# *Agency Contracts, Institutional Modes, and the Transition to Foreign Direct Investment by British Manufacturing Multinationals Before 1939*

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This paper analyzes the transition from agents to branch selling as alternative institutional modes for transacting abroad by pre-1939 British manufacturing multinationals. A model to explain the shift between alternative modes is specified in terms of transaction costs. Agent opportunism and contract monitoring costs are the major transaction costs. Besides transaction costs, the frequency of transactions and the accumulation of market-specific knowledge by the principal were found to be important variables.

ECONOMIC historians have only recently become interested in multinational enterprise.[1] The interest was stimulated by the literature on the evolution of the large corporation and by new estimates of aggregate foreign direct investment, which found that over 40 percent of British overseas investment in the Third World and South America by 1914 was direct.[2] According to John Dunning, by 1914 company investment abroad reached £14 billion, representing as much as 35 percent of the long-term capital stake and by 1939 there were well over 350 British manufacturing multinational enterprises.[3] The studies reveal that British multinational enterprises acted as an important but neglected mechanism for transferring technology, products, management skill, and know-how abroad.

The analysis of British multinational enterprises has been largely directed to explaining the reasons firms transact abroad. Utilizing a sample of British multinational enterprises, I discovered that 50 percent had technology advantages and 45 percent selling advantages; 32

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[1] John Stopford, "The Origins of British Based Multinational Manufacturing Enterprises," *Business History Review*, 48 (Autumn 1974), 303–45; D. Paterson, *British Direct Investment in Canada, 1870–1914* (Toronto, 1976); S. J. Nicholas, "British Multinational Investment Before 1939," *Journal of European Economic History*, 11 (Winter 1982), 605–30; Peter J. Buckley and Brian Roberts, *European Direct Investment in the U.S.A. Before World War I* (London, 1982).

[2] Peter Svedberg, "The Portfolio: Direct Composition of Private Foreign Investment in 1914 Revisited," *Economic Journal*, 88 (Dec. 1978), 690–722.

[3] John Dunning, "Changes in the Level and Structure of International Production: The Last 100 Years," mimeographed (1982), pp. 4, 31.

percent integrated abroad to secure raw materials and 31 percent to avoid tariffs.[4] From eight case studies of European investment in the United States, Buckley and Roberts found that the three dominant motives for making a foreign direct investment were the desire to avoid American tariffs, the opportunity to exploit "patents," and the need for local production to satisfy local demand.[5] To explain pre-1939 foreign direct investment, Dunning emphasized the technological capacity of international firms.[6] Patented technology and special skills in selling are knowledge created inside a firm but nonappropriable because of transaction costs in the international market.[7] By nonappropriable I mean that the firm is unable to capture the value to society of the knowledge. All the studies argue that the internalization of the functions of the market within the firm was the point of direct investment.[8] The firm economized on transaction costs by providing an institution for appropriating technology and selling knowledge and transferring property rights in goods.

The uniformity of approach by economic historians reflects the consensus by economists that internalization explains foreign direct investment.[9] The roots of the notion are found in Coase's work on the nature of the firm.[10] Coase derived the dictum that the firm will "tend to expand until the cost of organizing an extra transaction within the firm becomes equal to the cost of carrying out the same transaction by means of exchange in the open market."[11] Recent theoretical work has replaced the Coasian firm-market dichotomy by a "comparative institutional analysis" distinguishing institutions (such as markets intermediate cooperative modes—agents, licensing, franchising, and other long-term contracts—and the hierarchical firm) all of which economize on transaction costs.[12] The comparative institutional analysis recognizes

[4] Nicholas, "Multinational Investment," p. 10.

[5] Buckley and Roberts, *European Direct Investment*, p. 119.

[6] Dunning, "International Production," pp. 4.26–4.65.

