is tied to markets. If markets grow, the firm must grow. If the firm stops growing, it dies. Anything that interferes with the growth of the firm, such as balance-of-payments restrictions, while the organic life of the market goes its way will kill the firm. But the issue can wait.

The second view connects direct investment not with

8. From a master's thesis at M.I.T. by G. V. Lydecker, "Direct Foreign Investment and the Balance of Payments: A Study of the President's Program of Voluntary Restraint" (1966), p. 106.

Another company (*ibid.*, p. 98) stated that the bulk of its dividends came from the mature investments "as would be expected."

See also "Cummins Trimming Ventures in Europe," *New York Times* (January 22, 1968), which states that losses to date are about \$8.4 million on \$17 million invested in three plants in Britain, one opened in 1957 and two in 1966.

markets but with the cost of capital to the firm. Many economists regard retained earnings as not only cheaper capital than borrowings or the sale of new equities, but so cheap as to approach a negative cost. Extra dividends for stockholders only lead them to expect more. So long as there is any reasonable basis for expansion, the firm should reinvest rather than pay out profits above some long-run, and very slowly rising, amount. In addition, ploughed-back earnings escape the personal income tax and can be cashed in, if need be, at the lower rates on capital gains. If opportunities for growth at home are limited, look abroad. In any event, grow.

There is something to this doctrine, but how much cannot be tested quantitatively with current Department of Commerce data, which lump open-book claims with equity as "direct investment." In 1957, when the latest published survey of United States foreign investment was undertaken, foreign sources of capital provided 40 percent of total assets, largely in debt, and 25 percent of the total debt financing was furnished from the United States. Since 1957, however, and especially since 1963, United States companies have been borrowing in the Euro-bond market and the Euro-dollar market at rates of interest that may be small compared with expected profit possibilities and with the rates at which European companies borrow but are high by United States capital market standards. Direct investment involves much more than the reinvestment of funds that United States business is reluctant to distribute to shareholders. Firms grow, and may grow abroad rather than at home for one reason or another, but direct investment involves entering into commitments and taking risks, not merely investing earnings for which no better use is handy.

Monopolistic Competition

Each of these explanations—capital movement packaged with decision-making and associated with technology, former of capital, consequence of the growth of the firm—has an element of the truth but none provides an entirely satisfactory explanation of the phenomenon. The United States government is currently fostering direct investment while seeking to limit the capital outflow involved. The thesis that asserts firms are irrational and invest as if they were gambling is hardly persuasive, possibly not *a priori*, but at least in a Darwinian sense. As long as some foreign markets continue to be served by imports, as well as by production near the market, the notion that direct investment is a function of markets alone is unconvincing. Control may lie at the root of the problem presented by direct investment, but why do some firms want to control and not others?

A more general theory—originally propounded in a thesis at the Massachusetts Institute of Technology by Stephen H. Hymer—is that direct investment belongs more to the theory of industrial organization than to the theory of international capital movements.⁹ The investing company can earn a higher rate of return abroad than at home—as it must if it undertakes the risks and overcomes the costs of operating in a different political and legal environment, at a distance from its decision-making center. It is not enough for the return to be higher abroad than at home. If this were all, capital would move through organized capital markets rather than through

9. Stephen H. Hymer, "The International Operations of National Firms: A Study of Direct Investment" (doctoral dissertation, Cambridge, Mass., M.I.T., 1960).

firms that specialize in the production and distribution of goods. Capital markets specialize in moving capital, and under competitive conditions they are better at it than firms engaged in other lines. In addition to earning more abroad than at home, the investing firm must be able to earn a higher return in the market where it is investing than local firms earn. There are costs of operating at a distance, costs not only of travel, communication, and time lost in communicating information and decisions, but also costs of misunderstanding that leads to errors.¹⁰ For a firm to undertake direct investment in a foreign country it must have an advantage over existing or potentially competitive firms in that country. If not, those firms, operating more cheaply in other respects because nearer the locus of decision-making and without the filter of long lines to distort communication, would put the intruder out of business. One is tempted to say that foreign firms which specialize in market-oriented products will be able successfully to establish subsidiaries in a country that does not produce the goods. But this is not so unless the firms possess some advantage which they can transfer from one country to

10. Answering a question at a business conference, a banker stated: "Most American companies expect and do get a higher return on their capital abroad than they do in the U.S. This is justified if only because the risk of investment outside your own country is greater. This is not so much a political risk in Europe as the risk of not being able to see business opportunities as clearly as the local company." See E. Russell Eggers, Manager, The Chase Manhattan Bank, Paris, "The Pattern of American Investment in Europe," Record of Proceedings Second International Investment Symposium, New College, Oxford, July 1964, in *The Changing World* (London, P. N. Kemp-Coe, 1965), p. 287. For this last risk, of course, it is necessary to have a higher original rate of return than foreign, not domestic, companies.

another but which cannot be acquired by local firms. With perfect international markets for technology, management, labor skills, components, and other material input, the market abroad will be served by a local firm.

