The Characteristics, Motivations, and Effects of Japanese and United States Direct Investments in the Pacific Basin

I. INTRODUCTION

In this paper I survey the present state of economic analysis of private foreign direct investment in the Pacific Basin, including in particular the flow between Japan and the United States, and Japanese and United States investments in Southeast Asia and Australia. I first summarize prior studies of the motivations for and characteristics of these investment flows. I then survey the major issues raised by the studies of the effects of foreign direct investment and present an outline of possible directions for future research.

The primary characteristic of those past studies is that they have been fragmentary, duplicative, and lacking in the firm theoretical base so necessary for meaningful empirical analysis. The existing theoretical work on direct investment is composed of two complementary but not well-integrated approaches to the problem, namely, a microeconomic theory of industrial organization and a macroeconomic theory of the international movement of goods and factors of production.¹

The microeconomic, industrial organization approach was developed by Hymer in his studies of monopoly power, international oligopolies, and

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multinational corporations (Hymer 1960 and 1972 and Hymer and Rostow 1970). The Vernon product cycle model was developed as an explanation of trade and investment, emphasizing the economics of new-product development (Vernon 1960). Other contributions have included Knickerbocker's study of oligopoly structure and direct investment and Caves's synthesis of differentiated oligopoly theory and international trade theory (Knickerbocker 1973 and Caves 1971 and 1974). Stevens (1973) has surveyed both the theoretical and empirical literature on the determinants of investment for the multinational firm. He notes that most of the studies have merely been international applications of domestic investment studies and have yielded no compelling theoretical base or empirical evidence for deviating from the microeconomic assumption (and resulting investment implications) of profit maximization. He concludes pessimistically that lack of a data base may for the time being limit progress in this area of analysis.

On the other hand, the macroeconomic theory of international trade and factor movements has proved useful in analyzing the characteristics of and motivations for direct investment in the context of international factor endowments and in explaining the direction of factor-oriented foreign investment flows. There is no implication in either of these theories that the gains to a host country from the introduction of a package of capital, technology, and managerial skills through direct foreign investment will be unambiguously positive. The gains include tax revenues, product improvement or lower output prices, higher wages and prices of the local inputs, upgrading of the labor force, and increases in productivity. Losses from foreign investment can occur if social benefits derived from externalities (say, in the creation of knowledge) are greater for domestically owned firms as compared to foreign-owned firms that cannot be captured by the domestic firms, if foreign-owned firms provide products that are socially undesirable, if the cost of repatriated earnings is too high, if the presence of foreign investment results in monopoly power, or if the cost of servicing the investment (through increased exports or decreased imports) is too high. In only the last case, however, is the restriction of direct foreign investment a first best policy, and, in fact, the losses may well be due to other distortions in the domestic economy. Other arguments against direct foreign investment are noneconomic and include the need for national economic independence and defense (implying restrictions on foreign investment in selected industries).

At present these theories have not been satisfactorily adapted for use in empirical work. The concepts of benefits and costs outlined above are not easily measurable for a given investment. In addition, no useful method of comparison between an economy with a given pattern of foreign direct investment and the same economy with some unspecified alternative to that investment has been developed.
Both the microeconomic and macroeconomic frameworks present the empirical researcher with a comprehensive yet somewhat ad hoc framework for analyzing the characteristics of and motivations for foreign investment, but neither provides well-defined, adequately measurable concepts that are useful to economists interested in studying the effects of foreign investment. Consequently, we find in the empirical work an overabundance of ad hoc studies in which the characteristics of and motivations for foreign investment are analyzed, and there are a few discussions of the effects of these investments in which use is made of an ambiguous and empirically unverified notion of some collection of "spillover" effects in the host economy. In fact, with the exception of some of the Australian analyses there are no studies that systematically measure the costs and benefits of direct foreign investment to the host country. And in the Australian literature it is the use of thoughtful economic analysis rather than any presentation of substantive empirical evidence that is refreshing.

The collection of material used in this study is selective. All available material was reviewed and any that was considered irrelevant or of insufficient merit was not included in the bibliography. A supplementary bibliography of source materials is also provided; it is intended as a guide to available data on the subject and is not meant to be exhaustive.

Japanese investment abroad in general is discussed before its status in the United States is examined as a special case. Next, foreign direct investment is surveyed by host area: Japan, Australia, and then Southeast Asia. The last section contains an outline of the topics in which future research would be most productive.

II. JAPANESE FOREIGN INVESTMENT

Characterization

Perhaps nowhere is the lack of direction and extent of duplicative effort more evident than in the literature summarized below on foreign direct investment by Japanese enterprises. The only constraint on the growth rate of papers on this area—a rate of growth surpassed only by that of Japanese foreign direct investment itself—is the number of research centers, agencies, and institutes willing to sponsor conferences or studies on the subject and the number of journals willing to publish the results. The problem is that not only have the great majority of these characterizations of Japanese investment and its motivations yielded substantially identical conclusions and projections for the future, but the quality of the analysis has been highly uneven. On the other hand, little if any work has been undertaken (or at least completed) on the economic effects of this investment, owing in
no small part, as discussed above, to the lack of an empirically testable theoretical base.

Japanese foreign investment has grown tremendously in the last few years (it had an annual growth rate of 36 percent between 1969 and 1973). Despite this large growth in recent investments, Japan still is a much smaller international investor (as a proportion of GNP) than other developed nations (1.6 percent of its GNP as of March 1970, as compared to 20 percent for the United Kingdom, 7.5 percent for the United States, 5.2 percent for Canada, and 2.9 percent for Germany; see Kitamura 1973). By the end of 1973 approximately 31 percent of all Japanese foreign investments were in mining and natural resource investments, 28 percent in manufacturing, 11 percent in commercial investments, and about 8 percent in financial and insurance concerns. Geographically, 24 percent of its investments were located in North America, 23 percent in Asia, 20 percent in Europe, 17 percent in Latin America, with the balance in Oceania and the Middle East (only about 2 percent were in Africa). Note that over half of those investments were in less-developed countries as compared to only 35 percent for the United States. Approximately 80 percent of all manufacturing investment was in less-developed countries (with about 40 percent in Asia), whereas 70 percent of all investments in North America were in banking concerns or commercial operations, e.g., sales subsidiaries.

Profitability figures are always difficult to interpret, but in the case of Japan it seems that whereas foreign investment has not been an overwhelmingly profitable venture in the past, it has been steadily improving. Only half of Japanese investments showed a cumulative profit as of 1971 (only 60 percent showed a profit for the year 1971; 74 percent showed a surplus by 1973; see Heller and Heller 1974 and Morita 1974). Africa and Southeast Asia were the most profitable areas (74 percent showed a profit in 1971). Two major reasons are ordinarily given for the relatively low profitability: (1) most Japanese ventures are new, and (2) many of the investments are undertaken to provide raw materials or other inputs to the parent company rather than to earn profits. As Japanese ventures abroad mature, their profit figures should improve.

Two major factors have made the sudden surge of Japanese investment possible. These have been (1) increasing liberalization of capital restrictions by the Japanese government and (2) the existence of the large trading companies, without whose knowledge of foreign markets and opportunities many investments, especially those of small manufacturing firms, could never have been undertaken. The program of capital liberalization pursued since the early 1960s was making considerable advances in the early 1970s because of external pressures on the Japanese government and because of a number of factors related to the Japanese economy and the development of Southeast Asia.
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Before capital liberalization, Japanese investments abroad were only permitted by the Japanese government for the procurement of raw materials necessary for Japanese industrial expansion and to ensure necessary channels for Japanese exports. Similarly severe restrictions were placed on foreign investments in Japan. But as it became clear that investments were merely being rechanneled into Southeast Asia and were competing with Japanese exporting firms, that Western technology was becoming increasingly less available by licensing agreements, that the Japanese could not continue to run large balance-of-payments surpluses, and that export markets were being lost abroad, the Japanese government began relaxing its constraints on the flow of direct investment both into and out of Japan.