[7] See Peter J. Buckley and Mark Casson, *The Future of the Multinational Enterprise* (London, 1976), pp. 10–30; Mark C. Casson, *Alternative to the Multinational Enterprise* (London, 1979), pp. 31–43; Harry G. Johnson, "The Efficiency and Welfare Implications of the International Corporation" in *The International Corporation*, ed. Charles P. Kindleberger (Cambridge, Massachusetts, 1970), pp. 35–39; Steven P. Magee, "Technology and the Appropriability Theory of the Multinational Corporation" in *The New International Economic Order*, ed. J. Bhajwati (Cambridge, Massachusetts, 1976), pp. 319–21.

[8] See Buckley and Roberts, *European Direct Investment*, pp. 8–9; Nicholas, "Multinational Investment," pp. 9–10; Dunning, "International Production," pp. 4-24, 4-34.

[9] For a review of the literature see A. K. Calvet, "A Synthesis of Foreign Direct Investment Theories and Theories of the Multinational Firm," *Journal of International Business Studies*, 12 (Spring/Summer 1981), 43–57.

[10] R. H. Coase, "The Nature of the Firm," *Economica*, n.s. 4 (1937), 381–405.

[11] Ibid., p. 397.

[12] A. Alchian and H. Demsetz, "Production, Information Costs and Economic Organization," *American Economic Review*, 62 (Dec. 1972), 777–95; C. J. Dahlman, "The Problem of Externality," *Journal of Law and Economics*, 22 (April 1979), 141–62; O. Williamson, "The Modern Corporation: Origins, Evolution, Attributes," *Journal of Economic Literature*, 19 (Dec. 1981), 1545–50.

that nonmarket organizations do not simply duplicate the allocative results of a price system. They are chosen because they lead to a different allocation of resources.[13]

But the comparative institutional analysis is static. The transition between alternative institutions remains unexplained. The historical evidence shows British and American multinational enterprises passing through stages of overseas involvement from exporting with merchants and the firm's salesmen to the so-called agency system, thence to the foreign direct investment as a sales subsidiary, and finally to direct investment in foreign production.[14] For example, in a study of British multinational enterprises, 88 percent of the firms entered into agency agreements before making an initial direct investment in a sales branch abroad, and few British multinational enterprises began overseas production without first establishing sales subsidiaries.[15] In part, the static analysis of the comparative institutional approach arises from the failure to distinguish between the reasons firms transact abroad and the reasons they choose a particular form. The same arguments used to explain the decision to transact with foreign countries have been used to explain the choice of the mode of transacting.[16] I offer here a dynamic model to explain the transition from selling through an agency system to selling through a hierarchical sales subsidiary between 1870 and 1939. Using agent-principal theory, a transaction cost model is developed to explain the choice of mode.

## THE PRINCIPAL'S PROBLEM

The theory of the agent and the principal concerns long-term contracts for repeat sales. The repeat sales are between the producer (the principal) and the seller of the product (the agent). The principal will often have exported through his salesmen or merchant houses, but the appointment of an agent indicates that the principal's knowledge of the market is limited. The agent knows the language, local customs, and laws, and lives in the country where the product is sold. The principal has knowledge of the product, which is imperfectly transferred to the agent.[17] Conflicts tend to develop between agent and principal over holding stocks in the good, promotional effort, discretionary pricing, and "reasonable" levels of service.[18]

[13] John C. McManus, "The Costs of Alternative Economic Organizations," *Canadian Journal of Economics*, 8 (Nov. 1975), 335–50.

[14] Nicholas, "Multinational Investment," pp. 14–16. See also Mira Wilkins, *The Emergence of Multinational Enterprise* (Cambridge, Massachusetts, 1970), pp. 207–13; Mira Wilkins, *The Maturing of Multinational Business* (Cambridge, Massachusetts, 1979), pp. 417–22, 432–37; Buckley and Roberts, *European Direct Investment*, pp. 44, 65, 87, 91–92.

[15] Nicholas, "Multinational Investment," p. 15.

[16] For a similar point see Calvet, "Synthesis," p. 56.

[17] Magee, "Technology," p. 316.

