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Articles

Problems Associated with the Growth of International Firms

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PROBLEMS ASSOCIATED WITH THE GROWTH OF INTERNATIONAL FIRMS*

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The term "international firm" is used in this paper to describe a business organization that is engaged in production in a number of countries through branches, subsidiaries, or affiliates, which may or may not be separate corporate entities in the several countries in which they operate. The term "organization" implies that the entire group, including the head office as well as the various types of subsidiary units,[1] is operated within an administrative framework which knits the whole together in such a way that the general policies and administrative and financial procedures of the group are reasonably consistent and coherent throughout the firm. Individual subsidiaries may have considerable autonomy in their own operations, but if they operate entirely independently of the group as a whole they are better treated from the point of view of the growth of the firm as a simple investment by the parent companies and an extension of its financial influence than as an integral part of the industrial organization, or "firm".[2] It should be clear, therefore, that we shall not be concerned with financial firms nor with firms that merely import and export; we are concerned with firms that engage in production in a number of countries and whose activities are organized within a coherent administrative framework.

The large international firm has today become one of the most important types of international economic organization, dominating a wide variety of industries ranging from pharmaceuticals and automobiles to the petroleum industry. A very great proportion of these are American, but there are also important European firms, including particularly British, Swiss, German, Dutch and French, as well as Japanese. Although we speak of international firms because of the international spread of their operations, each such firm with few exceptions, has a distinct nationality, which is the nationality of the parent firm.[3] The controlling centre, or head office, is usually located in the country in which the parent company is incorporated, the firm having acquired its international status by extending its productive operations from its home

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[1] From now on I shall use the term "subsidiary" to include branches and affiliates as well as true subsidiaries, since the distinctions between them are not important for my purposes.

[2] The degree of autonomy that can be granted to subsidiaries without destroying the administrative coherence of the firm is almost impossible to define in the abstract. The boundaries of any given firm can only be determined with reference to the actual organization of the operations of that firm. For further discussion on this point, see my *Theory of the Growth of the Firm* (Oxford, 2nd ed. 1965).

[3] There are exceptions, of which perhaps the Royal Dutch/Shell is one of the best-known examples. This "firm" is not a firm in a formal sense but is a kind of agreement between two international holding companies, the Royal Dutch Petroleum Company and Shell Transport and Trading Company, under which the assets of the firm are held in undivided ownership in the proportions 60% Royal Dutch and 40% Shell Transport, with income being divided in the same way as well as membership in the controlling Board of Directors. This grouping can be called a "firm" on my definition because its activities are carried on within a co-ordinated administrative framework, but it has no single nationality and consequently no clear national orientation. I have elsewhere suggested that Royal Dutch/Shell, partly because of its lack of a distinct nationality, has a more truly international outlook than that of any *other international* oil company. See *The Large International Firm in Developing Countries: The International Petroleum Industry* (Allen & Unwin, 1968) p. 109.

country to other countries. This process, which includes the establishment and subsequent expansion of producing units abroad, is called "direct foreign investment", and is usually, though not always, undertaken by enterprises that are predominately privately owned. Hence, in discussing problems associated with the growth of international firms we are at the same time discussing problems of direct foreign investment.

Foreign investment of this kind may be undertaken by a firm for a wide variety of reasons: there may be geographical advantages in producing abroad which relate to the nature of markets, the existence of raw materials, or the availability of other factors of production; there may be a variety of government restrictions on trade and payments which make local production economically advantageous or even necessary; or there may be tax advantages associated with production in particular countries. In the space available here it is not possible to examine these considerations nor to discuss the entire range of problems associated with the growth of firms as they spread activities internationally. Although many of these problems involve aspects of organization and co-ordination, and of adaptation to particular circumstances and markets, perhaps the most interesting relate to the peculiar problems a foreign firm may face in making itself acceptable to the peoples and governments of the countries in which it operates. I shall therefore select for discussion four types of problems from the latter category, all of which become more important as a firm grows in size, and especially if it comes to account for an increasing proportion of the output of an important industry in any particular country.

The first of these problems arises from the significance of transfer pricing, since an international firm is, by definition, an integrated firm, and thus there is likely to be considerable trade in goods or services between its subsidiaries across national frontiers. The second relates to the fact that an international firm, especially if it is in the newer technologically progressive industries or has access to large economics of scale or unusually extensive financial resources, is likely to enjoy a fairly strong monopoly position in its host countries, and particularly in the less developed of these countries. The third problem arises when the firm produces for the local markets of the host countries and attempts to finance local expansion largely from local earnings. Finally, we shall discuss the problems that may arise if the firm desires, or is forced, to accept the participation of local equity capital or local management.