**Motivation**

Japanese foreign investment can be characterized as being one of four types: natural-resource-oriented, market-oriented, factor-oriented, and what we might call government-control-oriented. Historically, the first category has been of crucial importance to the growth of the Japanese economy, accounting for over 40 percent of all investments in the less-developed countries and nearly one-third of the investments in Asia by the end of 1972 (Industrial Bank of Japan 1974). The policy of the Japanese government and business community has long been to ensure an orderly flow of raw materials to the growing Japanese economy.

Investment based on the need to capture markets abroad or to protect existing export markets usually follows existing trade patterns and has often involved small- to medium-sized firms in light manufacturing industries setting up behind tariff barriers in the developing countries of Southeast Asia or Latin America. This type of investment has also been encouraged by the Japanese government when it has been tied to export promotion, such as in the assembly of finished products from parts produced in Japan. It has been increasing as a result of competitive pressures from the developing countries and, in general, in terms of transfer of technology, yields a much higher payoff to the host country than resource-oriented investments. Another spur to this investment flow which is mentioned less often in the literature is the reduced competitiveness of Japanese industry as a result of the revaluation of the yen; this inducement has worked to make production facilities more attractive both in Asia and the United States.

The third type, factor-oriented investment, is in the case of Japan actually labor-oriented investment. The attractiveness of cheap foreign labor in Southeast Asia in the face of rising wages and a growing labor shortage in Japan has become a major factor in inducing many Japanese firms to move production facilities abroad. This motive is cited in many studies as having
become more important than the securing and protecting of foreign markets behind tariff walls. As the growth of the Japanese economy creates bottlenecks in the production process, such as the one now present in the labor market, foreign investment will continue to be increasingly attractive.

The fourth type, or government-control-oriented foreign investment, involves two factors: the actions of foreign governments and the actions of the Japanese government. In the former category are such attractions as tariff walls, tax concessions and holidays, and duty-free export zones. On the other hand, the Japanese business community has a very close relationship with the Japanese government, and policies dealing with the pattern of economic growth and foreign investment are determined through this working relationship. The capital liberalization program has accelerated because of external pressures and a relaxation of the need for controls on capital outflows when balance-of-payments surpluses became large. In addition, a large portion of capital outflows is in the form of government loans to Japanese firms. The most recent factor inducing Japanese direct investment has been stricter government pollution regulations on industry, a policy which will have the not surprising effect of driving some of the heavy manufacturing and chemical industries out of Japan and into other countries.

**Future Investment**

The literature universally lists the most important factors determining the future pattern of Japanese foreign investment as the increasing liberalization of capital flow restrictions, the need for an orderly flow of natural resources to fuel economic growth, rising Japanese wages, domestic land and labor shortages, restrictions on pollutants and polluting industries, the increasing capabilities of Japanese managers, invitations from less-developed countries in the form of tax incentives and trade barriers, and the increasing maturity of Japanese firms and the subsequent need for oligopolistic defensive investments.

Projections based on these analyses indicate that Japanese investments will rise somewhere between sixfold in eight years to tenfold in ten years; investments in the developed countries will be increasingly in commercial and tertiary activities, whereas manufacturing investments (especially among smaller firms) will dominate in the less-developed nations. Litvak and Maule (1973) point out that Japan will look increasingly to more stable markets for raw materials (e.g., Canada and Australia) and as a result of Japanese technological advancement will produce many products abroad that are not yet marketable in Japan. Roemer (1974) predicts the increasing importance of financial packages that include Japanese government loans in return for product-sharing agreements, especially in the field of natural
resource procurement. The increasing importance of oligopolistic elements in Japanese markets is noted in many studies, as well as the implications for patterns and motives of future investments, especially of the “defensive,” market-oriented type. For example, Morita (1974) has observed a positive correlation between the size of Japanese domestic firms and the amount of their overseas investments.

Joint Ventures
One of the characteristics of Japanese direct investments has been a higher incidence of joint ventures than among United States firms. The explanations for this range from “it is their wish to do so for public relations reasons” to “they are forced into joint ventures by host governments.” The latter explanation may be the more significant one, and Japanese industry with its close ties to government is in no position to have those pressures removed as long as the Japanese government pursues a similar policy toward foreign direct investment in Japan.

Clark (1972) notes that Japanese firms have a sales or trading skill rather than a technological or managerial skill and for this reason prefer joint ventures. Tsurumi (1974), on the other hand, feels that the preference for joint ventures is a conscious risk-reducing strategy on the part of manufacturing firms in Southeast Asia, while Yoshihara (1973) claims that smaller firms need joint ventures to reduce the size of their initial investment. It follows that as Japanese firms increase their technological and managerial skills and maintain a uniform sales strategy (finding it necessary to influence the production plans of their overseas subsidiaries) they will be less willing to accept reduced ownership proportions despite the risk.

Other reasons cited include the need for local partners to handle distribution problems in Southeast Asia because of unfamiliarity with the local culture (Yoshihara 1973), the problems of “economic nationalism” that can presumably be overcome by including local firms in the venture (Kitamura 1972), and the fact (in Taiwan) that the Japanese are closer to the Chinese than are the American companies (Lin 1972). The most telling observation, however, may be Yoshihara’s (1973); he notes there are actually fewer joint ventures in Indonesia for the simple reason that the Indonesian government does not require them.

Reactions to Japanese Investment
Reaction to Japanese investments in Southeast Asia is beginning to echo the reaction to United States investments in Latin America. Japanese investments have received increasing criticism as they account for an
increasing proportion of the total in Southeast Asia, creating fears of foreign domination. The situation is exacerbated because the Japanese investments are the most recent and are predominantly in already existing industries, bringing them into direct competition with local firms (Tsurumi 1974). The Japanese investors have been criticized for exploiting natural resources, not hiring local managers or technicians, using techniques that utilize low technology (Sebestyn 1972); for wanting only to capture the host market and not exporting, insisting on continued tariff protection, using second-class personnel abroad, selling only inferior or second-hand machinery (Ong 1972); for having too close an association with the local government in power—no doubt an extension of the government-business relationship in Japan (Itoh 1973); for paying low wages and not fulfilling the expectations of their hosts that as fellow Asians they would not be mere profit-seekers but would also be agents of economic development (Tsurumi 1974). It has even been noted that their knowledge of the local language has caused friction in Taiwan. Lin (1972) has observed that the Japanese companies have used Japanese managers, whereas the American companies have out of necessity had to hire Chinese managers—a potentially severe source of conflict in the Japanese firms.

In light of this criticism of Japanese investments, there is a curious argument that runs through the Japanese literature, an attempt to characterize Japanese investments (as opposed to American investments) as being somehow inherently beneficial to world welfare. Kitamura (1972) has pointed out that whereas United States investors are in general oligopolists interested in market control, Japanese firms are usually smaller enterprises with a more easily absorbed technology, utilizing more local labor and improving trade relations. And, since they are usually in industries that are declining in Japan, they are part of the process setting the stage for the industrialization of the less-developed countries through worldwide specialization of production. He observes elsewhere (Kitamura 1973) that Japanese investments combine entrepreneurship, capital, and not very advanced (and therefore easily digestible) techniques with abundantly available cheap labor in a manner that is very compatible with Asian countries. He attributes the resulting low level of economic power to the small capital base rather than to any lack of desire for power or intentional low profile.

