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## 2

# New Perspectives on Foreign Direct Investment

Rachel McCulloch

Foreign direct investment is hardly a new subject for controversy, whether among policymakers or among economic analysts. Until the 1980s, the controversy centered primarily on outward investments of U.S. multinationals. Indeed, so great was the perceived dominance of the United States as quintessential source country, that the emergence of significant two-way flows of direct investment has required a fundamental shift in both analytical perspective and policy stance.

Statistics on inward direct investment document a dramatic turnaround in the U.S. position. As a host country, the United States was barely on the map during the 1960s, when less than 3 percent of direct investment globally came to the United States. In 1987, shortly after the United States had overtaken Canada as the leading host in terms of book value of accumulated direct investment, the U.S. share of total annual inflows peaked at nearly 50 percent.

In terms of outward investment, the U.S. position also changed substantially as firms based elsewhere became important players. During the 1960s, U.S. firms accounted for nearly two-thirds of all direct investment flows globally. By 1987, the U.S. share in total outward investment had dropped to less than one-quarter. However, the United States remained a top source country for outward direct investments. In fact, it was still the leading source country for the decade of the 1980s; in terms of annual flows, Japan did not replace the United States as the leading source until 1988.<sup>1</sup>

When the United States assumed its new role as the world's leading host to inward direct investment and Japan took its place as the leading source for new

1. Flow data are from Lipsey (1984) for the 1960s and from the International Monetary Fund's *Balance of Payments Yearbook* (1991 and earlier issues) for the 1980s. Shares are based on total balance-of-payments flows that include local reinvestment of subsidiary profits but exclude expansion financed through subsidiaries' local borrowing. On adequacy and interpretation of direct investment data, see Stekler and Stevens (1991).

outward direct investment, U.S. policy retained the nationalistic “us versus them” orientation of earlier decades. Where analysts once probed the consequences for U.S. trade and employment of U.S.-controlled investments abroad (e.g., Bergsten, Horst, and Moran 1978), the same questions have instead been raised about the growing domestic role of foreign subsidiaries of companies based in Europe, Canada, and especially Japan.

There is, however, one striking difference. Where the debate of the 1960s and 1970s often lumped U.S. multinationals with the foreign “them,” the 1990s debate prominently includes the impact on U.S.-based firms with the domestic “us.” Formerly quoted more as an ironic commentary on U.S. corporate greed, Charles Wilson’s dictum, “What’s good for General Motors is good for the United States,” now merely reflects the conventional wisdom of many U.S. policymakers.<sup>2</sup> Rather than the earlier battle of U.S. organized labor against footloose U.S.-based multinationals, the recent motif pits beleaguered U.S. companies (capital perhaps even more than labor interests) against rapacious foreign-based multinationals.

This paper reviews the changing composition of global direct investment flows and relates these developments to contemporaneous changes in global competition. My theme is that direct investment is an integral part of large firms’ overall strategy for global production and sales. The emergence of significant two-way direct investment flows signals that U.S. companies no longer have a monopoly on the firm-specific competitive advantages required for successful global expansion.

## 2.1 Why Firms Invest Abroad

It comes as no surprise when successful firms expand their operations. Indeed, along with profitability, growth is often a yardstick for measuring success among firms in an industry. Substantial increases in *domestic* market share rarely come without some geographic expansion, first of sales and service operations, later of production facilities. However, it is the initial success that drives the expansion, both through lower costs associated with the learning curve and through increased access to and thus lower cost of financial capital.

Sooner or later—usually later for firms located in large domestic markets such as the United States, earlier for firms located in small markets such as Switzerland—the expansion process spills over into foreign markets (Caves 1982, 44). In manufacturing, exports typically come first, accompanied or followed by investments in sales and service facilities (Bergsten, Horst, and Moran 1978, chap. 3). After a successful trade initiative, establishment of pro-

2. According to Webber and Taylor (1992), Wilson’s actual words and meaning were somewhat different. In 1953 hearings on his nomination to become secretary of defense, Wilson was asked whether he would be willing to make a decision with adverse consequences for General Motors. Wilson replied that he would but that he could not conceive of a need to do so, “because for years I have thought that what was good for our country was good for General Motors—and vice versa.”

duction facilities close to the new markets is often the next step. Depending on cost conditions, some subsidiary production may eventually replace domestic production even in supplying the home market. This process can entail plant closings, but firms have an incentive to take the less conspicuous approach of sourcing only increases in domestic sales from foreign subsidiaries.<sup>3</sup>

In this account, both trade and foreign direct investment (FDI) are simply aspects of competition among (large) firms. During the early postwar period, burgeoning U.S. exports and the contemporaneous expansion abroad of U.S. companies were reflections of the same underlying circumstance, namely that most of the world's highly competitive companies were American. Trade statistics for the subsequent decades chronicle a steady deterioration in the relative attractiveness of the United States as a site for export production, as measured by the share of total world manufactured exports produced in the United States.

Over the same period, U.S.-based multinationals also lost ground, as measured by their share (U.S. plus foreign subsidiary production combined) in total world exports, although the loss was not as large as for on-shore production alone.<sup>4</sup> A similar picture emerges from statistics on production for the U.S. domestic market. For manufacturing as a whole and for almost every manufacturing industry taken individually, both imports and foreign-controlled domestic production have increased as a share of total domestic sales.