Transfer Pricing

When a firm establishes manufacturing subsidiaries abroad the new plants will, in general, be producing or distributing products similar to those which the firm is also producing elsewhere, or will be producing raw or semi-finished materials which it uses in its own operations elsewhere. The former is commonly known as "horizontal" integration and the latter as "vertical" integration. Thus, oil companies may establish refineries or distribution networks to serve local markets, and import the crude oil or products required, often from their own subsidiaries elsewhere, or they may undertake crude-oil production largely for the purpose of exporting crude-oil to their own refining subsidiaries in other countries. Pharmaceutical companies establish plants for the manufacture of drugs in other countries, but often supply raw materials or semi-finished products to them from other subsidiaries in other countries. In both cases, services such as managerial and technical services and patent rights are also made available to subsidiaries, often at a substantial fee.

For some such products and services, market prices may exist; others are of such a specialized nature, or subject to such a degree of monopoly in production (e.g., patented products with no close substitutes or, until recently, crude-oil outside the United States), that the price at which they are transferred between subsidiaries cannot be compared with any reasonably free market price. In these circumstances, international firms may possess a very large amount of discretion with respect to the prices at which they transfer products and services across national frontiers between their subsidiaries. And governments have a legitimate interest in these prices.

Without entering into the controversy over whether firms actually attempt to "maximize" profits, it is probably reasonable to assume that most firms like to make as much profit as seems reasonably practicable under the circumstances, and that by and large they are interested in profits *after* taxes on income. An international firm is subject to income taxes in many countries and will thus have an incentive so to price the products (or services) transferred between their subsidiaries as to minimize the total income tax payments for the consolidated firm, by allowing as much profit as possible to appear in those countries where tax rates are lowest. Thus, there is, in a sense, an in-built incentive to discriminate in transfer pricing among the several countries in which the firm operates, and such discrimination has often brought international firms into conflict with host governments.

The discrimination may be in favour of the home country or in favour of certain of the other countries in which subsidiaries are located. The Swiss pharmaceutical firms, for example, seem to favour the former, while the inter-affiliate pricing of crude-oil by the international petroleum companies has clearly favoured the crude-oil producing countries.[4] In any case, as the firm grows in size, the significance of its transfer prices may also increase with respect both to the balance of payments of the countries importing or exporting the transferred products and to the income tax receipts of their governments (which are, of course, interrelated). Problems may arise which can lead to considerable public criticism, and sometimes to acute political controversy, with the governments in the strongest bargaining positions being able to obtain concessions which cannot be obtained by weaker governments. Different firms adopt very different policies with respect to transfer pricing, including charges to their subsidiaries for managerial services, patent rights, etc., but in the absence of competitive "arm's length" market prices, there are no unambiguous criteria that firms can use for the determination of what is "fair" to all countries concerned.

The Problem of "Monopoly"

When a firm establishes subsidiaries abroad, it presumably does so because it believes that it has some competitive advantage over other actual or potential producers. It may possess specialized technological, managerial, financial or marketing expertise; it may have been able to acquire some special type of protection or privilege from governments (including patent rights) for its activities or products; it may operate under private market-sharing arrange-

[4] See *Ibid.*, Chapter VI, for a discussion of the petroleum industry. For evidence respecting the drug industry see the *Report of the Committee of Enquiry into the Relationship of the Pharmaceutical Industry with the National Health Service*, 1965-1967 (Sainsbury Report). London. HMSO. Cmnd. 3410. 1967. Appendix I, paras. 15, 23.

ments; or it may simply have a head start over other producers in a market too small to support additional efficient producers. Such competitive advantages, whether they be attributable to the firm's own superior efficiency, to government policy, or to private monopolistic arrangements, may enable the foreign subsidiary to obtain a dominating position in an important industry or even in the economy as a whole, of the host country. Such a situation is common in developing countries, but it is also important in some industries in industrial countries, especially in an industry where patent protection plays an important role. Clearly, the expansion of a foreign subsidiary in such circumstances can give rise to difficulties with host governments, particularly in countries that are sensitive to the prospect of foreign "domination" of their economies.