[18] This problem has been examined by the marketing channel literature. See L. W. Stern, B. Sternthal, and C. S. Craig, "Managing Conflict in Distribution Channels: A Laboratory Study,"

Contractual arrangements between agent and principal are essentially decision problems under uncertainty.[19] The principal tells the agent what to do. The more accurate the principal's knowledge of the agent and the lower the costs of monitoring his behavior, the lower the risks. The risks in the agent-principal problem are that the agent will make a bad decision, hurting the principal. Even if he promises not to, the agent may have incentives to cheat the principal.[20] The contract will be drawn to attenuate such opportunism. Nevertheless, there are costs of monitoring the agent, especially when he provides a service dependent on the energy he devotes to the task and when he is distant from the principal.

A commission on sales is both a control and incentive system. As a control system, commissions meter the agent's performance, allowing the principal to identify and punish bad performers. As an incentive system, commissions discourage opportunism. Having made a promise to sell vigorously, the salesman has less incentive to renege if he is on commission. The posting of a bond by the agent is another control device. Bonding includes investments by the agent in physical capital such as warehouses, or human capital such as knowledge of the product, which locks the agent into the contractual relationship.[21] The more idiosyncratic to the principal's products is the agent's specialized capital investment the greater the lock in effect of bonding. Government or legal enforcement is a third control device, used sparingly because of its great cost. Overwhelmingly, principals rely on the threat of dismissal or the withdrawal of future business for contract enforcement.[22] The

*Journal of Marketing Research*, 10 (May 1973), 169–79; M. Pearson and J. Monoly, "The Role of Conflict and Co-operation in Channel Performance," in *Marketing: 1776–1976 and Beyond*, ed. K. L. Bernhardt (Chicago, 1976), pp. 240–44; L. J. Rosenberg and L. W. Stern, "Conflict Measurement in the Distribution Channel," *Journal of Marketing Research*, 8 (Nov. 1971), 437–42.

[19] M. C. Jensen and W. H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure," *Journal of Financial Economics*, 3 (Nov. 1976), 305–11; Stephen Ross, "The Economic Theory of Agency: The Principal's Problem," *American Economic Review*, 63 (May 1973), 134–49; Stephen Ross, "On the Economic Theory of Agency and the Principal of Similarity," in *Essays on Economic Behaviour Under Uncertainty*, ed. M. Balch, D. McFadden, and S. Wu (Amsterdam, 1974), pp. 215–20.

[20] Oliver Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York, 1975), pp. 26–37; David J. Teece, *Vertical Integration and Divestiture in the U.S. Oil Industry* (Stanford, 1976), p. 31; Oliver Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations," *Journal of Law and Economics*, 22 (Oct. 1979), p. 233. Of course, the principal could also act opportunistically. The paper, however, is concerned with the principal establishing branch selling rather than the agent's contractual problems with the principal.

[21] B. Klein, R. Crawford, and A. Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," *Journal of Law and Economics*, 11 (Oct. 1978), 297–326; B. Klein, "Transaction Cost Determinants of 'Unfair' Contractual Arrangements," *American Economic Review*, 70 (May 1980), 356–62; B. Klein and K. Leffler, "The Role of Market Forces in Assuring Contractual Performances," *Journal of Political Economy*, 89 (Aug. 1981), 615–41; Williamson, "Transaction Cost Economics," p. 234, 238–45; Klein, "'Unfair' Contractual Arrangements," pp. 358–59; Klein, Crawford, and Alchian, "Competitive Contracting Process," pp. 302–7; Klein and Leffler, "Role of Market Forces," pp. 618–25.

[22] Klein, Crawford, and Alchian, "Competitive Contracting Process," p. 303; Klein and Leffler, "Role of Market Forces," pp. 616–20.

model predicts a transition to branch selling when monitoring costs incurred by the principal outweigh the agency's benefits relative to branch selling. The transition from agency agreements to foreign direct investment in a selling branch by pre-1939 British multinational enterprises provides a testing ground for the model.