Put the matter another way: in a world of perfect competition for goods and factors, direct investment cannot exist. In these conditions, domestic firms would have an advantage over foreign firms in the proximity of their operations to their decision-making centers, so that no firm could survive in foreign operation. For direct investment to thrive there must be some imperfection in markets for goods or factors, including among the latter technology, or some interference in competition by government or by firms, which separates markets.

This theory may be illustrated by contrasting it with another. In their interesting *Federal Tax Treatment of Foreign Income*, Krause and Dam assert: "Another reason for investing abroad is that production costs may be lower than in the United States because of favorable wage rates, raw material prices, or interest rates . . . or because of the opportunity to reduce transportation costs, distribution costs, inventory and servicing costs to the markets for which the outputs are intended."¹¹ In the present view cheaper costs abroad than at home are not enough. What must be explained is why the production abroad is not undertaken by local entrepreneurs, who have an inherent advantage over outside investors. There must be a more than compensating advantage on the part of the foreigner before direct investment will be called forth.

The nature of the monopolistic advantages which pro-

11. Lawrence B. Krause and Kenneth W. Dam, *Federal Tax Treatment of Foreign Income* (Washington, D.C., The Brookings Institution, 1954), p. 64.

duce direct investment can be indicated under a variety of headings:

1. departures from perfect competition in goods markets, including product differentiation, special marketing skills, retail price maintenance, administered pricing, and so forth;
2. departures from perfect competition in factor markets, including the existence of patented or unavailable technology, of discrimination in access to capital, of differences in skills of managers organized into firms rather than hired in competitive markets;
3. internal and external economies of scale, the latter being taken advantage of by vertical integration;
4. government limitations on output or entry.

It may be useful to illustrate these separate advantages briefly.

Goods Markets

That product differentiation breeds direct investment is indicated by its prevalence in branded products such as pharmaceuticals, cosmetics, soft drinks, and specialty foodstuffs, and in concentrated industries such as automobiles, tires, chemicals, electrical appliances, electronic components, farm machinery, office equipment. It does not occur in standardized goods produced by competitive industries such as textiles, clothing, flour milling, and distribution (except for Sears, Roebuck in Latin America). In oligopolistic industries there is likely to be two-way investment, with Lever Brothers and Royal Dutch Shell in the United States and Procter and Gamble, Esso, and other United States oil companies in Britain, or

Campbell Soup and Heinz in Europe and Knorr and Nestlé in the United States. Indeed, in concentrated industries there is pressure for each firm to develop a position in each important or potentially important market—regardless of the rate of profit obtainable in absolute terms—to prevent any of its few competitors from obtaining a substantial advantage which it could put to use over a wider area. The threat of competition by a foreign firm in the home market may be reduced if the domestic firm stands ready to retaliate through an existing subsidiary in the market of the threatener. A major drug company is said to admit that it loses on its investment in Brazil but has to be there to cover the actions of the competition.

Marketing skill was what brought one of the earliest types of United States investment—life insurance—to Europe and is what Americans and Europeans alike believe is the major contribution of many American companies today. It is closely associated, of course, with product differentiation through advertising and with administered pricing (though European competitors complain of price cutting). Incidentally, the experience of the life insurance companies supports the theory that direct investment is based on an advantage of one kind or another and is impossible where such advantage does not exist. United States companies taught their marketing secrets to European insurance companies and then withdrew to the confines of this country. Theories that rely on the growth of the firm have little explanation for withdrawal. Servan-Schreiber states, "United States troops will leave Vietnam, but United States industry will not leave Europe."¹² Hymer, on whose theory this

12. *The American Challenge*, p. 275.

analysis relies, puts it colorfully: "Corporations do not die like ordinary trees; they are like California redwoods."¹³ But these pronouncements do not take account of some failures, such as those American companies which tried to introduce cake mixes and bowling into Europe in the last decade, or of withdrawals other than that of the life insurance companies—General Electric, Rexall (Boots drug), and Woolworth—from Britain at the end of the 1930s.

Factor Markets

Superiority of management may be the advantage that many companies bring to foreign investment, though it usually must be combined with monopoly advantages in goods markets or increasing returns to scale to convert it into a basis for operating in foreign markets. The nature of that superiority is elusive, being said variously to consist in centralization of decision-making and in decentralization, in scientific cost-benefit analysis and in merely a concern for marketing, in the maintenance of high standards on technical performance, tolerances, delivery dates, and so on, at the same time that it runs afoul of local practices and especially of trade union tradition. These aspects of the problem will be developed in subsequent lectures.

