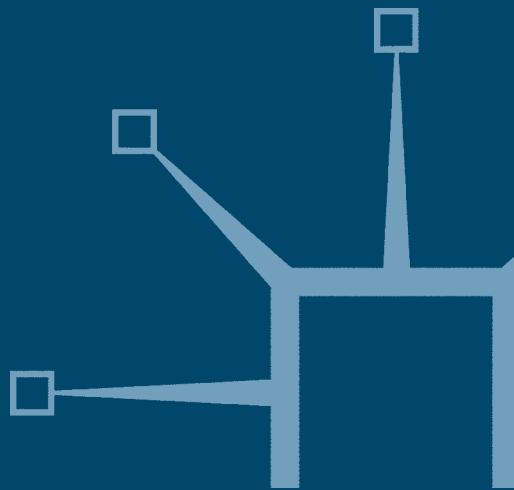


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# The Changing Global Context of International Business

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Peter J. Buckley



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*Also by Peter J. Buckley*

MULTINATIONAL FIRMS, COOPERATION AND COMPETITION IN THE WORLD ECONOMY

INTERNATIONAL BUSINESS

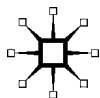
INTERNATIONAL STRATEGIC MANAGEMENT AND GOVERNMENT POLICY

THE FUTURE OF THE MULTINATIONAL ENTERPRISE: 25th Anniversary Edition  
(*with Mark Casson*)

# **The Changing Global Context of International Business**

Peter J. Buckley

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*For Bob Pearce*

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# Foreword

Since the publication in 1976 of *The Future of the Multinational Enterprise*, co-authored with Mark Casson, Peter Buckley has continued to write on different aspects of international business. The present volume, *The Changing Global Context of International Business*, contains a series of papers written by Peter Buckley and several colleagues during the years 1997–2001.

The domain of international business is not clearly defined, though it can be viewed as dealing with cross-border interactions between different organizations, with interactions between different units belonging to a single enterprise, between independent enterprises and between enterprises and the environments in which they operate.

The distinction between international and domestic business is manifested by several factors, most of which are related in some sense to distance. Geographic distance, economic distance, cultural distance and political distance constitute factors that affect cross-border interactions. Distance gives rise to distance premiums which, when applied to cross-border transactions, constitute trade and investment barriers. To overcome these barriers, firms engaged in international business have devised operating modes, institutional structures, control mechanisms and other business techniques different, more complex and more challenging from those commonly employed in domestic business practices. Bearing in mind the growing importance of international business in the world economy, and the increasing complexity of managing international interactions, it is not surprising that international business has attracted the attention of a growing number of scholars from different disciplines, ranging from economics, through political science, sociology, law and philosophy.

Technological developments especially in transportation, communication and information processing have dramatically lowered the international trade and investment barriers discussed above. Barriers have been further lowered by the adoption of pro-trade and pro-investment policies by governments. A growing number of first, second and even third world governments have relaxed trade and investment retarding policies such as state trading, high tariffs and strict control of both incoming and outgoing foreign direct investment and have adopted liberalization, deregulation and other pro-market policies. These trends

have been instrumental in promoting the phenomenon of 'globalization' – the growing integration of the world economy – manifested by a dramatic increase in world trade and investment, accompanied by the growing economic power and prominence of large multinational enterprises (MNEs), mostly from the USA. These developments constitute the changing global context of international business which the present book addresses.

The opening essay, 'The Moral Basis of Global Capitalism', co-authored with Mark Casson, sets the tone of the book. Following John Dunning, the authors argue that the survival of global capitalism cannot be taken for granted. Survival depends on global capitalism's ability to cope with a number of difficult problems, created in part and certainly exacerbated by its tremendous achievements. The list includes the skewed distribution of economic development and income, the deterioration of the environment and the decline of non-renewable natural resources.