The most recent example of this type of analysis is a paper by Kojima (1973) in which he tries to analyze the macroeconomic welfare implications of international capital flows. He distinguishes two types of foreign investment: trade-oriented (or Japanese type) and anti-trade-oriented (or United States type), where the former is beneficial because it flows in accord with comparative advantage and the latter is detrimental. He characterizes United States investments as justifiable ventures from a
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Microeconomic point of view, but points out that they reduce international trade since they are primarily directed at protecting or establishing markets and are therefore detrimental to both the host country and the United States. On the other hand, trade-oriented (or Japanese) investment occurs in industries that are declining in Japan and therefore follows comparative advantage, increasing international trade and increasing benefits in both the host country and Japan.

There are a number of problems with this analysis (see Arndt 1973). The distinction between anti-trade-oriented and trade-oriented investments is neither as simple nor as clear-cut as it is presented, nor is it necessarily valid so simply to characterize Japanese and United States investments into one or the other category (which Kojima readily admits in his reply to Arndt). A great deal (and an increasing proportion) of Japanese investment is of the market-oriented variety and therefore anti-trade-oriented. A recent survey has shown that 75 percent of Japanese manufacturing firms invest in Asia specifically to service the local markets as compared to only 40 percent of United States firms (see Allen 1973b). In addition, there are severe problems with Kojima's welfare criterion. He confines himself to a purely static analysis by looking only at the trade effects of international investment. He thereby ignores all of the familiar dynamic benefits of investment such as employment creation, upgrading of the labor force, increasing technological capabilities, and other spillover effects that may well be greater for market penetration (i.e., anti-trade-oriented) investments than for trade-oriented ones such as natural resource extraction.

Both Arndt and Roemer (1974) point out that Kojima's observations on Japanese investment may well be based on coincidence rather than on any free-market tendency to invest along lines of comparative advantage. Roemer contends that Japan's natural sphere of influence is in Southeast Asia, where any investments (including United States investments) are labor intensive; as the Japanese expand their investments into more developed areas, they will become more capital intensive and less involved in industries in which Japan has a comparative disadvantage. Arndt contends that both Japanese and United States manufacturing investments are oriented toward protecting export markets, but since the Japanese markets being protected are for labor-intensive consumer goods rather than technology-intensive goods (as in the case of the United States) the Japanese have an advantage in Southeast Asia, and as a result their investments are in industries in which the region has a comparative advantage.

Kojima's analysis is difficult to reconcile with a world in which substantial portions of Japanese investment have been and continue increasingly to be characterized as attempts to avoid tariff barriers, protect and preserve domestic markets in foreign countries, secure a flow of raw materials to
fuel Japanese industrial development, and export those industries for which the social costs of industrial pollution are too high for the Japanese economy. His conclusions—that the world should move toward free trade and an elimination of foreign direct investment—cannot be justified by an analysis that completely ignores dynamic considerations.

III. JAPANESE INVESTMENT IN THE UNITED STATES

Characterization and Motivation

Between 20 percent and 25 percent of Japanese investments have been in North America. Initially they were made to secure raw materials, but increasingly they have been in commercial operations or banking concerns (70 percent). Heller and Heller (1974) break these investments down: 70 percent in securities (with 79 percent of those representing 100 percent ownership); 23 percent, loans from the Japanese Export-Import Bank; 6 percent, real estate; and 2 percent, branches of Japan-based enterprises. The total investment at the end of 1970 represented only 1.7 percent of foreign direct investment in the United States, and whereas the return on these investments was higher than for other Japanese foreign investments, it was less than for either United States domestic or foreign investments.

The Hellers found in their study of Japanese investments in Hawaii that the major explanation for the recent boom has been the relaxation of Japanese restrictions on tourism and the recent exchange rate realignments. There exists a great deal of tension and increased opposition to further Japanese investment because many Hawaiians feel that the Japanese firms discriminate against non-Japanese in their hiring—an accusation supported by the fact that 88 percent of the employees of Japanese firms in Hawaii are of Japanese extraction.

Tsurumi (1973c) observes that successful manufacturing investment in the developed countries depends on adequate distribution, and the only area for economies of scale available to Japanese industry is in marketing. The benefit from such investments to Japanese small and medium-sized firms is that they are able to keep in touch with United States managerial, financial, and engineering advances. He foresees that the increased need for engineers, managerial staff, and skilled workers, coupled with the high cost of plant site construction and development in Japan, will induce many small and medium-sized Japanese firms to move their production facilities to the United States.
Future Investments

The Boston Consulting Group (1974) has recently completed a projection of future Japanese investment in the United States for the Japanese government. They project that it will have grown to only $6 billion to $7 billion by 1980 without any serious political problems (except possibly in tourism in Hawaii and the West Coast). They feel that the principal factors in the growth of this investment will be growing Japanese shortages, growing trade surpluses, increasing protection of United States markets, and the need for raw materials. The major negative impact on the United States will come from increased competition for scarce raw materials, natural resources, and labor. They distinguish among four categories of investments: (1) export substitution (the benefits will be large to both countries, and there should be no negative reaction in the United States); (2) resource acquisition (there is a limited scope for such investment, with a high risk of negative reaction due to increasing shortages in the United States); (3) technological acquisition (there is a high benefit to Japan with little risk of negative reaction in the United States); and (4) diversified investments (there is little gain to Japan and a high risk of negative reaction in the United States). They conclude by suggesting to the Japanese government that it urge a slowdown in type 4 investment because of the high risk involved. It is important to note, however, that if future Japanese investments are subject to the criticisms that they have received in Asia and Hawaii, then the negative social and political reaction to the first three investment types may be seriously understated by the Boston Consulting Group’s analysis.

IV. FOREIGN DIRECT INVESTMENT IN JAPAN

Characterization

Due to the severity of the controls on capital imports into Japan, most research has focused on the nature of the controls and the arguments for and against their removal. The investments that have managed to enter Japan have been principally from the United States (60 to 70 percent of total foreign assets and 62 percent of the firms by the early 1970s). This investment grew significantly from 1960 to 1968, induced by both the high growth rate in Japan and the liberalization of capital inflows. Whereas only about 5 percent of most sectors is controlled by foreigners, the proportion is substantially higher in the high-growth industries: 70 percent of the computer market, 50 percent of the petroleum market, and 20 percent of
the rubber manufacturing industry (see Halleck and McCormack 1973 and Sherk 1973). Foreign firms have been on the average more profitable than domestic ones because of the heavy incidence of the former in the high-growth industries (Kobayashi 1970).

Japan is strategically located near the world’s population center, has been the United States’s largest overseas market, is one of the world’s fastest growing economies, and has had a very stable government and currency. Despite these factors, less than 2 percent of United States foreign investment through 1966 was in Japan—directly as a result of the program of capital flow restrictions. The motives for those investments included dividends from licensing, potential growth in Japanese markets, improved opportunity for exporting to third countries, and avoidance of tariffs. The objective of the Japanese government, however, has been to allow only those investments that were necessary for upgrading technology and materials and that did not substantially affect the economy. As a result, three major types of investment have been allowed into Japan: (1) investment that provided a supply of needed raw materials; (2) so-called yen-based companies, in which dollars were converted to yen and there were no assurances of repatriation (in 1963 this restriction was removed, but investments still required government approval); and (3) joint ventures (mostly minority equity operations) on a government-approval basis. Most investments have been joint ventures, and have not been very successful, owing to failures in long-range planning among the participants. However, unless there are drastic reductions in capital controls, joint ventures will probably continue to be the major form of foreign investment in Japan.