There is little or no advantage to the foreign investor in access to labor other than management and technical staff.

The advantage of the large international company in

¹³ In an unpublished memorandum, which he kindly made available to me.

raising capital is another topic that arises in specific contexts later.

This leaves us, at this stage of the proceedings, to discuss patents and industrial secrets, which are a major advantage of the large international corporation in differentiated products. Patents and restricted technology limit entry. The question that inevitably arises, however, is whether to exploit the advantage through licensing foreign firms or to undertake foreign production oneself. Examples can be found of each—and in the same industry. St. Gobain, a French company, developed a new process for producing plate glass and undertook to build a plant in Tennessee, which was called upon its completion "the most modern obsolete plant in the world." The reason for this obsolescence was that the British Pilkington company developed a newer and superior method of producing plate glass, the float process. But rather than undertake production in the United States Pilkington decided to license existing producers—Pittsburgh Plate Glass, Libby-Owens-Ford, and the Ford Motor Company. The choice was presumably made on the basis of fine calculations of costs and prospective profits. A further factor seems to have been that the Pilkington company is a family concern which hesitated to borrow enough capital to start production on the scale necessary to compete with the three American companies (which requires a full line of automotive glass products) and which perhaps was concerned that it would let loose the demon of cut-throat oligopolistic competition.

If we assume that a firm is not constrained by unwillingness to raise capital or by fear of the consequences of breaking into a foreign market, what will the choice be between licensing and direct investment depend on? Where

the license fee fails to capture the full rent inherent in technical superiority, the advantage lies in direct investment. There may be other considerations: whether the patent or industrial secret is adequately protected by the licensee, or whether at the expiration of the arrangement the licensor will find his secret gone; whether the licensee is likely to provide competition in other markets—possibilities which it might be illegal to protect against through agreement but which are safeguarded through ownership. Research is needed to amass a series of cases in which the choice between licensing and direct investment has been made in one sense or the other, in order to formulate exactly the nature of the governing considerations. Since both methods are used, however, it is evident that the calculation is a close one. Licenses tend to bring in a lower return, directly and indirectly, but are less expensive in capital, time, and energy.

One apparently irrational feature of the choice appears in statements gathered by interview from two American firms that they are willing to enter into joint ventures with foreign participants if the foreigners provide some advantage in kind—technical knowledge, marketing skills, or "some other valuable and unique service"—but not otherwise.¹⁴ The irrationality, to which we return, is that admission of local participants to the equity of a foreign investment should be a function of the price they pay, not the character of the payment. If the local capitalists pay a high enough price for a small enough portion of the equity, money is as good as real considerations, or better. The higher the price the greater the extent to which the foreign investor capitalizes the advantage, or a portion of it, that he brings to the venture, rather than drawing an income from it.

¹⁴ Lydenker, pp. 98, 112.

Economies of Scale

Economies of scale are very much in people's minds today in Europe where attention is focused on the large size of American companies compared with the relatively small size of European concerns. The advantages of large-scale production internal to the firm are self-evident, although it is useful to point out that there are counterbalancing diseconomies of scale in administration, which at some point, different in different industries and for different methods of management, set limits to the optimum scale of operations. Long-term cost curves turn up somewhere, or competition would reduce the number of firms in each industry to one.

Economies of scale must be distinguished from the profits available through horizontal integration which extends to the point where the firm has some control over price. The benefit to the firm from extending operations overseas may lie not in producing greater numbers at a cheaper cost per unit, but in raising the price at which units are sold. When this occurs, direct investment involves a loss for the world, though perhaps a gain for a country. Production is reduced rather than expanded, and price is raised above marginal cost, which remains at least as high as before. In the short run, the direct investment that obtains a larger share of the market and market power may be equally profitable—no more, no less—than the direct investment that lowers cost through internal economies of scale achieved through horizontal integration. In the long run, however, monopoly profits persist, whereas in the competitive situation profits return to the long-run level.

While internal economies of scale—and monopoly—account for horizontal integration, external economies of

scale lead to vertical integration. In a number of lines where production is bulky, inventories are expensive, and coordination of decision is required at several stages of the process, the firm may be a better means of organizing production than the competitive market. In oil, for example, it is possible for separate firms to produce crude petroleum, transport it, refine it, and market the products, dealing with each other at arm's length through markets. But there are substantial economies, it appears, in coordinating decisions at various stages of production, so much so that direct investment in the petroleum industry is the rule, both backward to sources of crude petroleum supplies and forward to consumer markets for refined products. In some industries, such as metals, vertical integration goes only to the source of raw materials. Steel companies own iron mines, copper companies produce copper ore abroad, aluminum companies own bauxite (and electricity), so that they may better coordinate the output and shipment of ore with the needs of metal refining. Their advantage over other firms with equal technology, managerial skill, access to capital, and so on is that they coordinate mining operations with transport and marketing—with an eye to minimizing both interruptions in flows and the piling up of unwieldy inventories. Like governmental planning in Rosenstein-Rodan's 1933 article on balanced growth, vertical integration converts external economies to internal profits.¹⁵ But the capital needed for operations on this scale tends to limit entry into these industries, and to provide at least the possibility of oligopoly which raises price above marginal cost. And the existence of separate stages of pro-