## TESTING THE MODEL

A nonrandom sample of 21 British multinationals was selected on the basis of archival availability and access.[23] All the sample firms met the United Nations definition of multinationals, as enterprises that control assets, either factories, mines, or sales facilities, in two or more countries.[24] The sample included a range of firm sizes. The four agricultural machinery firms were among the ten best known and largest in the 1870–1939 period, and Huntley Palmer, Reading, and Peak Frean, London, were the two largest biscuit firms in the pre-1939 period. Other firms (for example, Harvey & Co. and Blackie Sons Ltd.) were medium-sized firms. The basic agency contract was fairly standard across sizes of firms, specifying exclusive sales areas, sole agency requirements, and specific arrangements for performance, holding stocks of the good, and promotional effort. As far as it is possible to determine, the agency contracts for the firms in the sample correspond to agency agreements for nonsample firms.[25]

Agency contracts focused on the selling of goods and the payment for them. In every agency contract, vague (and unenforceable) provisions required the agents to "push the sale" of the principal's products.[26] Such promises to behave nonopportunistically involved monitoring by

[23] The firms, by industrial groups, were Huntley Palmer and Peak Frean in food; Bentall, Ransomes, Marshall and Fowler in agricultural machinery; A. W. Smith and Mirrlees Watson in sugar-crushing machinery; Alexander Cowan and Blackie Sons Ltd. in paper and publishing; in steel products and cutlery, Osborn Steel, Spear and Jackson, and George Wostenholm & Sons; in engineering, the pump makers, Weir, and Harvey & Co.; Gourock Rope Company in rope; Morton (Sundour) and Linen Thread Company Ltd. in textiles; and Beardmore in shipbuilding and iron and steel. The merchant houses, Anthony Gibb, London, and John Finlay, Scotland, acted as agents when they signed exclusive agreements to represent British firms abroad.

[24] United Nations, *Transactional Corporations in World Development: A Re-Examination*, E.78 II A5 (New York, 1978). This definition is also used by the Group of Eminent Persons in their report, United Nations, *The Impact of Multinational Corporations on Development and on International Relations*, E.74 II A5 (New York, 1974), p. 25; and by John Dunning, *International Production and the Multinational Enterprise* (London, 1981), p. 3. Further, 13 of the firms subsequently made an investment in assembly and manufacturing in the period.

[25] D. Coleman, *Courtalds: An Economic and Social History* (Oxford, 1969), vol. 1, p. 193. I would like to thank Robert Kirk for information on Platt Bros. agency contracts.

[26] For example, Spear and Jackson's agent promised to "deligently and faithfully service the market to the best of his ability and judgment" (Spear and Jackson, Agreements, SJ65 3/7/29, Sheffield Public Libraries Archives). Gourock's agent agreed "to take steps to introduce and sell to local customers" (Gourock, Agency Agreements, UGD42/163/3, 22/1/31, University of Glasgow Archives [where page numbers are not available the date of the reference is given]).

the principal. Agents could sit back and wait for orders. The demand for the principal's products, coming from investments in brand names, good will, product differentiation, and advertising, created an appropriable rent that the agent could capture at the cost of rudimentary paperwork. The scope for opportunistic behavior obviously increased when agents received some payment irrespective of the level of sales. By replacing the salary or guaranteed income with a commission the principal reduced the possibility of opportunistic behavior.[27]

One attempt to strengthen vague performance clauses and to ensure service quality was to write into the contract specific input requirements covering the amount of traveling, advertising, and showing the agent was required to do. The requirements were a form of bonding, involving investments by the agent, which locked the agent into the contractual relationship. To ensure a competent sales staff, principals required agents to invest in engineers or special salesmen with specific technical knowledge of the principal's product. For example, the 1898 agreement between Platt Bros. and N. Wadia & Sons, Bombay, stated "The Agents should at their own cost employ and retain the services of duly qualified representatives."[28] Even with such requirements, however, principals could not be sure that sales performance was adequate. One common practice was to share the expense of a technical representative or salesman, particularly when knowledge of the product was concentrated in the principal. The sugar mill machinery firm, A. W. Smith, shared the £300 salary plus expenses of a technician with their Indian agents, Martin & Co.[29] Many firms, particularly in engineering, provided a technical salesman or mechanic who lived with the agent. By 1920 five textile machinery firms, Asa Lees, Tweedale & Smalley, Platts, Dobson and Barlow, and Howard and Bullough, had one technical man at their expense based at the office of their Indian agents.[30] Having one of the principal's employees inside the agency reporting back to the principal was an effective if costly monitoring mechanism.