Capital Liberalization (Pros and Cons)

The arguments justifying past controls and favoring their future use fall into three major categories. In the first place, Japanese firms would be unable to compete in domestic markets with foreign firms because they are often small, undercapitalized, susceptible to acquisition, less flexible, owing to high debt-equity ratio, and have lagged behind in technological development (see Abegglen 1970, Okita 1967, and Yoshino 1970). It is felt that as long as they can import technology they will eventually become competitive. Secondly, there are institutional problems peculiar to Japan that would make the entrance of foreign firms undesirable. These include a weak capital market, a close government-business relationship into which foreign managers do not easily fit, a desire to pursue monetary policies independent of the financially flexible subsidiaries of multinational corporations, a fear of a loss of sovereignty by the government, and fears of foreign domination (see Abegglen 1970, Business Intercommunications 1969, and Yoshino 1970). Thirdly, there are the dynamic arguments for...
V. FOREIGN DIRECT INVESTMENT IN AUSTRALIA

Characterization

The literature on foreign investment in Australia is excellent, investigating and characterizing the motivation, profitability, and effects of that capital flow as though a well-organized research team rather than a group of independent economists were analyzing the phenomenon. This body of literature could possibly serve as a model for future research efforts on foreign direct investment.

The fifth largest amount (third largest per capita) of direct United States investment has been made in Australia. In 1966–1967 United States firms accounted for 4 percent of the equity and 25 percent of the output of Australian manufacturing industry; the comparable figures in the mining industry were 13 percent and 40 percent. Private United States firms accounted for only 7 percent of employment and 10 percent of output, although the proportions were higher for the high-growth industries. The United Kingdom currently accounts for a larger amount of investment than the United States, and the figure for Japan, which has invested very little in the past, is growing. In 1971 private firms in the United States, United

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Kingdom, and Japan invested $A3.5 billion, $A4 billion, and $A70 million, respectively.

In the 1950s and 1960s the bulk of the investments were in manufacturing. By the mid-1960s manufacturing investments had leveled off, and investments in mining and petroleum had begun to increase. From 1957 to 1967, 50 percent of foreign investments were in manufacturing, 13 percent in primary products, and 33 percent in services. About 71 percent were wholly owned subsidiaries or branches, but only 4 percent of foreign concerns owned less than a 50 percent equity interest. In general, United States firms tended toward a higher proportion of wholly owned subsidiaries, hired few non-Australians, and conducted about the same amount of research as local firms (Brash 1966).

Motivation

Three basic factors account for the large flow of investments into Australia. The first has been Australian natural resources (Brash 1970, Clark 1972, and Macleod 1969). The second has been the strength of the Australian economy, the stability of its political system, its potential for future economic growth, its well-educated labor force, and its strategic location for accessibility to Asian markets (Brash 1966 and 1970, Macleod 1969, and Perkins 1970). The third has been a program of government encouragement of capital inflows in the form of tariffs, import controls, tax concessions, and other direct and indirect policies. This last factor has been somewhat less significant of late, as indicated by the policies proposed following publication of the Vernon Report in 1965 (Brash 1966 and 1972 and Commonwealth Treasury 1972) and, more recently, the attempts to restrict capital inflows and the proportion of foreign ownership.

During the 1960s, the profitability of foreign enterprises fell from the levels of the 1950s, owing partly to falling profits in the motor vehicle and petroleum industries and partly to the large inflow of new firms (Johns 1967). Johns predicted that foreign enterprises would become more profitable as a whole when the newer firms matured and achieved higher rates of return, but would never reach the levels of the 1950s again. Brash (1966) found that although the profitability of United States companies was less than had been popularly believed, it was greater than that of either their British or Australian competitors.

The Effects of Foreign Investment

The literature on the effects of foreign direct investment in Australia has often been written in response to government policies toward capital inflows induced by fears of increased foreign ownership of Australian
industry and natural resources. In general, the authors of those economic studies have taken the position that the economic benefits of foreign investment in Australia are large while the costs are low, the effect of foreign ownership on firm behavior is not significant, and restrictive policies on capital flows should be eliminated in favor of policies aimed at correcting domestic distortions. The Australian government has tried on occasion to influence the proportion of foreign ownership by restricting the size of the inflow, encouraging greater domestic equity participation, and discouraging foreign takeovers (this effort was increased in the early 1970s). Brash (1969) has maintained that there has never been any demonstrated economic loss from foreign equity acquisition nor any gains from the joint venture form of investment. He further notes that microeconomic behavior with respect to production planning, wage policy, dividend policy, and labor relations (but not export markets) is the same for both domestic and foreign firms, that, in fact, subsidiaries of foreign corporations behave much like domestic firms and submit themselves to Australian sovereignty. The Commonwealth Treasury (1972) adds that increasing local equity participation does not at all imply an increase in control or a change in the firm’s behavior; in fact, it spreads local equity more thinly across Australian industry. They go on to express what has become a consensus viewpoint in this literature, namely, that it is the effect of local equity participation on Australian growth and resource allocation that should be analyzed rather than the effect on the proportion of foreign assets. Nevertheless, the Vernon Report in 1965 had looked into this question and concluded that if the then-existing levels of foreign capital inflow continued, the proportion of foreign-owned capital in Australian industry would rise significantly and the effects on the balance of payments would eventually be negative. The committee therefore recommended that foreign capital inflows be restricted to £50 million a year. Moffatt (1967) showed their results to be in error with regard to the balance of payments (he projected that the capital inflow could continue as a source of foreign exchange indefinitely), but did conclude that domestic ownership of Australian firms would have to rise at the unlikely annual rate of 7 percent if the proportion of foreign ownership was not to rise. On the other hand, Perkins (1966) demonstrated that the Vernon Committee’s conclusions on foreign ownership proportions were a result of an “error of statistical manipulation,” and found somewhat less pessimistic results. He went on to point out that the proportion of foreign ownership was not really the issue, but that the benefits in terms of the services rendered to the Australian consumer and industry by foreign-owned firms should be weighed against the costs in terms of profit remittances.

The question of foreign ownership of natural resources as discussed by
Hunter (1966) and Kindleberger (1969) is essentially a question of whether the foreign buyer is willing to capitalize (into real capital assets) the value of the present and future stream of benefits from the natural resources. The government must then require that the price paid for the resources be equal to their value to Australia, irrespective of the nationality of the buyer. Hunter points out specifically with regard to oil exploration that if foreigners find no oil, it is knowledge acquired cheaply by Australia; but if oil is discovered by foreign firms, the benefits in terms of the introduction of new skills and techniques, the improvement in the balance of payments, the increased domestic supply of cheaper oil, and the increased royalties by far outweigh the costs in terms of increased profit remittances.

The positive benefits of foreign direct investment that have been listed in the literature (and against which must be weighed profit remittances and political and psychic costs of foreign ownership) include increased employment, increased tax revenues, the spread of technological know-how, increased efficiency through competition and improved quality of goods, an increased export base, increased mineral development, increased capacity to industrialize, increased productivity, the creation of new and more efficient industries, and more research and product development (see Brash 1966 and 1970 and Commonwealth Treasury 1972).

