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# Bargaining and the Multinational Corporation: Lessons from Chilean Experience

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## **A Critique of the Neo-classical Theory of Foreign Investment**

Until a few years ago, the theoretical literature on direct foreign investment (DFI) was extremely limited, reflecting the failure of international trade theory to break with the Ricardian assumption of factor immobility between countries. During the 1960s a body of literature developed which considered the implications of foreign investment for home and host countries, stemming from McDougall's seminal article on 'The Benefits and Costs of Private Investment from Abroad'.<sup>1</sup> This corpus I shall refer to as the neo-classical theory of DFI.

The basic conclusion of this approach is that, in general, foreign investment is beneficial to the host country, in the sense that it increases income accruing to that country, and should be encouraged.<sup>2</sup> Within such a framework, it is difficult to see what role can be played by bargaining by the host country government. It is necessary therefore to begin with a critique of the empirical validity of the assumptions on which the neo-classical theory is based.

In the first place, perfect competition is assumed, and, where it is discussed at all, only lip-service is paid to the need to recognize the predominance of oligopoly. In practice, foreign investment is closely associated with oligopoly. The bulk of the main capitalist countries' overseas investment is accounted for by a relatively small number of firms. Between 250 and 300 US firms account for more than 70 per cent of that country's investment, while in the United Kingdom 165 firms control 80 per cent, and in West Germany 82 firms control 70 per cent, of all foreign investment.<sup>3</sup> Moreover, many studies have shown that foreign investment tends to be particularly heavy in the more oligopolistic sectors of industry.

The second assumption, which is implicit rather than explicit, is the identification of foreign investment with the export of capital. In fact this

assumption is more appropriate to the model of portfolio investment than that of direct foreign investment. It is by now clear that direct foreign investment comes in the form of a package which includes technology, and management as well as capital. Indeed, the package may include very little capital, since multinational corporations often prefer to raise capital locally rather than export it from the parent company.<sup>4</sup> Hirschman<sup>5</sup> has indicated that this identification with capital movements has been an important source of bias in the literature on foreign investment, particularly in underdeveloped countries. As long as investment is considered as a movement of capital to a capital-short country, its beneficial effects as a complement to local resources are highlighted. Once direct foreign investment is recognized as a package, the possibility that it may have an adverse effect is more evident.

A further assumption, related to the two previous ones, is that of perfect knowledge. Yet the fact that neither of the previous assumptions holds makes nonsense of perfect knowledge. The oligopoly position of the major multinational corporations is based, at least in part, on their control of information through patents and industrial secrets. Moreover, once it is accepted that foreign investment involves a package which includes technology as well as capital, the nature of the technology market as a market in information must be taken into account. In this market information cannot be freely available. A related assumption is that of certainty of expectations (or at least that all alternatives can be reduced to certainty equivalents). The recognition of oligopoly invalidates this assumption too, since the interdependence of firms' behaviour introduces an element of uncertainty which cannot be reduced to certainty equivalents. The fact that they operate in an uncertain environment is an important element in understanding the strategies of multinational corporations in the area of foreign investment.

An alternative analysis of direct foreign investment which emphasizes both the package nature

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1 Reprinted in Dunning (ed.), *International Investment*, Penguin, Harmondsworth, 1972.

2 In a subsequent note Kemp showed that in fact there may be a case for a tax on foreign investment analogous to the optimum tariff in international trade. See Kemp in Dunning, *op. cit.*

3 UN, *Multinational Corporations in World Development*, p. 7.

4 Between 1957 and 1964, only 11.8 per cent of total US direct foreign investment in Latin America was financed from the United States.

5 A. O. Hirschman, *How to Divest in Latin America and Why*, Essays in International Finance, no. 76, Princeton University, 1969.

of such investment and the importance of monopoly has been developed by Vaitos<sup>6</sup>, taking as a starting point the 'product cycle' theory of international trade and investment. The technological lead of certain firms enables them to earn monopoly rents. Foreign investment is a way of attempting to preserve this monopoly position. The collective nature of the inputs is a way of extending the monopoly to parts of the package where, taken singly, a monopoly position would not operate. The existence of such monopoly rents opens up the possibility of bargaining between host governments and multinational corporations.