Trade theory provides a reasonably coherent explanation for postwar changes in the global pattern of production and, thus, for the associated changes in trade flows. Broad trends in the world pattern of production can be linked to observed changes in relative factor abundance worldwide as predicted by the dominant Heckscher-Ohlin paradigm. But the standard neoclassical theory has little to say about the very large firms that carry out much of the world's production and even more of the world's trade, nor about the ongoing process of entry and exit that characterizes most international markets. Trade theory is thus relatively good at explaining why *country* shares of world production are what they are but less good at explaining *company* shares, or why so much production in virtually every nation is controlled by companies based elsewhere.<sup>5</sup>

Foreign direct investment has no place in a strictly neoclassical world. Un-

3. For the service-sector activities that now account for a large part of direct investment, exports in the sense of production in one country for sale in another are less often an option; sales may require establishment of local facilities. On international competition in services, see McCulloch (1988).

4. On the distinction between the competitiveness of U.S.-based multinationals and that of the United States as a location for production, see Lipsey and Kravis (1986). Franko (1991) documents the declining position of U.S.-based companies as measured by share of total industry sales worldwide. This measure differs from the one used by Lipsey and Kravis, who look at shares in world exports rather than total sales.

5. Although many in the United States are apprehensive about the increasing share of foreign-controlled production, the U.S. ratio still looks low in relation to other industrial nations, with the significant exception of Japan (Graham and Krugman 1991, chap. 1).

der “perfect” competition, atomistic firms all enjoy equal access to technology and markets, with none large enough to influence prices of inputs or outputs. The growth of any one firm’s production beyond the minimum efficient size of a single plant requires an explanation, because coordination of activities in multiple locations imposes additional costs. A firm will incur these costs only when they are more than offset by associated benefits from internalizing activities that could, alternatively, be carried out through market transactions. The associated benefits must be larger still if the multiple locations span several nations, as this entails still higher coordination costs. In part, these costs reflect the need to deal with several legal systems, tax codes, cultural environments, and perhaps languages. Moreover, no host country applies strict national treatment; operations of foreign-based firms are invariably subject to some types of discriminatory policies.

Foreign direct investment is most prominent in industries where the competitive paradigm fits least well. Old-style multinationals populated oligopolistic natural-resource-based industries such as oil and aluminum. Modern multinationals thrive in fast-moving Schumpeterian sectors such as pharmaceuticals and electronics, where products are differentiated, reputation is vital, and technology is firm specific and constantly improving. The competitive advantage of these multinationals is created through large investments in advertising and in research and development (R&D). Multinational firms typically earn above-average rates of return, in relation both to the average for all industries and to nonmultinational firms in the same industry. The extra return can be seen as rent earned by the intangible assets that constitute the firm’s competitive advantage.<sup>6</sup>

Firms possessing a competitive advantage such as superior technology, managerial know-how, established brands, or efficient channels for product distribution can exploit that advantage in a variety of ways, including but not limited to establishment of foreign subsidiaries. The most obvious choice is through trade, with all markets sourced from domestic production. Most manufacturing firms at least begin with this approach. Why do some choose to incur the extra expense of establishing production facilities abroad? Direct investment will be chosen instead of, or as an adjunct to, trade only to the extent that the location itself confers a substantial advantage to the company. This advantage may result from the usual elements of comparative advantage as reflected in lower production cost. Barriers to imports or other host-country policy inducements

6. From an industrial-organization perspective, these firm-specific advantages are barriers to entry. Empirical studies of several periods and host countries indicate a close relationship between seller concentration and the importance of direct investment (Caves 1982, chap. 4). This finding does not necessarily imply that seller concentration promotes direct investment, since entry barriers may affect both seller concentration in a given market and propensity of firms to establish foreign production. Morck and Yeung’s (1991) study linking  $q$ -ratios to firm characteristics concludes that companies with firm-specific intangible assets created through R&D and advertising gain additional benefits from multinationality.

also play a role in determining the most advantageous location for production.<sup>7</sup>

Because expansion through direct investment means higher cost of management, advantageous location is not enough to explain the establishment of foreign subsidiaries. Unless multinationals possess an advantage over local firms sufficient to offset the cost of international coordination, the benefits of location will be captured instead by indigenous firms. In the latter case, the foreign company's advantage may be shared with indigenous firms in the preferred location through licensing or other types of long-term contracts.

How a given firm-specific advantage is exploited thus depends on the balance, for each potential mode, between the benefits to be derived and the costs to be incurred. Relative to direct investment, exports or licensing will typically provide lower benefits but entail lower costs. However, coordination costs vary across firms; those already large in the home market reveal a firm-specific advantage of intrafirm coordination. Small high-technology firms are more likely to use exports or licensing agreements to exploit innovations where larger companies find internalization (i.e., establishment of production subsidiaries) profitable.

## 2.2 Exchange Rates and Direct Investment

Since exchange rate movements are an important determinant of ex post rates of return on many types of internationally traded assets, anticipated *movements* in currency values play a significant role in shaping international capital transactions. Currency *levels* may serve as a proxy for anticipated future movements toward a trend value such as purchasing power parity. This implies an essentially speculative investment motive and should thus be more important for portfolio than for direct investment, which generally involves a longer planning horizon. But even if anticipated currency movements do not affect firms' overall plans for expansion abroad, they may influence timing of flows associated with those plans.