While acknowledging the achievements of globalization, Buckley and Casson offer a scathing criticism of its shortcomings, which they ascribe to western commercial culture. In their view, 'Western commercial culture is like a "public bad" – a low-trust culture, based on selfish manipulation – gained credibility from the enormous strength of western technology, to which it appeared to be linked'. They point to a philosophical difficulty associated with the attempt to understand globalization and possibly overcome its shortcomings – the assumption that firms' actions, impelled by the profit motive, can be counted on, through the mechanism of Adam Smith's 'hidden hand', to bring about socially desirable outcomes.

Many of the shortcomings of globalization can be attributed to the simple fact that the hidden hand's assumptions concerning the functioning of markets simply do not hold in the globalized world economy, which is characterized by a series of systemic market failures. These failures are not random, they are endemic to systems characterized by 'ownership advantage', i.e. firm-specific assets, which constitute the *raison d'être* of MNEs. Moreover, the dark side of 'ownership advantage', when unconstrained by Adam Smith's 'hidden hand', is also manifested by the ability of MNEs to manipulate consumer tastes and by the inadequate bargaining power of their host governments, which are unable to impose on them rules and regulations consistent with public interest.

Buckley and Casson suggest that the major achievements of globalization might be preserved provided the MNEs adopt a code of behaviour based on ethical values. In their words, 'Modern social science presents a misleading view of human nature which overlooks the crucial significance

of self-control. The only antidote is better social science based on development and refinement of ideas about human nature found in traditional religions rather than attempting to replace them with some radically different secular alternatives' (p. 36).

In my view, the phenomenon of globalization suffers from another structural problem, vividly illustrated in the 2002 Johannesburg summit on sustainable development. I am referring to the phenomenon that the late Raymond Vernon referred to as 'sovereignty at bay'. Global business transactions are carried out, as we have seen, mostly by multinational enterprises operating in a world divided into national states, claiming sovereignty over all economic activities taking place within their boundaries. However, while sovereignty does not extend beyond the national borders, MNEs are able to shift resources globally, thus escaping some of the controls national governments seek to impose on them. Governments apparently value sovereignty over all other considerations. Consequently they have failed to agree on the establishment of worldwide institutions endowed with credible authority to monitor and regulate global business transactions conducted by global enterprises. Here lies the primary responsibility for the failings of globalization so convincingly analysed in the essay.

In the essay entitled 'Corporations and Structural Change in the World Economy', which further explores the globalization phenomenon, Buckley distinguishes between three types of market integration: Financial markets, trade and investment markets and labour markets. Financial markets are globally integrated, trade and investment are more and more regionally integrated, while labour markets remain largely subject to national regulation. Since business activities require access to all three markets there are predictable inefficiencies and market failures whose existence favours certain types of enterprises over others. MNEs, for example, benefit due to their ability to locate different activities in the 'best' locations, i.e. those enjoying 'ownership advantage', and to transfer resources efficiently between different locations. Consequently, if more governments were ready to submit to the disciplines of integrated markets, MNEs would lose some of the advantages they enjoy because of their superior ability to exploit market imperfections.

Regional groupings, ranging from loosely organized free trade areas (NAFTA) through all-embracing economic unions (EU) undoubtedly provide a limited answer to the challenge of the MNEs to the sovereignty of both home and host governments. Regional groupings also pose structural and locational challenges to firms located both inside and outside the region. It is therefore understandable that the book

contains several essays concerned with regional integration. Traditional integration theory explores the effects of integration on the economies of the participating countries, on the changing relationships between different insiders and between insiders and outsiders. Here the focus rightly shifts to the firms, the economic agents which transform the abstract notions of trade creation and trade diversion into real cross-border trade and investment flows, accompanied by a whole range of business activities undertaken in response to changing environmental conditions.

Individual countries have additional motives when they engage in international groupings. They seek to promote or maintain their share of world investment, employment income and growth. Regional economic integration is a way of increasing the preference of MNEs for local production by discriminating against outsiders. Outsider and insider firms are encouraged to locate activities within the integrated area. By eliminating borders and other barriers to cross-border transactions, regional integration is a substitute for country size. Moreover, regional integration encourages firms to increase their own size, by exploiting economics of scale, of scope and of learning, and by engaging in firm-specific asset creation, which has been increasingly recognized as the major source of competitive advantage.