Perhaps the most important bonding and monitoring arrangement was the requirement that agents carry stock of the good to be sold. Stocks were vital to ensure prompt delivery, and also served as advertising when displayed in offices and showrooms. Idiosyncratic investment in machines, offices, warehouses, and showrooms effectively locked the agent into the contract. Stocks for sale purchased by the agent,

[27] Spear and Jackson, Agency Correspondence, Alex Vox, Paris, SJC65, 26/4/27, 1/6/27, 3/7/29, Sheffield Public Libraries Archives.

[28] Platt, Agreement, DDPSL 1/109/1, Lancashire Record Office, Preston. Also Fowler, Toepffer Agreement, CO1/9, Institute for Agricultural History, University of Reading; and Bentall, Agreements, DF1/16 1924, Essex Record Office.

[29] A. W. Smith, Directors' Minute Book, UGD118/13/1, 19/2/69, p. 5, University of Glasgow Archives.

[30] S. M. Rutnager, *Bombay Industries: The Cotton Mills* (Bombay, 1927), pp. 643–46. I would also like to thank Robert Kirk for information on this point.

however, tended to be carried at less than the optimum level, while consignment goods, which earned the agent commission but remained the principal's property, tended to be overstocked. Nearly all firms accepted that their agents would hold mainly consignment stock, since most agents lacked the capital resources to purchase stock.[31] Moreover, consignment stock allowed the principal to advance credit to customers and assured prompt delivery.

Provisions for consignments in the contract were supplemented by a range of monitoring mechanisms. Stocks were monitored by weekly, monthly, or half-yearly stocklists provided by the agents.[32] Alternatively, agents might be required to send terms of each sale to the principal.[33] The arrangements were given teeth by rights to inspect the stock, to inspect the agent's books on demand, and to appoint the agent's bookkeeper or storekeeper.[34] Nevertheless, stocks were a source of principal-agent conflict. For example, when Marshall's found that Johannes Donalsen, their Swedish agents, kept consignment stocks above the four engines and three thrashers stipulated in their 1883 agreement, a new 1889 contract specified that three engines and two thrashers could be stocked.[35] The contract encouraged vigorous selling by moving consignment stock to the sales account after 12 months and making it immediately payable to the agents.[36] Spear & Jackson's contract with Aktu Mokuzai Kaisha, Tokyo, although allowing the agent to keep consignment stock, required the agent to purchase stock valued at £1,000 per year.[37]

A large part of the costs of agency agreements involved regulating sales behavior and stock levels. The most effective monitoring mechanism was to send directors or the firm's traveling representatives to check agents. For example, after accumulating high stocks with little evidence of increasing sales activity, directors of Osborn Steel visited B. M. Jones in the United States, replacing the consignment stock agency with a purchasing or sales agency in 1909.[38] In 1911 Osborn's decided that stockholding of their Warsaw agents was not justified and sent a salesman to Warsaw to review the agency and report to the

[31] In 1929 Fowler's stocked machinery valued at £15,297 with their Italian agents and £16,956 with their German agents. Fowler, Memorandum on Branches, AC9/63, 31/12/29, Institute for Agricultural History.

[32] Marshall, Agency Term Book No. 1, pp. 238–40, Institute for Agricultural History; Gourock, Agency Agreements, UGD42/103/3, 22/10, 31, University of Glasgow Archives; Smith, Minute Book, UGD118/13/1, 17/8/14, p. 114, University of Glasgow Archives.

[33] Ransomes, Agency Book, AD7/48, p. 7, Institute for Agricultural History.

[34] Ibid., pp. 36–42; Marshall, Agency Term Book No. 1, pp. 238–40, Institute for Agricultural History; Fowler, Toepffer Agreement, CO1/9, Institute for Agricultural History.