Other things equal, a weaker currency makes a country's products a better buy in world markets. Is the same true for its productive assets? An asset (a factory or a hotel, for example) is a claim to a stream of future domestic-currency-denominated profits. If those profits will be converted back into the currency of the foreign investor at the same exchange rate, the level of the exchange rate does not affect the present discounted value of the investment; neither a permanently strong nor a permanently weak currency alters the antic-

7. Some advantages of multinational activity are associated with being multinational rather than with any specific host location. A global production network permits the firm to diversify risk and, more generally, increases its potential for optimizing responses when conditions are volatile (Kogut 1983). Enhanced opportunities for tax avoidance are an additional benefit; multinational firms raise global after-tax profits by using advantageous transfer prices to shift profits to lower-tax jurisdictions.

ipated return. When an activity requires imported inputs or results in exports to other markets, the domestic-currency value of the profits will not typically be independent of the exchange rate. However, the direction of the effect is ambiguous—some investments will become more profitable, others less so, as the exchange rate falls.<sup>8</sup>

The most important effect of exchange rates on local-currency profits is through production costs. By raising production costs relative to those elsewhere, an appreciation of the source country's currency might shift direct investors' locational preference toward other regions. Even so, an advantage of integrated global management is still required to make direct investment a profitable response to the new currency values. Otherwise, local firms will be better able to exploit the locational advantage of lower production costs.<sup>9</sup> Moreover, lower production costs are obviously not the sole determinant of expected profitability. During the U.S. recession of the early 1990s, a weak dollar has not been enough to entice foreign investors.

Given the large swings in key rates during the 1980s, from apparent undervaluation to apparent overvaluation and back again, the explanation for increases during the late 1980s in both inward U.S. investments and direct investments worldwide may lie less in the specific level of the exchange rate at the time of the investment than in the high probability of future large movements. Here the benefit of global management plays a key role. Firms with multinational production and sales networks enjoy greater flexibility in shifting marginal production and marginal sales in response to future exchange rate realignments.<sup>10</sup>

### 2.3 The Role of Import Barriers

International trade theory predicts that restriction of trade flows will stimulate compensating factor flows. If a nation limits imports of autos, for example, it seems almost self-evident that frustrated foreign suppliers ought to establish domestic production facilities.<sup>11</sup> The automobile and electronics industries

8. See Caves (1989). Another argument appeals to a wealth effect on firms facing imperfect capital markets. Other things equal, a fall in the dollar increases the wealth of foreign firms and thus allows them to outbid their domestic counterparts (Froot and Stein 1991). Long-range corporate planning of investment expenditures in terms of the home currency would have a similar qualitative effect on observed dollar flows.

9. Aliber (1987, 302) cites an overvalued dollar as one factor explaining the dominance of U.S. firms among multinationals: "U.S. firms were obliged to invest and produce abroad if they were to be competitive in foreign markets." But the strong dollar merely favored a foreign production location. Other advantages of U.S. firms must be invoked to explain why these firms could make money in head-to-head competition with local competitors.

10. Lipsey (1991) finds trade of foreign-owned U.S. manufacturing firms more responsive to exchange rate movements than is trade of U.S.-owned firms.

11. Investments can also be the implicit price paid by foreign firms to avoid the imposition of new trade barriers. Bhagwati (1985) has coined the term *quid pro quo investment* to describe this link.

seem to offer visible support worldwide for the proposition. Yet statistical analyses do not always confirm a strong systematic relationship.

One likely reason for the weak empirical findings is that protection creates a locational advantage by raising the cost of serving the market through trade. In some cases, this locational advantage does promote foreign investment; in others, it affects mainly domestic entry and exit. When there is no firm-specific competitive advantage best exploited through integrated global management, domestic producers should be better able than subsidiaries of foreign companies to capture the benefits of local production.<sup>12</sup>

The conspicuous cases of autos and electronics, important though they are in their own right, may not point to a general rule. In these industries, technological and managerial know-how provides advantages that allow foreign producers to compete effectively with established domestic firms. By contrast, the highly protected apparel and footwear industries have seen relatively little direct investment from abroad. For these low-technology industries, firm-specific advantages are apparently too small to offset the greater costs incurred by foreign investors.<sup>13</sup>

Evidence at the country rather than the industry level also casts doubt on the role of protection as a strong magnet for inward direct investment. Among developing countries, open export-oriented economies such as Hong Kong have been more successful than nations pursuing import substitution strategies in attracting new investment. Among the industrial nations, the most important host countries have been Canada, the United Kingdom, the United States, and Germany, all with relatively liberal trade regimes.

## 2.4 What Firms Do When They “Invest Abroad”

Direct investment, particularly in the manufacturing sector, is often discussed under the heading “location of production,” implying that the central issue affected by investment decisions is where production is located. As suggested above, the focus on location is misleading. Foreign direct investment is, by definition, the acquisition by a firm in one country of *control* over business activity in a second country. This may or may not be associated with a change in the location of production, but it is necessarily associated with a change in *which firm* controls production in that location. In particular, for the significant fraction of direct investment that entails acquisition of an existing local busi-

12. A separate explanation of weak results in cross-sectional studies relating direct investment to tariffs is that tariff rates change over time and many other economic developments also affect the level of subsidiary activity at any given date. Thus, current activity and current tariff rate may not be closely related “even if that relationship was originally a potent one” (Caves 1982, 41).