Brash (1966 and 1970) and the Commonwealth Treasury Report (1972) conclude that many of the observed negative aspects of foreign investment are, in fact, distortions in the domestic economy. For example, the existence of monopoly power and subsequently higher prices are better solved by generating a competitive environment and regulating monopoly power across all sectors than by preventing the inflow of foreign capital. The losses in tax revenues often attributed to transfer pricing practices of foreign firms can be recovered by framing and administering efficient tax laws. They note that each state within the commonwealth has its own tax inducement scheme to attract foreign capital; this competitive taxation policy has little impact on locational decisions by foreign firms and deprives state governments of needed revenues. Similarly, the existence of too many inefficient firms in an industry is best solved by restricting entry into that industry rather than restricting inflows of foreign capital.

VI. FOREIGN DIRECT INVESTMENT IN SOUTHEAST ASIA

General Characteristics

Both the scope and quality of research on United States and Japanese investments in Southeast Asia are spotty and fragmented. Serious studies of United States investment in Southeast Asia are all but nonexistent.* How-
ever, I will draw whatever generalizations are possible on the basis of the 
existing literature and then present a country-by-country review.

Foreign direct investment in Southeast Asia has been increasing at a 
rapid rate because of expanding local markets and the existence of natural 
resources, cheap labor, a high relative rate of return, and decreased 
opposition by local governments owing to reduced fear of foreign domina-
tion as a result of the rise in the number of countries that are sources of 
investment (see ECAFE 1971 and Sherk 1973). Private flows account for 
about 30 percent of total resource flows and the foreign share of the capital 
stock represents from 15 to 30 percent of the total capital stock (ECAFE 
1971). There is an increasing trend toward manufacturing production and 
export promotion in these countries, trends that are instrumental in the 
determination of foreign capital flows (ECAFE 1971).

Hymer (1972) and Vernon (1972) have characterized United States 
investment abroad (including that in the less-developed countries) as being 
oligopolistic (fifty firms account for 60 percent of the investment), very 
large, more capital intensive than host country investments but less so than 
domestic United States investments, manufacturing oriented, motivated by 
both offensive strategies (seeking new profits) and defensive strategies 
(protecting markets from future competition), and composed mostly of 
wholly owned subsidiaries. Rhodes (1972) has observed that whereas the 
large corporations have continued to invest, the small companies had 
slowed their activity down by the end of 1971. In addition, the attractiv-
ness of the less-developed countries had declined somewhat owing to their 
political instability and insistence on joint ventures (the less-developed 
countries accounted for 27 percent of investments in 1961 versus only 20 
percent in 1971).

About 4 to 5 percent of United States investments has been in Southeast 
Asia. The value of these investments doubled between 1964 and 1970, 
while the number of subsidiaries rose 30 percent between 1963 and 1967. 
These investments are similar in character to United States investments as a 
whole: usually large, capital-intensive, oligopolistic firms involved in oil 
and mineral development (40 percent) or in technologically advanced 
fields (37 percent), usually wholly owned subsidiaries or at least majority 
equity arrangements (71 percent). The operations are often component 
production and assembly type, and a significant volume of their exports is 
Allen (1973b) has noted that 40 percent of those investments is undertaken 
to secure, maintain, and develop overseas markets, while 32 percent is 
amiled at developing a low-cost export base. He adds that this latter 
purpose along with the ability to secure, maintain, and develop a regional 
base to complement activities will be the dominant motives for future 
United States investment in this area.

On the other hand, 22 percent of all Japanese investments is in Southeast
Asia. They are, in general, more labor intensive: in the main, they consist of small manufacturing firms affiliated with one of the large trading companies. The Japanese investors are willing to own a smaller proportion of the equity (one reason: their investments have a lower degree of capital sophistication), and they are more oriented to import substitution industries, or those industries in which they are losing export markets (see Sherk 1973). The motivations for these investments have been discussed earlier. In brief, they include the existence of a low-cost export base, the presence of cheap labor, the desire to secure, maintain, and develop growing domestic markets, the existence of export processing zones, the availability of tariff preference schemes by the developed countries for exports of the less-developed countries, and the presence of tariffs in the host countries. The first two are also the primary motives for United States investments in Southeast Asia.

**Characteristics in Each Host Country**

About 30 percent of Japanese investments in Asia have been in Indonesia (only 12 percent since 1967). United States investments have been larger in value than those of Japan, but by number of firms the reverse has been true. Investments are almost exclusively joint ventures, with local equity required to be 50 percent within fifteen years of the initial investment; this generally relegates the Indonesian partner to the role of marketer for the firm. Japanese investments have been 50 percent in mining, 30 percent in manufacturing, and 17 percent in agriculture. Since the market-oriented investments have been undertaken to avoid tariffs and import restrictions, their potential for expansion is uncertain.

Indonesia, despite possible political instability and poor infrastructure, is attractive for its natural resources, cheap labor (although with poor productivity), and large potential market (although with low per capita income). Tsurumi (1973a) concluded that in order for foreign firms ever to realize their export potential, Indonesia will need to allow longer-term tax benefits, reduce restrictions on inputs, and remove export duties. Sadli (1972) observed that tax holidays have been of little help in bringing in investment. In addition, other incentives, which were necessary to offset risks and compete with other less-developed countries for scarce capital, have brought about fragmented markets with too many firms, implying a need for better government coordination on a regional basis.

As of May 1970, the United States was the principal investor in South Korea with Japan second; the United States accounted for 41 percent of the projects and 60 percent of the total value of investment, while Japanese firms accounted for 28 percent and 16 percent respectively. There is still some tension between Japan and Korea due to the earlier period of
colonialism, but investment has increased rapidly once it has been undertaken because of the oligopolistic nature of the Japanese firms. The export processing zone and some tax holidays provided some inducements, but the fear of loss of trade status with China has kept some large Japanese firms out of Korea.

Laos has no restrictions on direct foreign investments and has some incentives for industrialization, but political instability, military conflicts, and lack of opportunity have kept investments small. Those investments that have been undertaken are primarily extractive or financial and commercial.

In Malaysia direct foreign investment accounts for about 12 percent of total investment. The major investors are the United Kingdom, United States, Singapore, Hong Kong, and Japan (in that order). The most recent investments have been in light manufacturing and product processing. Because of the high tariff structure, much of that investment has been in import substitution activities, implying the existence of many small firms unable to compete without protective tariffs. Malaysia is blessed with political stability, a large supply of labor, and a large stock of natural resources; poor infrastructure and a shortage of high-skilled labor are the major constraints to further investment.

Foreign investment in The Philippines is dominated by the United States. It is basically undertaken to take advantage of the import substitution policy or to obtain raw materials (Japanese investment is almost exclusively in raw materials). There is an abundant supply of natural resources, a large, well-educated labor force, and a well-developed commercial banking sector. However, there is also an inadequate supply of skilled workers, inadequate infrastructure development, and waste and inefficiency in government planning. The government recognizes the contribution that foreign investment has made to modernization, but has recently begun to restrict the extent of foreign ownership in all except pioneering industries (foreign ownership must be no more than 40 percent, with even that to be phased out over a twenty-year period). Government efforts have also been directed at garnering investments toward exports and inducing firms to process raw materials before exporting them.