[35] Marshall, Agency Term Book No. 1, pp. 165–68, 183, Institute for Agricultural History.

[36] Ibid., p. 274.

[37] Spear and Jackson, Agreements, SJC65 10/2/20, Sheffield Public Libraries Archives.

[38] Osborn, Letter Book, Osb. 17, pp. 220, 230, 397, 421, Sheffield Public Libraries Archives.

Board.[39] Frequent trips by directors and traveling representatives were undertaken by every firm with an agency network. William Mackie, a director with A. W. Smith, traveled to monitor agents in India in 1920, 1935, 1937, South Africa in 1927, South America in 1931, 1932, and the West Indies in 1933 and 1937, in addition to yearly visits by their American and European salesmen.[40] One of Ransomes's representatives made 81 trips abroad between 1890 and 1900 including 5 to France, 18 to Germany, and 8 to Russia, while directors traveled regularly to Europe and the Americas.[41]

The second major area open to opportunism was the payments system. Of course, stock monitoring and the right to inspect the books also allowed the principal to monitor payments. Such methods were superfluous when the principal insisted on direct execution of orders to customers. Spear & Jackson and Gourock Rope Company, for example, specified that the principal would bill directly.[42] But the agent, by misinforming the principal, could collect a commission by passing orders of noncreditworthy customers. As a result, contracts specified that the agent should take every precaution to pass orders only of creditworthy customers, or to advise the principal whether credit should be given.[43] Peak Frean, the London biscuit firm, required the agent to share the loss from customers' bad debts.[44] Contracts explicitly allowed principals to refuse orders or to make the final approval of orders.[45] Despite such safeguards bad debts were common under the agency system. There were also risks in receiving payment for stock on consignment when customers paid agents for goods that were the property of the principal. A common arrangement was the requirement that agents pay by bill of exchange or letters of credit drawn on a London or European merchant house.[46] In these cases the draft or credit letter guaranteed the principal payment but involved the agent in the expense of a commission to the financial house.[47] Principals also encouraged payment through charging interest on outstanding payments

[39] Osborn, Works Meeting Minutes 1907–24, Osb. 142 9/10/11, 11/12/11, Sheffield Public Libraries Archives.

[40] A. W. Smith, Directors' Minutes No. 1, UGD118/17/2a, pp. 11, 149; Directors' Minutes No. 2, UGD118/17/2b, pp. 102, 104, 127, 232–34, 275, University of Glasgow Archives.

[41] G. Palmer, "The History of the Orwell Works," p. SP1/1HS, Institute for Agricultural History.

[42] Spear and Jackson, Agreements, SJC65 3/7/29, Sheffield Public Libraries Archives; Gourock, Agency Agreements, UGD42/103/3 1/12/27, University of Glasgow Archives.

[43] Gourock, Agency Agreements, UGD42/103/3 1/8/14; 1/12/27.

[44] Peak Frean, *Carr Agency Records*, PK13/4 1/7/01, University of Reading Library Archives.

[45] Spear and Jackson, Agreements, SJC65 12/3/19, 3/7/29, Sheffield Public Libraries Archives.

[46] Ransomes, Agency Book, AD7/49, pp. 68–79, Institute for Agricultural History; Gourock, Agency Agreement, UGD42/103/3 1/6/26, 4/22, University of Glasgow Archives.

[47] Gibb, General Records: Macfarlaine Strong Co. 1889, Ms 11,668/1, London Guildhall Archives; E. J. Perkins, *Financing Anglo-American Trade: The House of Brown, 1800–1880* (Cambridge, Massachusetts, 1978), pp. 5–8; P. Cottrell, "Commercial Enterprise," in *The Dynamics of Victorian Business*, ed. Roy Church (London, 1980), p. 240.