13. Changing cost conditions and extension of the Multi-Fiber Agreement to new production locations have given rise to short-lived direct investments based mainly on firm-specific advantages in the marketing of apparel. Such foreign operations, established, for example, by Taiwanese and Korean firms in Thailand and Malaysia, later pass into the hands of local investors.



ness, the transaction can alter control while leaving location of production unchanged.

Foreign direct investment is an intrinsic element of competition for market share within an industry. The typical pattern for U.S. companies in the 1960s, as well as for Japanese companies in the 1980s, was for global market share to grow simultaneously through exports and through direct investment abroad.<sup>14</sup> Viewing foreign investment mainly in terms of relocation of production begs the central issue.

A production site can become more attractive because of factors such as proximity to a growing market, changing cost structure, host-region incentives, or trade barriers; each of these has the potential to alter a firm's decision regarding location of production. However, such location factors do not explain why a foreign-based firm is able to increase its *share* of control over production in that location. A focus on location thus ignores the question of why particular firms are best able to exploit the advantages of that location.

Although it is crucial in understanding foreign direct investment, the distinction between location and firm-specific advantage may be easier to see in the more familiar case of domestic competition. The success of Houston-based Compaq in the market for IBM-compatible computers was primarily news about Compaq's growing share—at IBM's expense—in the U.S. market, not about the relocation of computer production facilities to Texas. In the many business press stories analyzing Compaq's rise, the Houston location was rarely if ever mentioned as a factor. The reason is obvious. Unlike other clone manufacturers, Compaq's success was due primarily to superior product rather than low cost. The Texas location may have been an advantage, but not *the* advantage. (Any Texas advantage was clearly not sufficient to save Texas Instruments, which dropped out of the market for PCs and other consumer products in the early 1980s.)

Compaq's growth was due primarily to a firm-specific competitive advantage over its rivals, an advantage that allowed it to increase market share while selling its products at a premium over other clone manufacturers. But, for the same reason, Compaq's initial success could not last. As other companies came closer to, or even exceeded, Compaq's quality standard while offering a substantially lower price, erosion of market share became inevitable.

At this later stage, where no one producer enjoys a significant product advantage (lower-end PCs are now described as having reached "commodity" status), location of production may appear to become the critical issue. Costs

14. The resulting positive correlation between exports and controlled foreign production led some analysts in the 1960s to conclude that firms' global expansion *caused* the growth of U.S. exports. The reality was, as suggested, more complex. Both types of growth were manifestations of the competitive strength of U.S.-based companies. Nonetheless, some level of direct investment abroad in the form of distribution and service facilities is almost a requirement for strong export performance. Until the mid-1980s, much Japanese investment in the United States was of this export-facilitating type.

in, say, Singapore or Taiwan are lower than in Houston; costs in Malaysia and China are even less. But all potential competitors, including firms already established in those regions, have the option to locate production so as to benefit from the lower costs. The interesting question from an analytical perspective still is: who controls the production, and why?

The numbers reveal that both Compaq and IBM are losing market share in the commodity environment, even though both now produce much of their output offshore. The firm-specific advantages that allowed first IBM and then Compaq to dominate the market are now insufficient to offset their *disadvantage* relative to the clones, presumably the disadvantage of higher costs of coordinating global production and sales. Who has lower coordinating costs? The answer may be, literally, no one. As firm-specific product or service advantages become less important, the market itself may provide a more efficient alternative to coordination within *any* multinational firm. The benefits of expansion, whether domestic or international, must be balanced against costs. Some costs decline with size; others grow exponentially. Bigger, as both IBM and General Motors amply illustrate, is not always better.

## 2.5 Trade and Employment Impact

Most economists agree that the extent of direct investment has minimal consequences for a nation's aggregate employment, yet both enthusiasts and critics focus their attention on the assumed impact on trade and associated changes in employment opportunities. Direct investment *can* have significant trade and employment effects at the industry or regional level. Anticipated trade and employment effects are important in shaping policy, but actual impacts are complex to identify, even *ex post*, and tend to be offset at the country level by induced changes elsewhere in the economy.

Direct investments can take one of two forms. A greenfield investment entails construction of new physical plant. Alternatively, investment may be carried out through merger with or acquisition of an existing domestic producer.<sup>15</sup> Greenfield investments are eagerly sought by host regions because they are perceived to provide a net increase in capital stock, with corresponding implications for regional trade and employment. In particular, greenfield investments are assumed to expand output of the domestic industry, thus allowing reduced imports or increased exports; more production is anticipated to mean new jobs, at least for the industry. Typically more controversial are investments that entail merger with or acquisition of an existing local business, as these are less obviously a source of positive trade effects and new jobs. (The associated change of management is also often bad news for incumbent executives, who may have considerable political influence at the local level.)

15. Actual investments often combine the two basic types, so that a merger or takeover may also include substantial additions to plant. In some cases, a takeover transfers ownership from one foreign parent to another.

Missing from the standard interpretation is an explicit statement of the counterfactual: that is, what would have happened in the absence of the investment. Without the greenfield investment, an existing producer might have added to domestic capacity; given the foreign investor's presence, another producer may decide to exit from the industry. The presumption of a net addition to industry capacity thus rests on the implicit and questionable assumption that other firms already established do not change their own investment decisions in response to the new circumstances.