### **Strategic Considerations in Bargaining with MNCs**

The neo-classical theory of foreign investment implies that any proposal from a multinational corporation which, on a cost-benefit analysis, shows a positive net value, should be undertaken. The implicit alternative is that of no foreign investment and therefore no project. The bargaining model implies that a positive net present value is not a sufficient criterion for accepting the investment for two reasons: first, because the alternative may not be no project but investment by another foreign company, or undertaking the project *without* direct foreign investment; second, because it may be possible, through negotiation, to increase the net present value of the original project. Once it has been recognized that foreign investment is not a matter of take it or leave it, as the neo-classical model implies, but involves the negotiation of a package which includes a large number of distinct elements such as profit remissions, royalty payments, tax treatments, tariff protection, local content requirements, export earnings, training of local labour, etc., the strategic factors in the host government's bargaining position must be considered.

The acquisition of technology which is available from a number of suppliers obviously presents a different picture from the case where it is tightly controlled by one firm. Most of the technology required by LDCs will be of the former type so that the competitive structure (at an international level) of the industry which is being considered may be an important element in the negotiating position of the recipient. The more tight-knit the oligopoly within the industry, the more likely it is that firms will achieve some kind of collusion when faced with a government that is prepared to negotiate the terms which it considers to be most beneficial. On the other hand, in an industry in which the oligopoly is less stable as a result of a

lower level of concentration, or a recent new entry, there will be more scope for bargaining.

A second factor which will influence the strength of the bargaining position of the participants will be the alternatives which face the host government in terms of its ability either to undertake the project without any assistance from abroad, or to rely on imports to supply the products concerned. The former is related to the level of technological development of the host country. The latter depends on the strategic importance of the industry both in terms of desirability of local production and the foreign exchange cost of continued dependence on imports which determine the feasibility of such a strategy.

There are a number of further strategic considerations which can be controlled, at least in part, by host governments. One of the deficiencies of early attempts at control of foreign investment has been the piecemeal way in which such policies have been applied.

This is to a large extent an organizational problem, deriving from the fact that a number of government agencies may be involved in determining various aspects of policy which affect the MNC, e.g. a royalties committee, the finance ministry, the foreign ministry. A firm's ability to remit the profits may be affected by all of these agencies since each deals with a different channel of remission. It is essential, therefore, to have a co-ordinated policy so that the effect of more stringent controls on royalty payments, for instance, will not simply be a higher level of transfer pricing.

A key element in any process of negotiation is information. The greater the information which a host government possesses about a company's operations the more likely it is to be able to estimate the margin within which it must settle and the most favourable terms which can be obtained from the foreign firm. There is, however, a cost involved in the search for information, and this sets limits to the extent to which it will be controlled in practice. Some of the requisite information will be specific to individual companies, some to particular industries and some to the investor's home country. At a more general level it is apparent that increased economic understanding of foreign investment is also an important element in bargaining. Since the objectives of firm and government differ, the firm being concerned mainly with long-run profit maximization and the government with increased employment, an improvement in the balance of payments, an increase in the country's technological capacity, etc., the situation cannot be described as a zero-sum game. The firm may be prepared to increase its exports

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<sup>6</sup> C. V. Vaitos, *Intercountry Income Distribution and Transnational Enterprises*, Clarendon Press, Oxford, 1974.

in return for a guaranteed rate of return. The government may be prepared to accept such an arrangement because of its effects on the balance of payments.

Inter-governmental co-operation is an important element in successful negotiation in the extractive industries but less so in the case of manufacturing investment, where the key factor in the bargaining position of the host country is access to the country's domestic market. In extractive industries the key element is access to a natural resource which may also be available elsewhere. Nevertheless, producer organizations such as OPEC have also played a role in the dissemination of information among member countries, for example, concerning the terms which have been negotiated with other governments. This strengthens the bargaining position of the producer country.

A danger to be avoided in negotiating the admission of foreign investment is to regard this as a once-for-all affair. There must be a system for continuous policing of the agreement, and also the possibilities of termination or renegotiation. This is vital since the agreement should be seen as a means of developing a local technological capacity which will either render it ultimately unnecessary or enable renegotiation on terms more favourable to the host government. Thus the government should not freeze the original terms of the agreement but on the contrary, keep its options open as far as possible.<sup>7</sup>

### The Chilean Motor Industry Negotiations

The Chilean motor industry at the time of the election of President Allende in 1970 consisted of ten companies which produced 24,591 vehicles in that year. The output of each firm varied from 120 to 5,634, and although the nominal local content required by the government was 58 per cent of the value of the vehicle, most companies achieved this percentage through importing parts from other LAFTA countries (mainly Argentina) and making compensatory exports of certain simple parts such as radiators and springs. The industry was therefore essentially an assembly industry. The major mechanical and body parts were all imported.