15. P. N. Rosenstein-Rodan, "Problems of Industrialization of Eastern and South-eastern Europe," *Economic Journal*, 53 (June-September 1943).

duction in different countries within the same company gives rise to problems of transfer pricing, discussed below.

Vertical integration can also serve an economic purpose in helping to avoid the risks of technological change or new channels of trade, which require coordinated new investments at various stages of the movement of a commodity from production to consumption. I became aware of this in studying the economic history of Britain, noting that tenant farmers found it difficult to shift from wheat to dairy products because of the difficulty of dividing the risks of investment, and the profits, between the owners of East Anglian farms and their tenant-operators, or that the failure to change from small coal cars on the British railways to larger, more efficient ones was because the cars were owned by the coal mines but new investment by both the mines and the railroads was needed to arrive at the new size. A current illustration given by my colleague, Morris Adelman, is the profitability of large new investments—in coal mines, railroad cars, and loading facilities in the United States, large ships and unloading and distribution equipment in Europe—to bring West Virginia coal to Europe at half the cost that coal can be mined there. It proves impossible to undertake the investments needed at each stage of the process without vertical integration which would coordinate it.

Vertical integration can also be a pathological condition. Competition, like matter and games, is subject to entropy. Even where there are no economic advantages in coordinating production at various stages, or of coordinating new investments at different levels of production to carry through innovation, companies may feel safer with assured access to sources of inputs and to outlets for products. In these circumstances the industry will shift

from numerous firms which are small and competitive at each stage to one of a few large, vertically integrated concerns. Once started, the process acquires momentum. When the oil company that used to sell gas feed stocks to petrochemical companies acquires a petrochemical subsidiary of its own, other chemical firms it used to supply feel constrained to acquire their own sources of supply. A striking example is the purchase by Alcan Aluminium Limited of Canada of a half interest in the government-owned Aardal og Sunndal Verk (A.S.V.) aluminium smelter in Norway, a move that expanded the former's "aluminum capacity by almost 20 percent and eliminated a source of price competition that had vexed the entire industry."¹⁶ Alcan's interest in acquiring A.S.V.—to reduce competition—is made evident in this remark. But the newspaper account goes on to indicate that the Norwegian government felt that A.S.V. needed a tie-up with a producer of alumina to assure future deliveries. "Norway feared that the trend toward integrated production . . . might leave a lone smelter without supplies or customers."¹⁷ In some industries, such as automobiles, vertical integration proves inefficient in the long run, and the industry proceeds to disintegration and the establishment of separate firms for component manufacture which deal at arm's length. The Cummins Engine Company of Indiana sought to obtain a foothold in the diesel-engine industry in Europe but found itself unable to develop markets since truck producers in Europe (Fiat, Berliet, Mercedes) all produced their own diesel engines—a stage in the development of truck production regarded as behind the disintegrated structure of the United States and

16. "Alcan Aluminium Active in Norway," *New York Times* (March 31, 1967).

17. *Ibid.*

Britain.¹⁸ Vertical integration can thus either make for direct investment reducing competition in goods markets and the markets for inputs, or it can frustrate direct investment.

A special form of imperfectly competitive market for factors is in capital. I have claimed that direct investment does not represent a capital movement, and this is largely true. But on occasion, in industries that need large amounts of capital, a foreign firm will have an advantage over a domestic firm because of its superior credit standing. The international capital market is not perfect, and even to the extent that capital markets are joined, different rates are charged to borrowers of different credit standing. Many borrowers cannot command the large sums necessary for capital-intensive investments at all. I do not mean to limit this to access to the New York capital market or the Euro-dollar bond market. Even before the restraints on United States investment abroad, United States firms were borrowing abroad despite higher nominal interest rates: in case of difficulty, the asset and the liability would be in the same currency basket and the net risk of loss thereby diminished. Since the restrictions, the propensity to borrow abroad has increased. And not only in New York and in Euro-dollars but abroad and in foreign currencies, American firms of worldwide credit standing typically have an advantage over domestic firms with only a national credit rating and limited liquidity. In some countries, foreign capital markets are particularly underdeveloped, and capital must be brought from the United States or transferred from one foreign operation to another. But this is not the essence of direct investment. With perfect capital markets,

18. "Cummins Trimming Ventures in Europe."

and assuming the borrowers are of equal credit standing, the domestic entrepreneur abroad could borrow in New York as easily as the American entrepreneur. The fact is that where the direct investor has an advantage over his local competition based on capital availability, this is the result not of his nationality, but of his better credit rating in all parts of the international capital market. Whatever the source of capital, the international firm with its large cash flow and high liquidity is a better credit risk than local enterprise and, in imperfectly competitive markets, gets lower rates on loans and preferred access to limited funds.