Standard inferences for trade and for industry employment rest on even shakier ground. The prediction of favorable trade balance effects relies on the assumption that total domestic output expands relative to demand. Since it is unlikely that overall demand for the product rises significantly as a consequence of new investment, new production mainly replaces reductions elsewhere. The key question is thus whether that "elsewhere" is at home or abroad—whether the new output substitutes mainly for other domestic production or for foreign production (goods otherwise imported or goods otherwise produced abroad for other markets).<sup>16</sup>

Even one-for-one substitution of domestic production for foreign production is unlikely to translate into equal changes in trade flows. Foreign-controlled producers typically use a higher percentage of imported intermediate inputs.<sup>17</sup> Positive trade balance effects in the first industry will then be offset at least in part by corresponding changes in the trade positions of the industries producing these inputs. Induced exchange rate movements or other associated macro-economic developments are a further offset to any impact beyond the industry level. Working in the opposite direction is the possibility that foreign-based firms may, especially in the longer run, prove to be more adept than their domestic counterparts in exporting to markets elsewhere. But again, this is likely to be offset in the aggregate by other induced changes economywide.

Although it is reasonable to assume that a favorable trade impact will translate into an increase in industry jobs, the effect will be diluted if the investor's competitive advantage includes higher efficiency in production. In this case, the investment is desirable precisely because it does raise productive efficiency; the emphasis on industry job creation thus distracts from the real gains from upgrading productive efficiency.<sup>18</sup>

Even *ex post* empirical data cannot be used to settle this issue. For example, further deterioration in an industry's trade position or employment tells only

16. To the extent that direct investment increases efficiency and competition in the industry, total sales should rise relative to what they would otherwise have been. In most cases, however, this effect will be small relative to the substitution among alternative sources of supply.

17. On this point and the relationship between foreign ownership and trade performance more broadly, see Lipsey (1991).

18. Empirical evidence for the United States suggests that foreign owners pay roughly the same wages as domestic owners in the same industry but have higher output per worker. For comparisons of U.S.-controlled and foreign-controlled U.S. companies, see Leonard and McCulloch (1991) and Graham and Krugman (1991, chap. 3).

what did happen, not what would have happened in the absence of an investment. The 1960s debate concerning the domestic trade and employment consequences of U.S. direct investments abroad produced predictions of sectoral effects that ranged from strongly negative to strongly positive. The large discrepancies arose mainly from contradictory assumptions concerning the substitution among alternative locations of production.<sup>19</sup> In light of the prevailing U.S. view that Japanese-controlled U.S. factories import too much of their intermediate inputs, it is interesting that the relatively high reliance of U.S. subsidiaries abroad on imported inputs was cited in the 1970s as one reason to expect favorable effects on domestic employment from foreign expansion of U.S. multinationals.<sup>20</sup>

The same qualification applies to the standard presumption concerning industry trade and employment impact of investment via merger or acquisition. The critical assumption is that domestic output remains the same. Yet such transactions often involve a domestic competitor too weak to survive on its own. In this case, the investment may *add* industry jobs to the ones that would have remained had the acquired firm exited instead.<sup>21</sup> This may be true even when actual firm and industry employment fall, as might be expected if the takeover raises productivity.

## 2.6 Impact on Industry Competition and Profits

Like expanded imports, ownership of local operations is basically a way for highly competitive foreign firms to expand their presence in a given market. As long as this expansion does not reduce the number of active competitors serving the market, its most predictable effect is to reduce profits of firms already in that market. This should hold both for domestic firms and for foreign firms that have previously entered the market through exports or direct investment, and the typical behavior of established firms in the affected industry is consistent with this outcome. As with competition from imports, beleaguered domestic firms are apt to label the activities of their foreign-controlled rivals as unfair or detrimental to the national interest.

Yet, as with other forms of entry, the net effect is not always to increase the number of active competitors. Takeovers of existing firms may leave the num-

19. Researchers in the early 1970s estimated net U.S. employment impacts ranging from losses close to half a million jobs to gains of a similar magnitude. OECD (1987, 212) compares six major studies.

20. A quaint echo of the earlier debate can be found in chapter 7 of the *1991 Economic Report of the President*, which cites increased demand for exports of U.S. production inputs among the likely benefits of expansion abroad of U.S. multinationals. The discussion asserts that if U.S. firms did not produce abroad, the markets would typically be lost to other suppliers—in other words, that controlled foreign production rarely substitutes for exports.

21. On the other hand, even an infusion of whatever foreign investors bring may not be enough to save a weak domestic firm, as with Renault's majority interest in the now-defunct American Motors.

ber constant or even reduce it; also, as suggested above, greenfield investment may induce exit by one or more incumbent firms. Moreover, some analysts in the 1970s suggested that entry via direct investment could help to maintain a stable pattern of oligopoly.<sup>22</sup>

Direct investments can also influence profits of firms that do not compete directly. The new entrants' operations change demand for productive inputs and for other outputs, thus affecting profits of related industries. Investments also affect regional and national tax revenues<sup>23</sup> and public expenditures. Opposition to locally provided inducement packages often comes from established firms in unrelated industries. These firms anticipate unfavorable effects on their own profits via higher future taxes and increased competition for skilled workers. In the longer run, foreign ownership is likely to affect—for better or for worse—even the legal structure within which the industry operates, as new owners lobby for advantageous legislative and regulatory action.