During the 1960s some rationalization of the motor industry had occurred as a result of the government's policy of increasing local content requirements, and the number of firms had been halved. By the late 1960s, however, the limits of such a policy had been reached without anything like the volume of production required to take

advantage of economies of scale having been achieved. The Unidad Popular Government decided therefore to attempt a direct restructuring of the Chilean motor industry with the following objectives:

- “(a) to produce commercial vehicles and cars for mass consumption;
- (b) to develop the technology of national industry, especially the metal-mechanical industries, and create infrastructural conditions which permit the development of new high technology industries for export;
- (c) to create, directly or indirectly, high productivity jobs;
- (d) to obtain fiscal resources and appropriate economic surpluses;
- (e) to compensate for the foreign exchange expenditures which satisfying the demand for cars implies;
- (f) to obtain the necessary efficiency in the industry in order to be able to exchange with LAFTA and the Andean Pact without losses for the country and within the competitive margin.”<sup>8</sup>

It was decided that the most appropriate way of achieving these ends was to open the industry to international bidding. The broad outlines of the form which the development of the industry should take were laid down in June 1971. The number of models was to be restricted to one small car less than 1200cc and its commercial vehicle derivative (Category A), one medium-sized car of between 1300 and 2000cc and its commercial vehicle derivative (Category B), and a chassis with diesel engine for a 6-8 ton lorry and a bus chassis based on the same mechanical parts (Category C). It was planned to produce 40,000 vehicles in 1973 rising to 100,000 by 1980, distributed as follows between the three categories:

	1973	1980
Category A	20,000	45,000
Category B	15,000	40,000
Category C	5,000	15,000

In terms of its international market structure the motor industry was particularly favourable from the point of view of the host country's bargaining position. Although oligopolistic, with less than a dozen firms dominating the industry all round the world, it is still a highly competitive industry partly because of the challenge to US dominance by the major European and Japanese manufacturers. In the past, this competitiveness, combined with the liberal policies adopted by most LDCs towards foreign investment, has led to the frag-

<sup>7</sup> See R. Kaplinsky, 'Control and Transfer of Technological Agreements', *IDS Bulletin*, vol. 6 no. 4, March 1975.

<sup>8</sup> D. Parkin, *El Consumo y la Via Chilena al Socialismo: Reflexiones en torno a la Decision Automotriz* (mimeo) 1971, p. 2 on the basis of internal documents of the Comision Automotriz.

mentation of national markets between a large number of firms and, as a result, small-scale, high cost production. The Chilean government, by restricting access to the domestic market, was able to turn this competitiveness to its own advantage. Despite the non-participation of the US firms, each category attracted bids from four companies: British Leyland, Citroën, Fiat and Renault in small cars, Fiat, Nissan, Peugeot and Volvo in medium-sized cars and British Leyland, Fap Famos, Fiat and Pegaso in lorries.

There was little possibility of developing a motor industry in Chile without foreign technical assistance in one form or another. The alternative of importing vehicles rather than local production also presented problems, since large-scale imports would have involved very heavy foreign exchange costs for the Chilean economy. Any attempt to place a heavier emphasis on public transport as opposed to private transport and to reduce the supply of cars was also rejected (although some writers argued at the time that the demand projections, on which the plans for the motor industry were based, were in fact incompatible with the government's declared income redistribution objectives).<sup>9</sup> Nevertheless, the division of the car market into two categories, small and medium-sized, did provide the government with some room for manoeuvre. When in February 1972 the results of the first round of bidding were announced, Category B was not allocated to any firm, since none of the offers reached the required standard. The government then declared its intention to meet the demand for the medium-sized cars by imports, but better offers were subsequently received from the companies, and the category was finally awarded to Peugeot. Thus, over a limited sector of the market, the Unidad Popular Government was able to use the threat of withholding access to the market in order to obtain a better bargain.

The Chilean case also illustrates the difficulties of retaining bargaining within the sector concerned and the problem of political pressure on the host government. The decision to grant the contract for producing a lorry and bus chassis to the Spanish firm Pegaso was much criticized. Originally Category C was awarded to Fiat with Pegaso in second place. It had been argued that the vehicle which Pegaso proposed to produce was unsuitable for local conditions and that supply problems could arise in the case of parts provided from Spain because of the small size of the parent company. It is generally recognized that an offer of US \$50 million credit from the

Spanish Government to import grain at a time when the country was going through a grave political and economic crisis in October 1972, as a result of the lorry-owner's strike, was an important factor in signing the contract with Pegaso. It is also significant that Pegaso obtained much more favourable terms than Citroën and Peugeot who had already signed contracts in the two car categories. This was less a reflection of differences in the bargaining power of the companies concerned than of the changed economic and political situation which faced the Chilean government by the time the latter contract came to be signed.