The section on regional integration offers a number of predictions regarding the future effects of regional integration international business: an increase in the share of mergers and acquisitions over greenfield investments, increased volatility in labour-seeking investment, increasing importance of generalized managerial skills relative to technological skills, increasing importance of globally integrated MNE groups, and an increase in the competition between national territories for incoming foreign direct investment.

Two papers explore international joint ventures. This operating mode, though observed in domestic business situations as well, is certainly more common, more pronounced and generally more interesting, when considered in the context international business. It is a mechanism employed to reduce risk, to overcome deficiencies in resources, to gain time, and to neutralize strategic moves of competitors.

International joint ventures are, however, notoriously unstable. They find it increasingly difficult to overcome the built-in conflicts between parent companies, embodying different managerial cultures, different expectations, different views of risks and opportunities, and different interests concerning the goals and operating modes of the organization they jointly own. While some of these conflicts can be foreseen, others



cannot. They evolve over time, as the relative bargaining power of the parents changes as a consequence of unforeseen developments. Consequently a very high proportion of international joint ventures, and other forms of coalitions, are either dissolved, or taken over by one party. Much more research must be done on international coalitions in general and joint ventures in particular before we can claim to understand this phenomenon and derive meaningful conclusions about their relative merits as instruments for acquiring needed resources, handling risks and undertaking strategic moves in the global marketplace.

The final section of the book consists of two papers which address issues of cross-border knowledge management. The authors appear to be fully aware of the fact that the relatively new discipline of knowledge management has yet to be formulated in a manner which will facilitate incorporation of its relevant parts into the theory and practice of international business. The challenges posed by the knowledge revolution requires the transformation of the enormous quantities of data made available by the new transmission and processing technologies into manageable, systematic and useful decision tools. To achieve these ends, it is necessary to devise organizational mechanisms which will facilitate efficient communication between different parts of the organization and co-ordination between them for the purpose of ensuring consistency with the firm's overall goals.

Following Casson, the firm is viewed as a 'specialized intermediary, created by an entrepreneur, to synthesize information routinely about different sources of volatility'. Three such sources are identified. Primary uncertainty arises from exogenous shocks such as random acts of nature, unpredictable changes in consumer preferences and technological changes. Secondary uncertainty is represented by the risk that individual managers will not combine their knowledge with their colleagues in an optimum fashion. Tertiary uncertainty arises from opportunism – the risk that managers will fail to utilize the knowledge they have acquired in the best interests of the firm.

Chapter 13 suggests that 'knowledge management' is about coping with the secondary uncertainty identified by Casson, namely the problem of aligning the knowledge possessed by different managers in a manner which will best serve the interests of the organization. A superior knowledge management system is characterized by a mechanism for gathering data, processing the data first into information and then into meaningful business knowledge, efficiently transmitted between different parts of the organization so as to facilitate its timely exploitation.

The concluding paper consists of two case studies describing in some detail the strategies employed by two UK-based firms to achieve a sustainable competitive advantage by imaginatively using their firm-specific knowledge management systems. The authors should be commended for using the seemingly old-fashioned tool of a case study. I cannot think of any other research tool which could demonstrate more convincingly the advantages which can be gained by the imaginative employment of this potentially powerful, super modern but imprecisely defined, and as yet imperfectly understood management tool, provisionally labelled 'knowledge management'.

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This volume is dedicated to Bob Pearce, long-term friend and collaborator, with whom I shared an office at the University of Reading, 1973–4.

Leeds

PETER J. BUCKLEY

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# 1

## Introduction and Overview

This collection of my papers, published between 1997 and 2001, concentrates on four key issues in the world economy: the changing context of international business, the continuing pace of economic integration, international joint ventures, and knowledge management. In exploring these topics, my main concern is their relationship with the strategies of multinational enterprises (MNEs).