## 2.7 Policy toward Direct Investment

Nearly all countries make efforts to attract inward direct investment; at the same time, most also impose limits on access and otherwise restrict the activities of foreign-controlled companies within their borders. This carrot-and-stick approach can have important consequences for the location of economic activity and for the efficiency of that activity in any given location. In particular, investment policies can have predictable effects on trade flows, effects similar to those of policies aimed explicitly at trade: reducing imports, expanding exports, or both. Along with other nontariff measures that influence trade, investment policies have become more conspicuous in recent decades. As successive rounds of negotiations within the General Agreement on Tariffs and Trade (GATT) have reduced the importance of tariffs, a major unanticipated result has been expanded use of investment measures and other “opaque” forms of protection.

The Uruguay Round is the first GATT round to attempt negotiations on policies toward foreign direct investment. Some past agenda items (e.g., subsidies) have been comparable in importance to members' perceived ability to control domestic economic activity, but none has been such a core issue in terms of national sovereignty. In the case of direct investment, the national policies in question aim specifically at regulating the extent and character of foreign-controlled production *within the nation's own boundaries*. Moreover, as discussed above, direct investment tends by its very nature to be concentrated in sectors of the economy that conform least well to the paradigm of perfect

22. For example, Graham (1978). On the general issue of direct investment as a form of entry, also see Caves (1982, chap. 4).

23. Despite the notorious tax-avoidance techniques of multinationals, tax revenue remains the best-documented benefit of inward direct investment.

competition. Thus, standard efficiency arguments for laissez-faire are unlikely to hold without significant qualification.

## 2.8 A “New” Investment Theory?

The nature of direct investment implies that firms engaging in it will typically earn what might be considered supernormal profits. As the “new” trade theory dealing with imperfect competition has suggested, the existence of such rents creates an additional class of arguments for intervention. The basic theme is that a nation can use trade policy to garner a larger share of the industry’s worldwide rents. However, this new class of arguments has met with a cool reception. The theoretical case for any particular policy prescription is highly sensitive to modeling assumptions. Those with practical bent note that conditions in few, if any, real-world industries remotely resemble those required to make the case for national-welfare-enhancing policies along these lines; moreover, the policy process is unlikely to be endowed with the pinpoint accuracy required to ensure national welfare gains rather than losses. Most believe that this new literature, like the older one based on infant industries and other market distortions, yields little guidance for policymaking; adherence to free trade is still seen as the best practical advice.<sup>24</sup>

Is the rent-grabbing motive more persuasive for investment than for trade? As with policies toward trade, national policies aimed at investment tend in practice to reduce global efficiency via suboptimal allocation of resources in production and via associated rent-seeking activities. An important difference, however, is that investment policies are less likely to reduce the country’s *own* aggregate welfare than are those aimed directly at trade flows. International cooperation to avoid a “prisoner’s dilemma” situation may therefore be more important than in the case of trade.<sup>25</sup>

For a country small enough to have no appreciable effect on world prices, the cost of tariff protection is borne almost entirely by the country itself. Even for large countries, the net effect of protection on national welfare is typically negative. But when a tariff creates an incentive for import-substituting direct investment and investment policies are then used to extract some part of the rents generated by foreign-controlled production for the local market, the country may in fact gain.<sup>26</sup> However, the foreign investor will also gain (or

24. For example, Pomfret (1991) argues that the new case for protection is deficient even for jet aircraft, the real-world industry closest to satisfying the conditions of the models.

25. The policy process itself and the attempts of firms to shape policy and to maximize their benefits within any policy environment also use resources. Even when the location and operation of a footloose investment is, in the end, unaffected by competition among rival would-be hosts, the rent-seeking process may entail a substantial social cost.

26. The most obvious channel is via the host country taxation of multinational profits (see Caves 1982, chap. 10). However, profits may also be taxed implicitly through performance requirements imposed on foreign-controlled firms. Labor employed by subsidiaries can also capture part of the rent in the form of above-market wages.

expect to gain), at least relative to the situation of protection but no investment.

For example, assume that a monopoly producer would otherwise serve the local market through imports from plants elsewhere at a fixed marginal cost, but a sufficiently high tariff barrier makes local production the monopolist's preferred alternative. Although less profitable for the monopolist than the *laissez-faire* situation, local production is likely to mean a lower *marginal cost* of serving the market. Thus, the monopolist will maximize profits by selling a larger volume of output at a lower price than before the tariff was imposed. The host thus gains relative to free trade.<sup>27</sup> This gain is augmented by any local tax revenue generated or rents incorporated in wages paid to local workers.<sup>28</sup>

Corresponding losses, although potentially larger in the aggregate, will be spread among other nations (in the example, the main loser is the alternative production site)<sup>29</sup> but may be small for any one of them. An important implication is that the "problem" of investment policies is at least in part problem of incomplete liberalization of trade that creates a locational advantage. Without tariffs, quotas, and other important barriers, there would be less rent to extract and thus less scope for performance requirements. Likewise, harmonization of taxation across potential hosts would reduce the scope for rent-shifting via tax incentives.