Another example of political pressure, this time internal rather than external, led to an agreement being signed with Nissan in September 1973, a few days before the military coup, to produce an intermediate vehicle between the Citroën and Peugeot models. Before 1970 there had been four major centres of vehicle assembly in Chile: Arica in the north where Citroën, British Leyland, General Motors and some smaller plants were located, the new plant jointly built by Renault and Peugeot at Los Andes, the Fiat plant at Rancagua and the Ford plant at Casablanca. The selection of Citroën and Peugeot and the decision that Pegaso should produce at Casablanca meant that Fiat's plant at Rancagua would have to close down with the loss of over 1,000 jobs. The Fiat workers at Rancagua put pressure on the government to continue production at the plant, and an agreement was reached under which an intermediate vehicle could be accommodated through a reduction in Citroën's market. Obviously, from the point of view of the government's policy of rationalizing the motor industry, this can only be seen as a retrograde step.

The manner in which the negotiations were carried out with the foreign motor companies does provide some useful guidelines for bargaining strategies. The Chilean Development Corporation (CORFO) was put in charge of the negotiations with the foreign firms, covering such items as profit remittances, royalty payments, ownership structure, managerial structure, the supply of parts, etc. It was thus possible for the government to pursue an integrated policy and identify possible trade-offs which would be acceptable to both parties. The companies appeared prepared to accept relatively low rates of return (the contracts specified both a guaranteed minimum and a maximum) in order to participate in the market. Citroën accepted a minimum profit rate of 5 per cent and a maximum of 10 per cent, while for Peugeot the two were equal at 6.5 per cent, and for Pegaso they were 6.5 per cent and 12 per cent respectively.

<sup>9</sup> See Parkin, *op. cit.* and S. Bitar and E. Moyano, 'Redistribucion del Consumo y Transicion al Socialismo', *Cuidemos de la Realidad Nacional* no. 11, 1972.

The government's main concern was to minimize the foreign exchange costs of the motor industry since it was found that other aspects of the proposals submitted, such as investment requirements, did not differ greatly between projects. Thus the difference between export earnings and the cost of imports of parts and remissions of profits and technical assistance fees became a major element in the negotiations. This is exemplified by the case of medium-sized cars. As mentioned earlier, none of the projects in this category was accepted initially. The reason given was that even the most favourable offer would have involved an outflow of foreign exchange of US \$130 million over the ten years of the agreement. The contract finally signed with Peugeot reduced the foreign exchange costs to US \$3 million, mainly as a result of increased exports. The original Peugeot offer undertook to export only gear boxes and back-axles, the annual value of which would be less than US \$2 million. Apart from this commitment, the firm indicated its willingness merely to encourage exports of Chilean copper to France, and to study the possibility of exporting finished vehicles to Eastern Europe. (It would hardly need a very profound study to suggest that the latter possibility was negligible.) In the contract eventually signed with Peugeot, exports were increased to more than US \$100 million over an eight-year period, and motor industry products accounted for three-quarters of these exports. On a less spectacular scale, the Chilean government was able to negotiate a four-fold increase in Citroën's exports over the level initially proposed by the company. This meant that there would be no net outflow of foreign exchange from the Citroën operation.

The pioneering nature of the Chilean government's negotiations with the motor manufacturers

meant that there was probably little information available about the operations of these companies in other countries. For the form in which the proposals of the companies had to be submitted, a considerable body of information about the parent company and its international operations had to be collected for use in the course of negotiation. The decision to form joint ventures in which CORFO would have a majority participation was one manner of ensuring a flow of information once the companies were in operation. Similarly the need for continuing control of the multinational corporations was also partly met by majority ownership and by the fact that eight of the 11 directors, including the managing director, were to be appointed by CORFO and the firm's workers. The original contracts were to cover a ten-year period, after which they could be renegotiated or terminated by the government buying out the minority shareholders. This provided some room for manoeuvre for the government at the end of ten years.

### **Conclusion**

The coup of September 1973 makes it impossible to assess the success of the policy followed by the Unidad Popular Government in the motor industry, and in any event such an exercise would be beyond the scope of this paper. But the case of the Chilean motor industry negotiations does illustrate the scope that exists for bargaining between host governments and multinational corporations. Contrary to the implications of the neo-classical model, government policy towards foreign investment is not simply a matter of deciding whether it is a good thing or not. Host country relations with multinational corporations involve a whole complex of issues and require an integrated approach.