and offering a discount—usually 2½ or 3 percent—for cash within one to three months of the sale. The provisions, however, did not always work. Osborn's in 1905 demanded that their American agents, B. M. Jones, reduce their outstanding credit of £23,000. When the next six months witnessed the dispatch of goods valued at £11,000 but payment of only £9,600, a director's investigation of the agency resulted.[48] Sales representatives or directors also were used as a monitoring and enforcement mechanism to encourage payment. When Ransomes's agent in Rumania in 1882, F. Freund, "never completed payments within specified times," Ransomes's director visited Freund in 1883 to sort out discounts, payment, and the size of the trade.[49] Ransomes's found that Freund was "perfectly honest."[50] A Fowler's director sent to sort out a similar problem at the Societa Anonime La Penetrazione Roma concluded that "the main trouble is that Fowler's are completely in the hands of the Italians who are as cute as can be."[51]

The ultimate enforcement device was the termination of the contract. The standard nonrenewal clause required three to twelve months notice after the contract had run a specific duration, usually two years but on occasion as many as ten. Additional termination conditions including "failure to carry out provisions," "termination at any time," or "termination at the pleasure of the principal" favored the principal.[52] Many principals followed Spear & Jackson's contracts, which provided for termination due to "misconduct or incapacity," and in fact, most terminations were for fraud or concealment by the agents.[53] The option of termination in midcourse was, however, rarely used. Most agency agreements ended by nonrenewal. For example, Burn & Co. were appointed by A. W. Smith as their Indian agents in 1932 and immediately ran into trouble over nonfulfillment of the agency contract. Rather than terminating the agency, Smith's decided in June 1935 to await payment by Burn before ending the agreement. By September a further recommendation saw nonrenewal replace termination "due to the threat of a lawsuit which would freeze money in India."[54]

## FREQUENCY AND NATURE OF TRANSACTING AND LEARNING

A solution to costs resulting from monitoring and opportunism is vertical integration. There is evidence that shifts from an agency system

[48] Osborn, Letter Book, Osb. 17, pp. 222–30, 397, 421, Sheffield Public Libraries Archives.

[49] Ransomes, Agency Book, AD7/48, p. 8, Institute for Agricultural History.

[50] Ibid.

[51] Fowler, Packet: Societa Anonime La Penetrazione Roma, AD6/8, Institute for Agricultural History.

[52] Marshall, Agency Term Book No. 1, pp. 47–48, 235–37, Institute for Agricultural History; Peak Frean, Special Agencies, PF14/2, University of Reading Library Archives.

[53] Spear and Jackson, Agreements, SJC65 3/7/29, Sheffield Public Libraries Archives.

[54] A. W. Smith, Directors' Minute Book, UGD118/13/2, pp. 213–14, 221–27, 275, University of Glasgow Archives.

to a selling subsidiary occurred in order to economize on such costs. The shifts seem commonly to occur as direct investment in response to a crisis, where the collapse of the agency triggers investment in a selling branch by the principal. For example, John Dickinson, papermakers, Cape Asbestos, Harvey & Co., engineers, Thomas Fenner, makers of leather belts for machinery, all established sales branches as a response to crisis.[55] Nevertheless, it would be misleading to see crisis investment as the typical case of the transition between agency and branch selling. Most firms who made a foreign direct investment in branch selling were not reacting to an immediate contractual breakdown, but were investing abroad after an agency nonrenewal. To construct the theory of foreign direct investment solely on the basis of transaction costs disregards the cooperative nature of contracts. What really happened is that the principal gradually gained information about the market, including the name of customers through direct sales data, regular stocklist, and sales reports by the agent. The monitoring of the agency relationship, by which directors and travelers visited the agents, inspected books and stock, and provided skilled mechanics and representatives, meant an accumulation of knowledge within the firm on the servicing of a particular overseas market. Learning by the principal made the agent unnecessary, even occasionally when sales were few.

