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1 Home-Country Effects of Outward Direct Investment

Robert E. Lipsey

A decision to change the way American firms are taxed on the profits from their foreign operations must involve some judgment as to the desirability of increasing or decreasing the extent of U.S. firms' foreign operations. This paper reviews past research on the effects of the overseas operations of U.S. firms on the U.S. economy.

Four main topics are discussed here:

1. The growth and decline of U.S. firms' internationalized production
2. Overseas production and export market shares in manufacturing
3. Does foreign production substitute for home-country exports?
4. Foreign production and home-country labor

1.1 The Growth and Decline of U.S. Firms' Internationalized Production[1]

The establishment of foreign operations by American firms, and the establishment by any country's firms of production, including sales and service activities, outside the home country, is often referred to as the internationalization of production. The heyday of U.S. direct investment outflows, in the 1960s and at least part of the 1970s, involved considerable internationalization of U.S. firms' production, in the sense that higher and higher proportions of the production they controlled took place abroad, larger proportions of their employees were outside the United States, and larger shares of their assets came to be located abroad. Since then, however, the degree of internationalization of U.S. companies has stabilized or declined, as if the firms had overshot some desir-

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1. The data in this section are taken mainly from Lipsey 1993, 1994.

able level of foreign involvement and found it prudent to retreat somewhat. For example, employment in all overseas affiliates of U.S. firms was almost 11 percent of total U.S. nonagricultural employment in 1977, but only 7.5 percent in 1989.

U.S. manufacturing firms have long been much more internationalized than firms in other industries, with their overseas employment reaching about a quarter of domestic manufacturing employment in 1977 (from only 10 percent in 1957) and then declining slightly to about 22 percent in the late 1980s.

Within U.S. multinational manufacturing firms, the changes have not been so sharp. Foreign affiliate production was larger in the late 1980s relative to parent sales than in 1977, and affiliate employment was close to the earlier levels relative to parent employment. Thus, this group of firms has not exhibited the shift away from internationalized production that has characterized U.S. multinationals in general or the U.S. manufacturing sector as a whole.

The contrast between the changes in internationalization within U.S. firms and those in the U.S. economy as a whole reflects the declining role of multinational parents within the U.S. economy. Parent employment in the United States fell from 28 percent of U.S. nonagricultural employment in 1977 to barely over 20 percent in the late 1980s, not because employment was moved overseas, where affiliate employment was also declining, but because these multinationals were declining in importance as part of the U.S. economy. The shrinking of many large, established U.S. firms affected both their domestic and their foreign employment. The many anecdotes about the shifting of domestic employment abroad do not seem to add up to much in the aggregate, especially for the U.S. economy as a whole.

It is as yet difficult to judge whether the apparent retreat of U.S. firms from foreign operations during the 1980s is a long-term trend. There was an enormous shift in direct investment toward the United States by foreign firms, to the point where the United States absorbed an unprecedented share of the rest of the world's outflow of direct investment. Apparently, the United States was an exceptionally attractive location for investment during this period. If that was the case, it might also have been attractive, relative to locations in other countries, to American firms as well as to foreign firms. That attractiveness of the United States as a location would show up as a retreat from internationalization for U.S. firms while it tended to increase the degree of internationalization of foreign firms.

One reason for American firms' apparent retreat from overseas activity may have been the growth of efficient and aggressive foreign competitors. The levels of internationalization of the German and Japanese economies were much lower than that of the United States in the 1970s. Since then, the internationalization pioneered on a large scale by American firms has been copied by European and Japanese firms.

The practice of producing outside the home country is well entrenched, especially in manufacturing. Increasingly, it is the practice not only for firms based in the major industrial countries, but also for firms in at least the more successful developing countries, such as Korea and Taiwan.

1.2 Overseas Production and Export Market Shares in Manufacturing[2]

The share of the United States, as a country, in world export markets for manufactured goods has been declining over most of the last quarter century. In 1991 and 1992, the share was about 12.5 percent, more than 25 percent below the share in 1966. U.S. multinational manufacturing firms, exporting both from the United States and from their overseas production, held on to their shares much more successfully. By 1985, when the United States had already lost more than 20 percent of its share of twenty years earlier, U.S. multinationals had increased their share of world manufactured exports. By 1991, their share was only 4 percent below that of 1966.

How was this relative stability of shares achieved? A rising percentage of the multinationals' exports was supplied by their overseas affiliates: more than half since 1986. Thus, one way the U.S. multinationals kept their export markets, as the United States lost competitiveness in their industries, was by supplying these markets increasingly from overseas operations, a strategy obviously not available to nonmultinational U.S. firms.

The United States, Japan, and Sweden are the only countries that collect fairly comprehensive information on the trade of their multinationals' overseas affiliates. The data for all three countries suggest that one major role for overseas production by firms in all three countries has been retaining market shares when home-country economic conditions and exchange rate changes made the home countries less suitable locations for export production.

1.3 Does Foreign Production Substitute for Home-Country Exports?[3]

Most antagonism against foreign direct investment has historically been toward inward investment, on the ground that it displaced home-country firms in home markets. There has also been opposition to outward investment, however, often led by labor organizations, on the ground that outward investment "exports jobs," partly by producing products to be imported to the home-country market but mostly by replacing home-country exports by overseas affiliates' production.

Various studies (including some of my own) of the behavior of multinational firms view them as facing fixed or relatively fixed, worldwide markets for their products and making decisions mainly about how to supply that demand most profitably. The firm is pictured as choosing to supply the demand by exporting from the home country, by producing abroad, or by licensing technology,

2. For a more detailed discussion, see Lipsey 1994.
3. For a more detailed discussion and references, see Lipsey 1994.

patents, or other assets owned by the firm to foreign licensees who would produce outside the home country.