Efforts to bring investment policies under GATT discipline have come principally from the United States, propelled by the perceived interests of some U.S.-based multinational firms. Yet, while there is no question that many U.S.-based firms have been affected by investment policies of host countries, the evidence is far from conclusive that source countries such as the United States have been harmed significantly by the use of these policies. In some instances, as illustrated in the example above, the host country and the source country can both benefit on net at the expense of numerous "third" nations, each of which, however, bears only a small part of the cost.

Moreover, there is still less evidence to suggest that trade-related investment policies currently exert an important independent influence on global patterns of production and trade, especially in relation, say, to the remaining egregious

27. Free trade is not the optimal policy for a small country facing a monopoly producer (see Grossman 1990). However, implementation of the optimal policy requires extensive cost information as well as an enforcement capability. The second-best approach of forcing the monopolist to produce locally may be, from a practical point of view, the more attractive option.

28. In the example, a tariff provides the inducement to relocate. An alternative inducement could be favorable tax treatment. In this case, even the multinational may be better off relative to the initial equilibrium. The potential gains to the firm and the host region come in part from increased sales in the host market and in part from a shift in rents to the host (as taxes or wages) and to the firm (as higher after-tax profits).

29. Although the existence of monopoly implies that efficiency may be raised by intervention, the benefits to the host and firm reflect mainly the transfer of rents that would have accrued to a different region under *laissez-faire*.

and well-documented barriers in textiles and apparel and in agriculture.<sup>30</sup> The main effect of most investment measures, at least in the medium term, is to shift rents between the source and the host country.<sup>31</sup>

## 2.9 What Role for the United States?

The greatly increased extent of two-way foreign direct investment and even of two-way flows within a given industry has blurred the distinction, at least among industrial nations, between host and source countries. In the 1960s, the United States was the preeminent source country and thus also the most conspicuous potential beneficiary of international limits on nationalistic policies of host countries. In the 1990s, the United States remains a major source country as well as the strongest voice for international action to regulate investment policies. Yet it has also become the world's most important host to direct investment, with all the new political pressures that entails. Correspondingly, the European Community, Canada, and Japan have gained a new stake in placing limits on host country investment policies, particularly those of the United States.<sup>32</sup>

A key policy question on foreign investment for the United States in the 1990s is analogous to the one raised by the national debate on trade policy a decade earlier: whether the United States is willing and able to champion global goals even when this requires some sacrifice of perceived national needs. Specifically, is the United States willing and able to continue its leadership role in combating investment policies that achieve nationalistic objectives at the expense of global efficiency? Or will it instead join other host countries by adopting its own nationalistic policies? And should the United States opt for the route of nationalism, will any other country be willing and able to assume the responsibility of global leadership on this issue?

30. The decision to tackle investment measures primarily on the basis of their presumed role as nontariff trade distortions neglects important interactions between trade restriction and direct investment as *joint* determinants of the global pattern of production. Changes in trade policies have implications for foreign investment decisions; conversely, the effects of trade policies on productive efficiency and income distribution within and across countries depend crucially on the extent of induced changes in foreign investment. National investment policies can thus have an important though typically *indirect* influence on the consequences of protection and of trade liberalization. National investment policies may therefore be critical to the success of the GATT even though these policies in themselves do not constitute important distortions of trade.

31. Longer-run effects are more complex. If rents are the return to past research and development, policies that reduce the share going to the innovative firms can be expected to discourage future innovation.

32. The convergence of interests may have created a temporary window of opportunity for fruitful international negotiations on trade-related investment measures (TRIMs). On the likely elements of a bargain, see Graham (1991) and Lawrence (1992).



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## Comment Karl P. Sauviant

Rachel McCulloch's paper raises a number of intriguing questions; in particular, the policy issues on which it ends are very important. She presents three basic propositions, namely that the emergence of significant two-way flows of foreign direct investment (FDI) requires a fundamental shift in both analytical perspective and policy stance and that firms consider FDI as part of an overall international strategy. I will deal with each of these propositions separately.

### 1. **Emergence of Significant Two-way Flows of FDI Requires Fundamental Shift in Analytical Perspective.**

It is true that the relative position of the United States as a home country has decreased and that, as far as FDI outflows are concerned, there is a rough parity between the EC, Japan, and the United States, the three areas that make up the Triad (together, they account for about 80 percent of world FDI outflows) (See UNCTC 1991.) It is also true that the United States, as part of the triad that accounts for some 70 percent of world FDI inflows, has become the principal host country. And it is true that this raises all sorts of issues for the United States as host country, including those raised in the paper (e.g., impact on trade, employment, industry competition, and profits). But these issues are not new—there is a large literature that looks at these issues from the perspective of host countries in Western Europe or the developing world. Hence, it is not clear why the decline of the United States as a home and its size as a host country should require a fundamental shift in analytical perspective.

On the other hand, the rise of FDI inflows into the United States should stimulate analysis that revisits the work on FDI impact and systematically reviews the impact of FDI inflows on the economic growth of host countries. Given some changes in the world economy (e.g., the globalization of firms and industry, the importance of new technologies, the importance of the services sector, regionalization), such a reexamination could indeed be quite useful.