To the extent that the competitive advantages giving rise to a monopolistic position are the result of the superior productive efficiency of the foreign firm, the economy of the host country gains even if profits are considerably above "normal", but at the same time the local pricing policy of the firm may come under fire as an example of "foreign exploitation"—perhaps especially, but not uniquely, in underdeveloped countries. Again, there is no unambiguous economically "optimum" policy for the firm to adopt, although so long as the return on investment in one country is greater than that to be obtained elsewhere, the firm would presumably expand output to the point where returns are roughly equalized in each of the countries in which it operates. Some international firms apparently attempt to charge approximately the same prices for their products all over the world and thus to maintain a world-wide system of prices; others seem to price according to the elasticity of demand in different markets and thus practice geographical price discrimination. But if the growth of a foreign subsidiary increases its monopoly position in particular markets, the problem of pricing may become acute partly, if not largely, *because* the subsidiary is foreign owned, even if we can assume that much of the abnormal profit is properly classified as an economic rent attributable to its superior factors of production or management rather than to some form of protection or private monopoly. The problem here is often one of market structure which the firm can do little about, and in the setting of prices for the local market the firm may have to take public and government attitudes into consideration more than its own commercial interests. These last two are likely, of course, to be related.

It is common, however, for governments, especially in the developing countries, to insist that some proportion of the profits of foreign firms be reinvested in the country, for it is assumed that if the foreign capital is welcomed in the first instance as a desirable contribution to the growth of the local economy, then any increase in foreign investment that results from the reinvestment of the profits of foreign firms will be equally desirable. This brings us to the question of "self-financing", and the problems this may raise for the position of the firm as it expands.

"Self-Financing"

The term "self-financing", or the financing of investment from retained earnings, describes a situation in which a firm raises on a current basis all or the greater part of the funds it invests from its customers through the prices it charges. The expansion of local subsidiaries can be financed through borrowing from the local market or from abroad, through the issue of equity shares

in the local market, through additional capital investment from the parent company, or, if the profits of the subsidiary are high enough, through the reinvestment of these profits. If local equity shares are not issued any expansion of the subsidiary will increase the amount of foreign investment by the amount of the expansion. Finance through an influx of new investment from the parent will increase the foreign exchange receipts of the country concerned over what they would have been in the absence of the subsidiary. Finance through borrowing or through the reinvestment of retained earnings does not increase the foreign exchange receipts of the country over what they would have been in the absence of the firm, but the former permits local lenders to share in the gross return on investment, and the latter reduces the amount of foreign payments that the country would have had to make in the absence of the reinvestment and thus leaves its balance of payments better off, at least in the short run, than it would have been.

There are a large number of intricate aspects of these questions which cannot be dealt with in the space available here. The policies of different firms differ with respect to the weight they give to the desires of the managers of their subsidiaries to retain some of their earnings for expansion; the situation is different according to the type and amount of outside equity capital in any particular subsidiary; and, of great importance, the international firm may not itself be free to make its decisions according to its own commercial interests because of intervention from its home government as well as intervention from the host governments. Moreover, from the point of view of the economic effects on the country concerned, it makes a difference whether the foreign subsidiary is producing for export or for the local market, that is, whether it derives its income primarily or entirely from local sales.

Governments often put pressure on foreign firms to reinvest a substantial proportion of their profits, but the effect is, of course, to increase the foreign liabilities of the country since eventually dividends will have to be paid on the increased amount of foreign investment. This will create few problems if the foreign firm itself earns foreign exchange from exports, but if the firm is producing for the local market, then the servicing of the investment may at some point claim a large proportion of the foreign earnings of the country.[5] If the profits of the firm are due to its efficiency in production, then in principle the increase in the national income of the country due to the firm's activities will leave the country better off even after the payment of dividends abroad. This will not necessarily be the case if there is a significant monopoly element in the profits.

Moreover, in permitting very large amounts of investment in foreign firms producing for the domestic market, a country may find itself very vulnerable to sudden changes in the policies of the capital exporting countries respecting their own balance of payments. Both the United States and the United Kingdom have in recent years required their own "international" firms to reduce their investment abroad, which in many cases means an acceleration of the repatriation of earnings. This is a means of putting pressure on the balance of payments of other countries in order to improve their own and may occur at a particularly awkward time from the point of view of the countries in which the sub-

[5] An excellent example of this can be found in the experience of General Motors Holden in Australia. See my "Foreign Investment and The Growth of the Firm", *Economic Journal*, Vol. LXVI, June 1956.

sidiaries of the international firms operate. Foreign firms have been especially interested in attempts to create an international "charter" for foreign investors to project themselves against arbitrary actions by host governments. They should perhaps also protest against arbitrary action by their home governments which create a legitimate wariness in receiving countries and to some extent justify a refusal on their part to permit the free repatriation of profits in the normal course of commercial operations.