The assumption of a fixed market for a firm tends to bias the results toward finding that foreign production by a country's firms substitutes for home production. A more plausible view, I think, is that production abroad is often mainly a way of enlarging a firm's share of foreign markets, or of preventing or slowing a decline in that share. The inadequacy of the fixed-market assumption is obvious in any attempt to examine the impact of direct investment in service industries, since the nature of many of these industries precludes substantial exporting from one country to another and market share is almost completely contingent on production at the site of consumption. While this is most obvious for service industries, it applies also to the service component of manufacturing industries, a major part of the final value of sales of manufactured products.

Attempts to answer the question of the effect of overseas production on home-country exports face the problem of defining substitution and of constructing a believable counterfactual case. Exports from Japan's recently established or recently enlarged operations in Southeast Asia may replace exports that formerly came from Japan, but few would claim, after the rise in the exchange value of the yen, that they are replacing exports that could now be made from Japan.

There have been quite a few empirical studies of the impact of overseas production on home-country exports, based on both U.S. and Swedish data. The preponderance of evidence from these studies points to either no effect or a positive effect of overseas production in a host-country market on home-country exports to that market and of production by a firm's foreign affiliates in a market on the parent firm's exports to that market.

On the whole, then, it would seem reasonable to conclude that production outside the United States by U.S.-shared firms has little effect on exports from the United States by parent firms or by all U.S. firms as a whole. To the extent that there is an effect, it is more likely to be positive than negative. This relationship is probably a characteristic of other countries' multinationals as well. One reason this is true is that foreign production is undertaken to expand or to retain a parent firm's foreign markets. There is no indication that the absolute level of imports from the home country declines over long periods.

1.4 Foreign Production and Home-Country Labor[4]

Since overseas production does not appear to have any substantial impact on the amount of parent exports, one could assume that parent production levels are not substantially affected. However, overseas production could affect the overall demand for labor within the United States by parent firms, and the demand for labor of different types, even if total production in the United States were not affected. For example, the demand for labor by parent firms might be reduced if more labor-intensive products were allocated to multi-

4. For further discussion and references, see Kravis and Lipsey 1988, 1992a; Lipsey 1994.

nationals' foreign operations while more capital-intensive operations were allocated to U.S. operations. Similarly, the demand for unskilled labor by parents might decline if parts of the production process or products requiring highly skilled labor were allocated to the United States while processes or products requiring relatively low skills were allocated to overseas affiliates.

The opportunity for multinational firms to engage in such geographical allocation of their production presumably requires that the product be tradable. If a firm's output must be consumed where it is produced, as in many service industries, production will take place where the goods and services are sold and will respond to host-country demand and to host-country costs.

On the whole, the evidence suggests that in both manufacturing and service industries the effect of foreign operations on the average skill levels in parent companies was to raise them, but the effect was not strong and not universal across industries.

1.5 Summary

The explanation of the existence of direct investment and foreign production is centered on the idea that firms possess individual firm-specific assets, such as technologies, patents, and skills in advertising or marketing, that can be exploited most profitably by producing in many markets. These assets are mobile across international borders but not among firms, and firms cannot realize their value by selling them to other firms or by renting them to other firms by licensing.

The opportunity to exploit these firm-specific assets via direct investment adds to the incentive to acquire them. If R&D intensity and human-capital intensity are the strongest explanations of the worldwide trade shares of U.S. multinationals (Kravis and Lipsey 1992b), and possibly of their shares in world production as well, a restriction on direct investment would reduce the value of investment in such assets and therefore reduce firms' investment in them. If much of foreign direct investment is defensive, as suggested earlier, it may make investment in firm-specific assets more profitable by extending the length of time over which they can be exploited, a suggestion made many years ago by Vernon (1966).

While firms from different countries tend to possess different comparative advantages, the leading firms in each country tend to internationalize their production. With the long-term decline in costs of international travel and communication, the costs of controlling widespread production must be declining, and firms from most countries are increasing the extent to which they produce outside their home countries. With that fact as background, it seems unlikely that the decline in internationalization of American firms' production will go much further, and more likely that it will be reversed.

The availability of foreign production locations appears to have contributed a great deal to the ability of American multinational firms to retain their market shares in the face of declines in the market share of the United States as a country. The same seems to be true for the trade shares of firms from other countries, and this flexibility applies to softening the effects not only of long-term national declines but also of short-term events such as large changes in exchange rates.

The frequently expressed fear that American multinationals have been, in some sense, "exporting jobs" by substituting foreign production for American production has very little empirical support. For one thing, overseas employment and fixed investment have been for the most part declining relative to domestic employment and fixed investment for ten or fifteen years. And U.S. firms that produce more abroad than others tend also to export more in general and to the countries where the foreign production takes place. The same relationship is evident for firms based in Sweden, the only other country collecting similar data on multinational parents and affiliates. Overseas production has much more to do with contesting market shares than with finding low-cost production locations, although the latter is also a motivation.

Within multinational firms, the higher the share of overseas operations in the total production of the multinational, the higher the ratio of home employment to home production, more often than not. A possible explanation is that a larger share of foreign production requires a larger number of headquarters employees, such as R&D staff and supervisory personnel, whose contribution to output is not confined to the firm's domestic production.

On the whole, the evidence suggests that the effect of overseas production on the home-country labor market involves the composition of a firm's employment at home rather than the total amount of its home employment. That shift in employment composition is mainly toward more managerial and technical employment.

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