## 2. Firms Consider FDI as Part of Overall International Strategy for Global Production and Sales

I agree with the second proposition. Firms do indeed, regard exports, production abroad (i.e., FDI), licensing, and other forms of nonequity linkages as alternative ways to deliver goods and services to foreign markets. But it should be noted that the alternative of export versus production abroad does not apply to many services because these are not tradable. A good part of the text reads as if it dealt with *all* FDI, while in reality some of the discussion (e.g., the progression from exports to foreign production) only applies to the industrial sector. The paper would benefit from an explicit discussion of the manner in which this proposition holds in the services sector. In this respect, the increasing tradability of some services would deserve attention.

But the approach that FDI should be seen as an integral part of a firm's overall global strategy is a promising one and deserves further investigation. The focus of analysis would become *international production*: the emergence of a system of value-added activities across national boundaries that integrates international, capital, trade, technology, and training flows within the framework of firms. Is such an international production system actually emerging? If so, what is its nature? In which industries is it particularly important? How important is it? And so on.

## 3. Emergence of Significant Two-way Flows of FDI Requires Fundamental Shift in Policy

I agree with the final proposition but for reasons other than those developed in the paper. McCulloch suggests that, because the United States is now both a significant home country and host country, it may waver in the future in its commitment to an open, multilateral FDI regime. She also suggests that the United States is the "strongest voice for international action to regulate investment policies." The first point is well taken. Now that FDI is becoming relatively more important in the U.S. economy (although it is still considerably less important than in, say, the United Kingdom or Canada), there are voices that urge a restriction in inward investment. Such a course could have unfortunate implications for efforts to build an international regime for FDI and must therefore be carefully watched. As to the second point, it is necessary to specify that support for international action means support for an open system—that is, a system that defines primarily the rights of foreign investors and the responsibilities of governments and is fairly silent about the responsibilities of investors and the rights of governments. To be equitable and durable, a multilateral system ought to be balanced and hence address the rights and responsibilities of both foreign investors and governments. The current international situation offers a window of opportunity to establish such a system, but it does not look as if major steps are being made to seize that opportunity.

That does not mean, however, that no progress is being made. Most important in this respect are the achievements of the Uruguay Round in the areas of services (the General Agreement on Trade and Services, or GATS, if adopted, will cover FDI in services) and TRIMs. But some progress has been made in the Development Committee of the IMF and the World Bank, which have adopted guidelines; progress is being made by the OECD, where efforts have begun to devise an investment regime incorporating, among other things, the liberalization codes and the guidelines for transnational corporations (TNCs); and of course there is the United Nations Draft Code of Conduct for Transnational Corporation. All this, however, does not necessarily involve a new policy stance but rather is a continuation of old policies.

But a new policy stance *is* needed, because FDI is now probably the most important form of international economic transaction; as Raymond Vernon put it in the discussion: "The proportion of current account transactions attributable to TNCs has gone up dramatically." This has happened as a result of the absolute growth of FDI, its relative importance (e.g., foreign production is more important than exports in bringing goods and services to foreign markets), and the interlinkages of FDI and other international transactions (e.g., a good part of trade is intrafirm trade). As a result, as mentioned earlier, an international production system is emerging.

No international policy framework exists, either for FDI or for international production, in the same way as it exists, for instance, for trade. The framework ought to approach international economic transactions from the perspective of FDI, given the importance of FDI per se and the way in which it shapes a significant share of international trade and technology flows. (Transnational Corporations and Management Division [1991] addresses some of these issues.) Such a framework would, for instance, address strategic FDI policy—which is referred to in the paper but only from a rent-snatching perspective, not as a strategic, long-term approach. It would deal with investment-related trade measures (IRTMs), in the same way in which the GATT framework deals with TRIMs. It could make provisions for transparency regarding FDI policies and institute FDI policy review, patterned on GATT's trade policy review. It would also have to address the question of maintaining competition in the face of globalizing firms and industries and perhaps establish an international competition authority as a focal point for international policies in a world in which international production is assuming importance.

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## Discussion Summary

*Michael Adler* started the discussion by asking whether the main issue addressed by the literature on direct investment could be more clearly identified. He suggested one candidate: an evaluation of the contribution of FDI to economic development in host countries. In the current environment, an important issue is the possibility that FDI might substitute for the official and private portfolio investment that has dominated capital flows to developing countries in recent years.

*Rachel McCulloch* observed that the conventional wisdom in host countries has come full circle. Their preference had been for portfolio investment inflows and local ownership, but host country preferences seem to have shifted toward direct investment. There is now a widespread view that FDI involves imports of knowledge and efficiency as well as capital.

*Ray Vernon* observed that the theory of FDI is concerned with patterns of corporate control rather than with net financial transfers from direct investors to host countries. He would emphasize, for example, incentives for firms in oligopolistic industries to match direct investments by competitors, in order to ensure access to markets and inputs.

*Robert Lipsey* reminded participants that hostility to direct investment had a long history, not just in developing countries, but also in the United States in the nineteenth century. What is quite different today is that developing countries are encouraging and even subsidizing FDI.

*Michael Adler* asked whether subsidies to FDI could be efficient policies and, if so, what form would they take?

*Ann Harrison* pointed out that, in practice, FDI was often attracted by offering protection or was concentrated in protected industries. It is not clear this is an efficient policy.

*Rachel McCulloch* argued that in cases where FDI involved a valuable technology transfer, a small tariff could be optimal for the host country.