There was, however, a minimum sales volume or transaction frequency before a foreign direct investment could be undertaken. For example, Ransomes calculated that a £10,000-a-year trade would be required before a Paris depot could economically compete with an agency trading on less than £2,000 per year.[56] The costs of running branch sales offices were not insignificant, as the 1929 cost of Fowler's Budapest branch of £11,593 and George Wostenholm's New York City branch of £15,700 per year show.[57] The wholly-owned sales subsidiary incurred higher fixed transaction costs but a lower marginal cost of extending sales relative to employing an agent.[58] Furthermore, the larger the number of sales the greater were the monitoring costs of the agency system. Thus, the propensity to establish branch sales was greater the larger were the number of sales, the more complex the product, the greater the

[55] J. Evans, *The Endless Web: John Dickinson & Co. 1804–1954* (London, 1955), pp. 138–41; *Cape Asbestos: The Story of Cape Asbestos Co. Ltd., 1894–1953* (private, 1953); Harvey, Johanesberg Branch: Hosken's Account, DDH/85, Cornwall County Record Office, Truro; E. Vale, *The Harvey's of Hayle* (private, 1960), p. 44; R. Davies, *Twenty One and a Half Bishops Lane: A History of J. H. Fenner & Co. Ltd.* (private, 1961).

[56] Palmer, "Orwell Works," p. SPA/1F54C, Institute for Agricultural History.

[57] Fowler, Branch Reports, AC7/63, Institute for Agricultural History; Wostenholm, New York Office, WosR12(b), Sheffield Public Libraries Archives.

[58] Peter Buckley and M. Casson, "The Optimal Timing of a Foreign Investment," *Economic Journal*, 91 (March 1981), 75–87; M. Casson, "Forward," in *Inside the Multinationals: The Economics of Internal Markets*, A. Rugman (London, 1981), pp. 15–21; Buckley, "New Theories of International Business," pp. 2.12–15.

idiosyncratic investment in specialized capital and brand name by the principal, and the greater the appropriable rents from opportunism by agents. In part, this explains the sophisticated sales and stock level monitoring arrangements utilized by the agricultural and engineering firms.

Clearly, then, the timing of the transition between modes depended on the frequency and nature of sales, the size of the opportunities for cheating, and the extent of the firm's knowledge of the market. Knowledge of markets was most easily gained by taking over the agent. Fowler's asked their South Africa agent W. A. McLaren in March 1904 to investigate the establishment of branch selling.[59] "The only advantageous way to work our business in South Africa is to work it ourselves," McLaren argued, since there was a "business to work up which needed a lot of energy and special knowledge of machines."[60] McLaren argued that a branch would give people confidence that the firm was not composed of "itinerant bagmen who may never be seen again."[61] In 1905 a South African branch managed by McLaren was opened. Similarly, in 1939 Cowan's took the advice of Conmon Thompson and Thomas Steed, their Argentinian agents, to establish a warehouse, and the agents became full-time company employees.[62] When Cowan's took over their Brisbane agents the staff, including five salesmen, some motormen, warehousemen, office boys, clerks, and typists, were all continued.[63] The establishment of most selling branches did not involve the take-over of former agents, but it did require learning about the market.

## CONCLUSION

The agency system was a unique institution, in which information on markets and products was exchanged between agent and principal. For the principal the exchange of information was a learning experience about servicing a distant market. Market-specific knowledge shifted down the costs functions for branch selling relative to the agency. The greater the frequency of transactions and the more complex the nature of transactions the higher the costs of agency contracting and the relatively cheaper was branch selling. The accumulation of country-specific knowledge of markets, and some minimum transaction frequency were key variables in the timing of the transition to a foreign direct

[59] Fowler, South African Branch Correspondence, AD6/11 3/04, Institute for Agricultural History.
[60] Ibid.
[61] Ibid.
[62] Cowan, Reports: Argentina 1938, UGD311/7/34, University of Glasgow Archives.
[63] Cowan, Reports: Australia, UGD311/7/34, University of Glasgow Archives.

investment in a selling organization by British pre-1939 multinational enterprises. Of course, opportunism and monitoring costs were not totally eliminated: they occurred within the firm-owned selling branch itself. Within the firm, however, the organization could be more effectively audited and the machinery of resolving disputes within the firm replaced termination and nonrenewal as enforcement mechanisms. The firm-owned selling branch reflected the growing institutional and organizational maturity of British multinational enterprise in the years before World War II. The shift from one institution to another was dynamic and historical, a matter of learning by doing.