More has been written about foreign investment in Singapore than in any other Southeast Asian country. Much of the investment has been due to the stable economic and political environment, the development of the best financial market and commercial center in the region, the presence of a well-educated labor force and well-developed infrastructure, the locational advantage, a good government that has encouraged industrialization and foreign investment flows, and the need to forestall competition. In general, tax breaks, have not been an inducement, and have deprived Singapore of needed revenue. Japanese investments have accounted for 37
percent of all foreign manufacturing assets (although the Japanese flow has been declining because of wage increases). They have been capital intensive and technologically sophisticated; mostly joint ventures (United States ventures have been more wholly owned); and often reactions to competitive United States investments in Singapore (the high levels of protection have generated many oligopolistic markets). Recently, the political stability of Singapore has drawn investments away from other Southeast Asian countries.

United States and Japanese firms dominate foreign direct investments in Taiwan, with the United States accounting for 26 percent of total investments in 1970 and Japan, 65 percent (although this represented only 17 percent of the value). United States enterprises invest more often in wholly owned subsidiaries (which are not as integrated into the Taiwan community as are the Japanese firms), and as noted previously, they hire more local managers (Lin 1972). The Japanese firms are in general smaller, and because of that and their high labor content they are profitable ventures even at an early stage. The main attractions of Taiwan are its low wages, positive attitude toward investments, incentive program that is competitive (without costing it large revenues), export processing zone, and large potential market.

Japanese investments have dominated foreign direct investment in Thailand to the point where it is of concern to the Thai government (Japanese firms account for 73 percent of all wholly owned subsidiaries and 43 percent of total investment as opposed to 18 percent for Taiwan and 10 percent for the United States). The major attractions are Thailand’s political stability, the low wages and high quality of the work force, the supply of natural resources, and the import substitution policy of the government. The value of the latter, however, is partially offset by the underdeveloped capital market and lack of skilled labor. Most of the investment has been in light industrial sectors utilizing capital-intensive techniques and has brought needed know-how and managerial skills to the Thai economy. The import substitution policy has generated serious excess capacity, and it has resulted in a high import content of export goods because of low tariffs on intermediate goods and a high tariff on final goods. This has meant that the industrialization effort has not had the development impact that it might have. Consequently, a comprehensive program of export promotion is recognized as a fundamental need in Thailand.

The Effects of Foreign Investment

Those few authors who have discussed the effects of foreign investments, most notably Hughes (1971), Hughes and Seng (1969), and Sherk (1973), have concluded that the benefits include increased technological know-how, increased supplies of resources for industrialization, an upgrading of
the labor force, increased production capabilities, increased contact with international markets (including capital markets), and increased foreign exchange resources, management techniques, and employment. Listed among the costs of foreign investment are decreased domestic research and development capacity, stagnation of local capital markets and of managerial and entrepreneurial skills, insufficient use of low-cost labor, reduced national sovereignty, increased cultural conflicts, decreased revenue owing to tax concessions, some monopoly profits, introduction of inferior products, reduced competition, and a drawing away of the best workers from indigenous firms into foreign-dominated ones.

A number of these problems can hardly be attributed to the existence of foreign investments. It has often been the industrialization policies of many of these countries rather than the flow of foreign direct investment that has led to distortions in product and factor markets. Import substitution policies and accompanying tariff structures have brought about fragmented and oligopolistic markets, excess capacity, and distorted domestic markets (see especially Little, Scitovsky, and Scott 1970, Nartsupha 1970, and Sadli 1972). In response, ECAFE (1971) and Nartsupha (1970) have suggested that there should be more selectivity in granting investment licenses, greater emphasis on export promotion, and more favorable exchange rates for manufactured exports. Myint (1972) has proposed that natural resources be capitalized into a steady inflow of social overhead capital by allowing free entry into natural resource development and charging the full economic rent, thereby inducing investments in the primary and manufacturing export sectors in a positive way rather than through import substitution policies and tariffs.17

Competitive Incentive Schemes

Another serious problem has been caused by the loss of revenues from competitive tax incentive schemes levied by the Southeast Asian countries (ECAFE 1971, Hughes 1971, Hughes and Seng 1969, Sadli 1972, and Stikker and Hirono 1971). As has been the case among individual Australian states, since all countries have legislated the same tax schemes they have no effect in attracting foreign investment and merely deprive the countries of needed revenues. Both ECAFE (1971) and Stikker and Hirono (1971) have suggested that efforts at tax harmonization be undertaken to eliminate that unnecessary subsidy in the future. Many of the studies have also discussed the potential gains from integrated industrialization policies, regional harmonization, and a possible customs union, although members of the 1973 SEADAG conference pointed out that a major obstacle to cooperation has been and will continue to be the weakness of Southeast Asian bureaucracies.
The Transfer of Technology

The transfer of technology from Japan to the developing countries has been very significant. It has been restricted to a transfer of know-how by practice of only gradual employment of local labor by Japanese firms, even this has been limited because of the sophistication of the projects (Allen 1973a). The transfer from United States firms has not been of great significance either. Ozawa (1971a) feels that it has been even less than for Japanese firms because of the greater sophistication of the United State investments and the smaller proportion of technical contracts, whereas Allen (1973b) feels that United States firms have performed better in this regard because the Japanese use simple, indivisible production processes.

In a case study of The Philippines, Mason (1970, 1973) was unable to attribute significantly greater technology transfers by United States firms than their Filipino counterparts.

As a result of incentives to foreign direct investment and the complexities of the technologies relative to the skills of the labor force, technology transfers to the developing countries have been accomplished through direct foreign investment rather than through sales or licensing as in developed nations (Ozawa 1971b). Allen (1973a) recommends that Southeast Asian countries redirect investment toward export capabilities and away from the present raw material base as a way of capturing greater gains through technology transfers, while Hughes and McKinnon (in SEA-DAG 1973) stress the need to learn ways to "unwrap the package" of investment so as to retain greater benefits from direct investment.

The Proportion of Foreign Ownership

The question of the proportion of foreign ownership in Southeast Asia has been raised by Mason (1974), Reuber (1974), SEADAG (1973), and Vernon (1972). Vernon has observed that the transfer of tangible and intangible resources is less in a joint venture than in a wholly owned subsidiary, making joint ventures less desirable on economic grounds. In addition, the so-called fade-out policies (where foreign ownership is scheduled to be eliminated or to decline to a certain level) prevent some companies from undertaking investments or induce the least capable rather than the most capable firms to enter the market. Against these economic costs of joint ventures, of course, must be weighed the real or imagined noneconomic costs of foreign control of domestic enterprises.

In a preliminary study, Reuber (1974) has concluded that the larger the share of foreign ownership in a domestic enterprise (holding export shares constant) the larger the share of financing from abroad and the smaller the share of purchases from local firms, but there is substantially no effect on
local hiring or on the form of received earnings (if anything, there were fewer payments of fees and licenses). He concludes that if the proportion of foreign ownership has little effect on the behavior of the firm, there is no reason to require joint ventures as the principal form of foreign investment. The preferred policy under these conditions would be to remove restrictions on foreign ownership and try to obtain more of the gains for the host country (an admittedly difficult task with the existing level of competition among developing countries).

Mason (1974) has warned against general policies on technology acquisition, recommending that policies be studied on an industry-by-industry basis. He presents a comprehensive list of methods of technology acquisition and analyzes the factors that would be important in choosing the appropriate method of acquisition for a particular industry. ECAFE (1971), on the other hand, has recommended policies encouraging joint ventures and a gradual program of reducing foreign ownership in existing firms.