Let me present the pith of this theory of direct investment with the use of the simple formula for capitalizing a stream of income, $C = \frac{I}{r}$ where C is the value of a capital

asset, I is the stream of income it produces, and r is the rate of return on investment. Thus, for example, an investment producing a \$5 flow of income is worth \$100 at a 5 percent rate of profit. This theory of direct investment insists that ordinary capital movements take place between countries when interest rates differ, but that direct investment corresponds for the most part to differences in I that can be earned by entrepreneurs from abroad over local entrepreneurs. I is higher for the foreigner than for the local entrepreneur because of some advantage in goods markets such as a differentiated product or assured outlets or marketing skill; in factor markets, such as specialized technology or management skill; or in both goods and factor markets through coordinating operations at several stages of production. When the advantage in factor markets is access to cheap capital, because of either the larger cash flow of depreciation and profits in internal funds or a preferred position

in capital markets as a borrower, differences in r may contribute to the result. Primarily, however, the theory asserts that direct investment occurs when the foreign firm can earn a higher I than the local firm, whereas ordinary capital movements reflect a lower r . The exception for imperfect capital markets will be developed later. The theory can be illustrated with the far from hypothetical example of a European family seeking to sell out a family firm. A foreign firm, typically from the United States, is able to bid more for the going concern than its European competitors, i.e. pay a higher C , not because of a lower r —or perhaps better not solely, or even mainly because of a lower r —but because it can earn a higher I on the firm's assets.

Government

Finally government. The role of government does not affect the choice between local and foreign firms, except when it refuses to sanction direct investment. If we assume that foreign firms have an advantage over local firms, the question is whether the goods are provided by imports or by a direct investor. Here government enters with tariffs. Government may impose a tariff in the hope of stimulating production by nationals, only to find that it has encouraged the entry of foreign firms.

Brash, for example, claims that increases in tariffs have been decisive in stimulating American investment in Australian manufacturing industry.¹⁹ This statement can be broken down into two stages. Australian tariffs stimulate investment behind the tariff walls. The advantages of American manufacturing concerns over Aus-

19. Donald T. Brash, *American Investment in Australian Industry* (Cambridge, Mass., Harvard University Press, 1965), p. 40.

Italian firms result in the entry into Australian manufacturing of American rather than Australian firms. The same stimulation to direct investment presumably came from the formation of the European Economic Community, and again in two stages. The formation of the customs union favored firms inside the common tariff over those outside. Foreign firms that were discriminated against by the customs union set up subsidiaries within the customs area if they had an advantage that enabled them to compete successfully with local firms.

Government intervention to cut off imports and substitute domestic production may lead foreign firms into what has been called "defensive investment," i.e. investment that produces a less than average return, but where the difference between the gross return plus and the loss that would have resulted from exclusion gives the necessary rate of return on a marginal basis.²⁰ A firm threatened with a loss of 4 percent a year on an existing investment may find it worthwhile to undertake new investment at a below-average return to prevent the loss. The behavior is viable in the short, but not of course in the long run, when all costs are variable and average costs become marginal costs.

In my judgment, however, the major impact of the Treaty of Rome was not to create new opportunities for outside firms to invest within the Community or to threaten exporters with losses against which they sought to defend. More significant, I think, was the treaty's calling attention to opportunities for profitable investment which had until then been ignored. Europe had lain over the horizon of most American companies, out of sight. Opportunities for profitable investment existed,

20. A. Lamfalussy, *Investment and Growth in Mature Economies* (Oxford, Blackwell, 1963).

but company managements in the United States were unaware of them. Coming as it did when major domestic postwar investment programs had been completed, the Rome treaty, plus its forerunner, the European Coal and Steel Community, and successive steps toward integration which followed it, had little importance in altering the bases on which close calculations of alternative profit opportunities were made. What they did was to lift the attention of United States business to a wider horizon and to focus interest on the fast-growing European market with its unfolding investment opportunities. Government's role was minimal. The major stimulus to direct investment in Europe in the late 1950s and the 1960s was a discontinuous enlargement in the horizon scanned by United States corporate management. The Common Market may have triggered it. It did not produce it.²¹