It must be remembered, however, that capital may not be the most important contribution that a foreign firm makes to the local economy; the inflow of managerial skills, technological know-how, and marketing efficiency may be much more important and may be the real benefit for which the economy pays in the form of repatriated profits. At the same time, as the foreign subsidiary grows, it often trains local people and takes them into the firm, even into the positions of top management. In a developed economy, the point may be reached at which the subsidiary has become "local" in virtually everything but ownership, and if profits are abnormally high the economy may find itself paying a high price for capital alone. This may also be the result when an international firm expands by taking over a local firm and when the profitability of the take-over rests significantly on monopolistic advantages possessed by the international firm, as may be the case, for example, when an American oil company takes over a European refinery in order to obtain an outlet at non-competitive transfer prices for crude-oil it produces in subsidiaries elsewhere.

Partly for reasons such as those discussed above, some countries have pressed strongly for the acceptance of local equity in the subsidiaries of foreign firms. Others may want and need the foreign managerial and technical skills but be reluctant to accept the relatively high cost of equity capital investment as well. This brings us to our final set of problems, those associated with a fear of foreign domination and control of the local economy.

Local "Participation"

Local participation in ownership and management, or "partnership", is often proposed as a solution to some of the problems we have touched on, and some international firms have adopted the general policy as they expand abroad of proposing joint ventures with local businessmen. Others have accepted local participation under pressure. Except in countries where local managerial participation may raise political problems, most large international firms today go out of their way to train and accept local people in their managerial hierarchy, although "top management" of an international firm is still largely confined to the nationals of the home country. As noted above, however, if "indigenisation" reaches the point where local subsidiaries are entirely managed and staffed by local people, the foreign contribution made by the subsidiary to the economy may become reduced to its capital investment and whatever benefits may be derived from the remaining links with the parent company. These benefits may be considerable, but so may also be the costs, especially if problems relating to integration and transfer pricing are important.

The acceptance of local equity raises a different type of problem. In particular, it may destroy the coherent administrative character of the international firm. A wholly-owned subsidiary of an international firm is an integral

part of an international organization. Its managers may argue strongly and effectively in the various committees of the organization for their own views and for the interests of their own subsidiaries, but decisions on important matters are made by committees representing the firm as a whole, not by these managers alone. Usually the use to be made of the profits of the subsidiaries is one of these important matters, and the decisions are made in the light of the interests of the firm as a whole, as are decisions about large investment programmes or about sources of funds. Similarly, high managerial appointments are matters of concern to the entire firm. But if there exists a considerable amount of outside equity, all of these decisions will have to take account of the interests and demands of the outside owners, and the problems of administration may become magnified. In consequence, decentralisation may go so far that it will no longer be possible to treat the entire group as a coherent administrative organization falling within the definition of an international firm in the sense used here.

Partnerships, or "joint ventures", are nevertheless often useful means of reducing local antagonisms and thus of facilitating the growth of the international firm. It is sometimes alleged, however, that they bring about a substitution of local for foreign capital to the disadvantage of the receiving countries, for when an established firm admits local equity capital by selling shares to local investors, it is, in effect, repatriating part of its investment unless the new local capital is used for an expansion that would not otherwise have taken place. At the same time, it is likely that the supply of local savings for investment in countries allegedly "short" of capital is very much a function of existing opportunities for profitable investment, and that much saving which would otherwise flow in non-productive directions might become available for investment if more secure productive openings for local funds were also available. The shares of foreign firms could well provide very attractive opportunities for such savings and thus even increase the total supply of capital instead of merely effecting a substitution of local for foreign capital.

In this short paper I have raised and commented on certain types of problems associated with the growth of large international firms; I have provided no solutions. It is difficult enough to describe both reasonably adequately and also briefly even the nature of the problems, let alone to provide solutions. But unless solutions are found to the types of problems discussed here, it is highly probable that the acceptability of large international firms, already seriously questioned in many countries, will become increasingly undermined as they expand operations and grow in importance in more and more countries. They may then become little more than international investment companies whose activities are closely circumscribed by governments everywhere. And the fact that American firms are becoming increasingly dominant in some areas does not make the problems less difficult.

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