VII. TOPICS FOR FUTURE RESEARCH

As noted in the introduction, and as highlighted throughout the paper, the principal need in future research is for a theoretical framework that could be adapted for use in analyzing the economic effects of foreign investment. As foreign investment comes under increasing attack in Southeast Asia, Australia, and even lately in the United States, it would be useful if economists could show the real economic costs and benefits (in terms of economic growth and resource allocation) of restricting foreign direct investment. Presumably there is some real, estimable cost to achieving the goal of increased proportions of domestic ownership. The literature on foreign investment in Australia could perhaps serve as a starting point for such an effort—although the effect of these past studies on Australian policymakers will, it is hoped, not have a discouraging effect on future efforts. In addition to such a general study, individual country studies are needed on the effects of foreign direct investment, especially for the countries of Southeast Asia.

There is a surprising lack of research on the characteristics of and motivations for United States investments in Southeast Asia. Although this amount is small from the standpoint of the United States, the potential for positive contributions to the economic growth of Asian nations is very large. Similarly, studies of multilateral investments have been limited. A coordinated effort could be undertaken to analyze these investments on a country-by-country and regional basis.

Many studies have recommended regional harmonization of industrial-
ization plans, tariff schedules, and tax incentive schemes for Southeast Asia. Evaluation of these possibilities should include an analysis of the effects of regional harmonization of investment (both foreign and domestic) as a way of avoiding fragmented markets characterized by excess capacity in the industrialized sectors of the less-developed countries.

Reuber's (1974) preliminary work on the effects of foreign ownership on the behavior of the firm should be pursued further. As he concludes, if the firm's behavior is the same whether it is a wholly owned subsidiary or a joint venture, and if restrictions on the proportion of foreign-owned capital keep out needed investments, then the host country should not require foreign investments to be joint ventures.

In many studies, it was concluded that tax incentive schemes had no effect on the locational decisions of firms in Southeast Asia or Australia. The primary effect of these competitive tax schemes was to deprive the host governments of needed revenues. It should be possible to analyze the economic effects of alternative taxation schemes for a given country with or without cooperation from other countries. This could even be undertaken as part of a study of general (optimal) taxation in a given country or group of countries, perhaps in conjunction with a study of regional cooperation as discussed above.

The question of the possible benefits from the technological innovations embodied in direct foreign investment is crucial to the determination of the overall effects of this investment. As the trend in less-developed countries is for less licensing and sales of new technology and more direct investments, a serious (researchable) question arises as to how the host countries might better extract the technological innovations brought in by these investments. What policies can the host government pursue (other than the phasing out of foreign ownership, which often does not realize the desired end) that will maximize the technological spillover from foreign investment?

An observation that was not made in any of the studies was the opposite paths that Japan and Australia have taken with regard to foreign investment and industrialization. To be sure, the differences between the two economies in factor endowments and population density make comparisons difficult, but both countries have achieved significant growth in industrial capacity although one closed its doors to foreign investment and the other remained relatively open.

One factor often cited for the large demand for foreign capital in Southeast Asia has been the underdeveloped indigenous capital markets. Research on the development of those markets could significantly shorten the length of time those countries remain dependent on foreign capital for domestic development efforts.

Lastly, in many of the studies, it was noted in passing that the reevaluation
of the yen has helped to account for increased foreign investment activity by Japanese firms, especially in the United States with its recently devalued dollar. Makin (1974) has also made this point in a recent Princeton International Essay on United States investment. The rationale, of course, is that an overvalued exchange rate such as that for the United States dollar in the 1960s is a tax on domestic production and a subsidy to foreign production. Analogously, an undervalued exchange rate, as in Germany and Japan in that period, represents a subsidy to domestic production. It should then be expected that the exchange rate realignments of the early 1970s should lead to increased foreign investment in the United States and should induce the Japanese to invest more abroad. This is certainly an empirical question of some significance for the Pacific Basin. Note in this regard that the developing countries have long been accused of maintaining overvalued exchange rates as part of their import substitution policies. The implication of this exchange rate policy would be that they would have less foreign investment than if they maintained an equilibrium (lower) exchange rate. The effect of levels and changes in the levels of exchange rates on direct foreign investment in the Pacific Basin is an important empirical question.

The most productive direction for future research should, then, undoubtedly be on the effects of foreign investment in Southeast Asia, Japan, and Australia (and perhaps in the United States, although the impact of any one country’s investments will be very small for some time to come) with an eye toward helping host governments make rational decisions as to how and where to guide future investments. However, except on United States investments in Asia, there is already an oversupply of research efforts characterizing foreign investments (especially Japanese), and at the present growth rate this condition should continue.

NOTES

1. See Johnson (1970 and 1972). In the summary below I borrow heavily from Johnson’s summary of this material. For an excellent and comprehensive bibliography of the general topic of foreign direct investment, see Oho (1974).

2. I regret that there was only time (and expertise) to review materials in English. Many Japanese books and articles are discussed in some of the English selections, but undoubtedly some significant works are available only in Japanese and have regrettably not been included in this survey.

3. The most complete characterizations of Japanese foreign investment include MITI (1974a and 1974b), Miyoshi (1974), and Sherk (1973); investments in Southeast Asia are characterized in Allen (1973a) and Ozawa (1972b).

4. He notes that this explains why “there are many accusations against anti-trade-oriented
for American type investment but few in principle against the trade-oriented or Japanese type investment, although there are complaints about the performance and behavior of Japanese firms abroad" (Kojima 1973, p. 16).

5. This discussion of the program of capital controls draws heavily on Abegglen (1978).

6. The most significant works have been Bush (1966 and 1970), Perkins (1970), and Commonwealth Treasury (1972). The theoretical contributions are summarized by Corden (1968).

7. The major exception to these conclusions was an early study by Wheelwright (1963), who concluded that foreign direct investment was not as necessary as some people thought, that theoretically the effects were not all that clear-cut, and that the data were not definitive.

8. The most comprehensive work on United States investments is Allen (1973b). Stark (1973) and ECMT (1974) are the best studies available for purposes of comparison with Japanese investment in Southeast Asia. Kapoor (1972) presents the results of a survey of United States companies that is only of casual interest, while Lindert (1969) has studied United States investments in Singapore, and Schreiber (1977) has analyzed investment in Taiwan. Other studies that are somewhat more peripherally related include Halliday and McCormack (1973), Lin (1972), Litvak and Maule (1970), and Vernon (1972).

9. For studies of direct foreign investment in Indonesia, see Sadri (1972), Sebestyn (1972), Sikker and Hiruno (1971), and Tsurumi (1973a).

10. For studies of direct foreign investment in South Korea, see Ozawa (1972b) and Yang (1972).

11. For studies of direct foreign investment in Laos, see Hughes (1971) and Sikker and Hiruno (1971).

12. For studies of direct foreign investment in Malaysia, see Sikker and Hiruno (1971).

13. For studies of direct foreign investment in the Philippines, see Itoh (1973), Mason (1970 and 1973), Sebestyn (1972), Sikker and Hiruno (1971), and Virata (1972).

14. For studies of direct foreign investment in Singapore, see Hughes and Seng (1969), including Hiruno (1969) and Lindert (1969), Chang (1972), Ozawa (1972b), and Sikker and Hiruno (1971).

15. For studies of direct foreign investment in Taiwan, see Lin (1972), Ozawa (1972b), and Schreiber (1970).

16. For studies of direct foreign investment in Thailand, see Nartsupa (1970), Sebestyn (1972), Sikker and Hiruno (1971), and Viravan (1972).