Corollaries of the Monopolistic Theory of Direct Investment

The fact that the foreign corporation has some advantage over the local corporation, which makes direct investment possible, has a number of corollaries. It is a strong reason in the eyes of the investor against sharing his equity. The world of affairs abounds in the apparently reasonable suggestion that the overseas investor enter into joint ventures with local interests. Instead of buying 100 percent of a domestic firm, buy half. But the overseas investor asks why he should give half the scarcity

21. For a demonstration that the tariff was less of a stimulus to U.S. investment in the European Economic Community than industrial growth there, though the effects were additive rather than mutually exclusive, see Lawrence B. Krause, *European Economic Integration and the United States* (Washington, D.C., The Brookings Institution, 1968), pp. 126-31.

value of his advantage away. This reasoning assumes, as I have indicated, that there are barriers to adjusting the price paid for half the enterprise which would enable the foreign investor to capitalize on the scarcity value of his contribution. It may be difficult for the local investor to appreciate the profitability of the prospective enterprise, so that he would be unwilling to make his monetary contribution at an implicit valuation of the foreign contribution which accorded with the foreigner's view. To an economist, as I have said, the problem has an air of irrationality or imperfect knowledge about it. In a broad market there should be no difficulty in varying the price of the foreign contribution of a special advantage such as technology, relative to the domestic contribution of money, land, facilities, or whatever is involved, so as to represent something like its market real scarcity value.

There is, of course, one other aspect to a foreign investor's reluctance to share control, or even to tolerate a substantial interest, and in many cases it may be the controlling one. The interests of the partners may differ. The foreign investor may wish to accumulate capital, whereas the domestic investor wants dividends. In this case they would disagree on the appropriate rate of reinvestment of profits, or in readiness to undertake new investments to make good losses or to take advantage of new opportunities. Thus Heinz bought a higher share of its Japanese subsidiary after its partners in that country were reluctant to expand at the rate they thought was required; and Coca-Cola found it difficult to persuade its partner bottlers abroad to undertake the necessary investment to move from 6-ounce to 10- and 12-ounce bottles. Or the international corporation may have a wide number of interests, in a variety of countries, which are related to its interest in a particular subsidiary,

while the partner in that subsidiary has only one. The most usual source of a conflict of interest arises where the international corporation is integrated over a number of stages of production and the local subsidiary covers one. How intercompany transactions are priced may become a bone of contention in this case, as it affects whether profits are earned in the wholly owned parent or the partially owned child. Transfer pricing is an important question for that other partner of every company in every country, the tax collector, who clearly has an interest in ensuring that profits are earned and taxed in the jurisdiction where they ought to be.²²

The economic answer to the tax collector is easy to formulate, difficult to apply. Payments for all goods and services sold within a corporation, including rents, royalties, and fees for patents, industrial knowledge, and management services, should be set at the prices that would prevail in a competitive market, with all element of monopoly or monopsony eliminated. In the well-known case of oil tanker charges, however, one must be careful not to apply the single-voyage charter rates, which are highly competitive but cover such a small part of the market that they tend to fluctuate in exaggerated fashion as changes in total demand and supply are brought to bear against a limited segment of the market. In this and similar cases, some other criterion must be used. The market for short- and long-term charters is competitive, so that it is relatively easy to get a good approximation to a short- or long-term price which would be reached with competitive arm's-length bargaining. In the crude oil market, which is very imperfect and where actual

22. See James A. Shulman, "Transfer Pricing in Multinational Business" (doctoral dissertation, Cambridge, Mass., Harvard Graduate School of Business Administration, August 1966).

transactions are known only to a limited degree, it is perhaps possible to calculate a proxy competitive price. But in highly complex mechanical, chemical, or electrical goods, such calculation becomes impossible since there is no market from which "competitive" prices can be estimated or approximated. Tax commissioners and private partners may be able in one way or another to "construct" a profit which makes crude legal or bargaining sense perhaps, but it is difficult to devise an economically justifiable criterion.

The answer given by the large international companies to the demand for local participation is hardly satisfactory. They urge the local investor to buy shares in the parent company. But the local investor wants a piece of the monopoly profits from the corporation's advantage in the local market, profits which, in the nature of direct investment, are higher than those in the main place of business.

Where takeovers occur, or a minority shareholding is bought out, as in the Ford of Dagenham minority purchase in 1960, the local owner of assets or shareholder can capitalize a portion of the prospective gains by selling his assets for more than they are worth to him or to his countrymen. When Ford of Detroit offered the 40 percent minority shareholders of the British company 145 shillings a share, the market quotation was in the low 90s, and the local shareholder got a capital gain of more than 50 percent. Ford of Detroit, which had more than \$1 billion in idle cash in the home office and which anticipated no better use for it than buying up the remaining interest in its already controlled but prospectively profitable British subsidiary, was willing—or, perhaps it should be said, was obliged—to share the anticipated profits to a considerable extent in order to acquire the shareholding.

International corporations thus prefer 100 percent ownership to joint ventures or minority holdings. To the extent that they need additional finance, they seek it abroad, and through debt. This is to limit risk by holding assets and liabilities in the same currency and avoid the possibility of losing assets while liabilities remain. The reason for obtaining capital in debt form is to protect the company's equity. In 1957 United States firms owned 60 percent of the assets in their foreign subsidiaries, but this consisted of 85 percent of the equity capital and only 25 percent of the creditor capital. By subtraction, foreign investors had 15 percent of the equity and 75 percent of the debt. There are instances where United States corporations prefer to take a limited interest in foreign operations. The Kaiser company, for example, is said to limit itself to a 25 or 30 percent interest, wanting a voice in management, some earnings, but a quiet life. Again some governments, notably that of India, require foreign corporations, as a condition of entering the market, to undertake to sell as much as 30 percent of their equity to local investors. In these circumstances, the foreign investor naturally seeks to spread the stock widely so as to prevent the coalition of a strong minority voice in management. And, as we shall see in the fourth lecture, there have been strong measures proposed in Canada to get a substantial proportion of foreign equity in Canadian corporations into Canadian hands. But where the investment is based on an advantage over local competitors, and there are difficulties in getting the full capitalized value of this advantage in advance by selling it at its value to the holder, foreign equity owners may be expected to resist these pressures, quite apart from the complication of loss of control.

The second corollary is less evident. Direct investment

belongs to the theory of monopolistic competition. But while direct investment may gobble up competitors and exploit its monopolistic advantages, its main impact is in widening the area of competition. Domestic markets are protected, if not by tariffs, at least by distance, ignorance, lethargy. The small, inefficient domestic producer is typically more of a monopolist than the large, monopolistically competitive wide-ranging firm. Such a domestic market thrives on high prices and low volume. Sometimes, as in France before the European Coal and Steel Community and the European Economic Community, a handful of large firms holds a high price umbrella each over an entourage of small and inefficient coexisting or symbiotic firms in the rest of the industry. The French call this sort of market Malthusian.²³ Retail price maintenance, understandings that no firm will rock the boat, "conscious parallel action" even if no explicit agreement (to use the United States Supreme Court's phrase), make the local market before the entry of the international corporation much more monopolistic than the monopolistically competitive intruder. The cost advantages of the intruder are so great, even when its conduct is not aggressively competitive, that prices are reduced, volumes are expanded, and the monopolistic phenomenon extends the area of competition.

A strong case against this competition can be based on infant-industry argument. Given a chance to develop, to

23. As an interwar example of resistance to direct investment based on fear of competition, see Alfred Sauvy, *Histoire économique de la France entre les deux guerres* (Paris, Fayard, 1967), p. 372. The Czech shoe company, Bata, planned to construct a factory in France. Immediately, the so-called Poulleu Law of March 22, 1936, was passed to forbid the opening of new factories or ateliers for shoe manufacture, or the enlargement of existing ones.

acquire technology, penetrate markets, learn management skills, and so forth, national firms may grow to compete effectively with the large international firm, and it is useful to give them the chance. This is so not for nationalistic reasons or for sentiment, but for efficiency. This exception apart, however, the presumption is that the international firm, unregulated except where necessary to keep entry free, will lead to greater world economic efficiency. The small local firm will object to "unfair" competition; it is really objecting to competition. We recur to this theme in the last lecture on the international corporation, but it may be well to fore-shadow the theme here.

The International Corporation and Efficiency

Compare the growth of the international corporation in the 1950s and 1960s with the rise of the national corporation in the 1880s and 1890s in the United States. There was great concern for abuses of competition, culminating in the passage of the Sherman Anti-Trust Act of 1890. Muckrakers inveighed against big business. Populists attacked the domination of Wall Street. But the national corporation, emerging out of the growth of the local corporation and the regional corporation, made an important contribution, over time, to economic efficiency in the United States. Prior to 1900, factor markets in the United States were less perfect than they are now. Wage rates were higher in the New England and Middle Atlantic states and the West than in the South and Middle West. Capital was cheaper in financial centers than in the rural areas of the West and South. Capital markets of New York, Philadelphia, Boston, Chicago,

and the major cities were joined after a fashion, but the connections between them and the rest of the country were limited and fragile.