17. Note, however, that there are also serious problems caused by developed countries' tariffs on developing countries' exports (Hughes and Seng 1969). In addition, many of the free trade zones have had disappointing results because of legislated exclusions, especially in Japan (Ozawa 1972b).

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DISCUSSION

Speaker: Steven Kohlhagen
Discussant: Raymond Mikesell, University of Oregon

Mikesell praised the author for having provided the conference with such an excellent and thorough summary of the English-language literature on the subject of foreign direct investment in the Pacific region, and expressed relief that Kohlhagen had not had time to survey the Japanese literature on the subject! He then went on to say that Kohlhagen's paper raised two types of economic question: (i) What are the economic factors that explain foreign direct investment? and (ii) What are the respective costs and benefits for the capital-importing and capital-exporting countries?

Concerning the first question, Mikesell agreed with Kohlhagen that there is no integrated theory of direct foreign investment. At best, there exist only partial theories, such as Vernon's product cycle and other hypotheses,
which deal with the behavior of multinational corporations. Yet, Mikesell was careful to point out the unlikelihood of formulating a general theory of foreign investment that would be any more satisfactory in explaining the geographical breakdown and industrial composition of those capital flows than the Heckscher-Ohlin theory has been in explaining the pattern of international trade. In fact, trade and investment are so thoroughly intertwined that foreign trade and foreign investment models cannot be separated from one another.

The second type of question is much more controversial in that any suggested answer carries with it certain policy implications. Mikesell criticized the majority of the research in this area for being tainted with ideological bias or for inadequately defining the relevant elements of the cost-benefit analysis. More specifically, many studies deal with only one or two aspects of the cost-benefit equation, such as in the case of a microeconomic analysis of the impact of foreign investment on the balance of payments or on the quantity of employment.

As a result, Mikesell argued, the existing theories, in which an effort is made to evaluate the costs and benefits for the host country, should be expanded and enriched by additional empirical work. For example, future research ought to be undertaken to investigate the impact of foreign investment on the opportunity costs of domestic inputs, and explicit consideration should be given to the various externalities which currently receive only passing mention.

Moreover, Mikesell maintained that there is a need for studying the changing pattern of foreign investment within the Pacific Basin, given that an increasing number of countries are limiting the degree of foreign participation allowable for any given venture. In addition, does the extent of foreign ownership affect the efficiency of the enterprise? Can foreign investors achieve effective control as minority investors? How is domestic capital for a joint venture mobilized? And how can a host country ensure that the multinational corporation maximizes pretax profits of the domestic firm rather than global profits?

Clearly, then, as Kohlhagen had contended in his paper, a sounder theoretical framework is needed. But Mikesell argued that this need had been overemphasized by Kohlhagen. Rather, theoretical work should go hand in hand with empirical investigation. Decision making requires facts, and if economists are to help host-country governments make rational decisions about foreign investment, then much more than theorizing will be required to convince policymakers that economists are worth listening to.

When the floor was opened for general discussion, it became clear that others shared both the author’s and discussant’s concern over the lack of a strong theoretical framework for analyzing direct foreign investment.

Hang Sheng Cheng, for example, suggested that data collection without
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such a framework would not be terribly productive. Referring to Kohlihagen's observation of the macro-micro dichotomy of existing theory, Cheng suggested that it might be more fruitful to fuse the two polar cases. In particular, from the host country's point of view it might be best to analyze foreign investment in terms of economic growth theory, whereas something like the Vernon product cycle theory might be more appropriate when evaluating the same investment from the point of view of the capital exporter.

Unfortunately, this approach does no better at explaining that part of foreign investment behavior which is influenced by noneconomic forces. For example, Merlyn E. Doleman noted that corporate decision making is not always economically rational. In fact, the process of project approval is tempered by organizational conflicts, which means that the process itself is not always the same. Yet, any theory which is "academically pure" will fail to account for these important elements of organizational behavior.

Robert S. Einzig said that different foreign investors have different perceptions of how business operates in a given host country, which in turn affects the form (e.g., 100 percent ownership, joint venture) in which investments are undertaken. As a result, any theory used to predict investment flows will yield large stochastic values.

Leon Hollerman carried the argument further, suggesting that political motivations are also important. He cited the case of Japan, stating that for the most part, Japanese foreign investment has been motivated by "macro" national interests. Thus, foreign investments have been made for such purposes as reducing Japan's vulnerability to foreign trade, gaining access to natural resources, and reducing domestic pollution, whereas "micro" motivations, such as trying to get in behind tariff barriers, have been of only secondary importance.

Pan A. Yotopoulos saw the development of a consistent analytical framework as necessary to reconcile apparent anomalies. Referring to Kohlihagen's comment that domestic and foreign investment behavior had not been found to differ significantly, he argued that these findings were "most remarkable," given the distinctly different natures of the objective functions for the multinational corporation and the domestic company. That the behavior of a multinational corporation which maximizes globally is no different than that of a local firm could be explained only if environments were competitive, markets were perfect, etc. But if this is the case, then why is there the problem of unraveling the "direct investment package," as discussed elsewhere by Ronald I. McKinnon? Surely individual components of the package, such as technology, management, or financial capital, could be secured separately in the competitive markets.

McKinnon responded by suggesting that even with perfect markets, there would be little incentive to unravel the package because of the existing tax mechanism in capital-exporting countries. For example, under the current
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tax system, American companies prefer to operate foreign subsidiaries rather than merely contract for individual services, since the tax payments in the host country are deductible as a tax credit for the parent company. Thus, the entire package is transferred, whereas there are a priori grounds for believing that it would be in the best interests of the host country to break up the package.

This last proposition was questioned by several of the discussion members. Mikesell stated that while the provision of individual services might reduce the risk for the multinational corporation, at the same time it might be less willing to offer its best resources. Moreover, as in the case of Philippine mining interests, management and licensing fees accruing to the minority investors might exceed the dividend payments had the company been completely foreign owned. The idea that the sum of the parts might cost more than the whole was also supported by Michael Keran, who noted that many countries may lack the internal capabilities for using the separate services efficiently.

John Roemer suggested that the unraveling may become more widespread because of increased competition among capital exporters. He cited recent investment activity in the Middle East on the part of Americans and Japanese as evidence of the enhanced ability of host countries to secure production-sharing agreements on favorable terms. Roemer added that potential Russian and Chinese investment will further strengthen the bargaining power of host countries. In a sense, then, any theory developed to explain past investment behavior may well be obsolete, given the new trends in the relationship between the capital exporter and the host country.

Turning to matters of empirical research, Lawrence J. Lau wondered if there were sufficient data to undertake a comprehensive investigation of the investment flows within the Pacific Basin region. It was pointed out in subsequent discussion that the available data were quite limited—mostly aggregate data in the form of estimates, such as those published by ECAFE (Economic Commission for Asia and the Far East). Thomas Chirurg noted that even when hard data are available for specific sectors, there is no guarantee that the investments have been realized. This point was elaborated by Roener, who said that the Japanese investment statistics compiled by MITI (Ministry of International Trade and Industry) cover only planned investments, that is, the data are for projects that have received MITI approval but which in fact not have been launched. Moreover, the MITI data do not include reinvested profits or loans that have been secured in domestic markets. It was pointed out, however, that there might also be offsetting investments which were not recorded. Kohlhagen expressed the hope that the two types of discrepancies would perfectly balance!