The rise of the national corporation provided a new institution alongside the imperfect factor markets, which worked toward factor-price equalization and economic efficiency. Where capital failed to move easily to other cities, national corporations established financial offices and raised capital in New York. Where labor failed to move to the high wage areas in the North and East, corporations brought capital to labor in the South and West. There were other pulls on national corporations than factor-price differences—pulls, moreover, that also worked toward efficiency by attracting corporations to sources of supply, thus saving transport costs on heavy materials, or by pulling them to the market, thus saving transport costs on bulky assembled products. But owing to the immobility of labor and land and to barriers to the free movement of capital, factor markets by themselves were inadequate to produce the efficient optimum implied by equality of factor prices. The national corporation provided an economic institution, unforeseen by the classical economists, which, while it carried the threat of monopoly, brought the United States closer to the classic competitive world. To achieve this result it may have been necessary to maintain a strong anti-trust movement to ward off the evils of monopoly while moving toward the blessings of greater factor mobility.

The national corporation, it should be made clear, was a product of the railroad, telegraph, and telephone, which made it possible for a decision-making center to operate over wide distances without too great cost. The jet aircraft, the radio-telephone, and the rapid rate of growth in postwar Europe have lifted the horizons of many national corporations to the world scene, to join

the limited number of pioneers who go back to 1900 and earlier. The development of corporations which scan the world for investment opportunities does offer the possibility, along with the spread of monopoly, of equalizing factor prices, even in the face of the international barriers to the movement of capital and of labor, in strictly analogous fashion to the rise of the national corporation in the United States after 1880.

Circumstances Alter Cases

If direct investment may expand or reduce competition it follows that it is impossible to draw general conclusions about its desirability, assuming that competition is desirable. It is necessary, rather, to settle matters on a case-by-case basis. This is not unknown in the antitrust field. In the United States prospective mergers are submitted to the Department of Justice to see whether the character of the firms, or their resultant size, is judged—case by case—to restrain trade. In Europe, it is claimed that business agreements, or cartels, are not objectionable in themselves, but that there are good cartels and bad cartels, just as there are permissible and impermissible mergers in the United States. This is an uncomfortable position for the law. The economist, on the other hand, has long been used to deriving different conclusions from the same action, depending upon whether other things were equal (*ceteris paribus*) or altered (*mutatis mutandis*).

Equal treatment under the law requires the world to be indifferent to whether International Business Machines or the General Electric Company buys Machines Bull Compagnie, the French computer concern. But if I.B.M. were to acquire it, competition in the computer field would be reduced; for G.E. to team up with Ma-

chines Bull and Olivetti, on the other hand, or for Radio Corporation of America to join with Siemens, holds out the hope—although not, as it turned out, a very bright one—of widening the range of world competition in the computer field.

Direct investment is, then, a subject in which it is necessary to judge case by case, on the basis of the relevant circumstances, before coming to conclusions about the effects of one or another action. All the while countries, companies, and academic economists search for rules of thumb which can be generalized. "Investment for new enterprises, but not for takeovers"; or for "production, but not control"; or "in manufacturing, but not in distribution," and so forth. We shall encounter a variety of attempts to prescribe general precepts, and I will find it possible as a rule to suggest circumstances in which they are not appropriate.

The necessity for companies and countries to proceed case-by-case, depending upon circumstances, is not only offensive to Anglo-Saxon notions of jurisprudence; administrative discretion raises the possibility of rapid changes in rules of conduct and of arbitrary disagreements between countries. The beauty of the market, as economists extol it, is that it operates through the direction of the invisible hand. When the French government changes its mind three times in five years on general rules for foreign investment and ends up with administrative discretion lacking procedures for appeal or even for pushing for decision, the directing hand is painfully visible. Moreover, two hands, attached to two different countries, may push in different directions, letting the international company slide between them in one case, or punishing it doubly in another. But more on these issues below.

Lecture 2

United States Concern with Direct Investment

The bulk of this book deals with the concern of foreign countries about international firms, largely but not entirely companies owned in the United States. But it must not be overlooked that the United States has an interest in direct investment abroad by American firms. This interest may not be exactly what it is pictured to be by some shades of opinion at home and abroad which regard American companies, and the government and people of the United States, as bent upon the ruthless economic and political domination and exploitation of the rest of the world. It nevertheless exists.

We can safely neglect the possible concern of the United States about foreign corporations in the United States. During World War II, many people and the government were worried about German corporations which were thought to be engaged in spying and sabotage, much as American firms are occasionally accused of working for the operations branch of the C.I.A., or identified with the machinations of "imperial warmongers" in sensitized areas today. The United States government operated an Alien Property Custodian to root out the tentacles of German infiltration through General Aniline and Film Corporation, the Bausch and Lomb subsidiary of Zeiss, and others. A large Safehaven program was built to attack German penetration of Allied and neutral countries. It goes without saying that most of the concern was highly emotional and nationalistic, just as most if