Chapter 2, co-authored with Mark Casson, examines the moral basis of global capitalism. It was written, like all the contributions in this volume, before the horrendous events of 11 September 2001, but those events make a reconsideration of the values of modern capitalism even more important. It was part of a special issue of the *International Journal of the Economics of Business* dedicated to a reappraisal of John Dunning's eclectic theory, and it mirrors Dunning's concern that the growth of global capitalism has costs, especially in its low-trust form and when individuals are open to manipulation. Chapter 3 examines the notion of competitiveness of firms and nations in the dynamic circumstances of the world economy where new competitors are emerging. It examines the particular questions surrounding the modelling of the strategies of MNEs subject to these changes, and their role in shaping such changes. Chapter 4 examines explicitly the strategy of firms facing decline, threat or scarcity. It explores the alternative strategies of exit, voice, loyalty and institutional reorganization. This chapter utilizes Albert Hirshman's framework and was included in a special edition of *Management International Review*, edited by myself and Klaus Macharzina, which was a tribute to the late Gunnar Hedlund. Chapter 5 examines the role of multinational firms and inward foreign direct investment (FDI) in Egypt's development. This paper, co-authored with Stephen

Young, contains a number of small case studies illustrating FDI in Egypt. Overall, Egypt is not punching its weight in investment attraction, and the chapter examines the obstacles to be overcome before inward investment will flow in greater quantities. It further shows that inherent advantages of cost, labour availability, natural resources and location can be overwhelmed by excessive transactions costs.

The pace of economic integration is accelerating in Europe, North America and Asia. Section II explores the relationship between international economic integration and the strategy of multinational enterprises. The focus of Chapters 6, 7 and 8 is on Europe, with special reference to Germany and Australian investors in the UK. Chapter 9 examines foreign market servicing strategies (the choice of methods of doing business) in the NAFTA area. Chapter 10 examines economic integration as a means of gaining 'size' when countries combine – particularly with regard to FDI.

Section III examines the key issue of international joint ventures (IJVs) in Chapters 11 and 12. These chapters, both collaborations with Keith Glaister, examine UK IJVs, focusing on partner selection criteria and performance.

The final section consists of two chapters co-authored with Martin Carter on knowledge management in MNEs. The first (Chapter 13) applies the business process approach to knowledge management with cross-border complementarity in MNEs. It analyses six multinational ventures in the chemicals, pharmaceuticals and engineering industries, owned by either UK or US firms and located in a foreign country, so as to minimize extraneous cultural differences and to concentrate on knowledge management issues. Even after controlling for cultural distance, large varieties of practice are discovered and a framework for analysis is proposed. Chapter 14 examines two matched but contrasting examples of knowledge management in UK firms, and draws lessons for theory as well as practice.

# **Part I**

## **The Changing Context of International Business**



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## 2

# The Moral Basis of Global Capitalism: Beyond the Eclectic Theory

*with Mark Casson*

John Dunning's work has taken a distinctive turn in recent years. He has placed greater emphasis on policy, and addressed much wider issues than before (see, for example, Dunning, 1994). This is particularly evident in his book *Global Capitalism at Bay?* (2000). The title not only echoes Raymond Vernon's *Sovereignty at Bay* (1971), but also conveys Dunning's concern that capitalism's survival depends not only on international trade and technology transfer, but also on the efficiency of the institutions that support them. Institutional efficiency depends in turn on the legitimacy conferred by moral systems.

The Festschrift for John Dunning, which was published on his retirement from Reading (Buckley and Casson, 1992) naturally concentrated on the technical aspects of his eclectic theory, which he had elaborated during the 1980s. The focus was the interplay of ownership, location and internalization advantages in the foreign investment decision. The range of issues addressed by the eclectic theory has expanded very considerably since that time. The eclectic theory is now concerned as much with the general institutional framework of international business and the political economy of government intervention as it is with specific issues relating to the foreign investment decision. Reflecting this shift of emphasis, this chapter focuses exclusively on wider issues of this type – and in particular on the issues raised in the first two chapters of Dunning (2000). These chapters address the future of capitalism, and the Christian response to it. They contain little reference to the original technical concerns of the eclectic theory; indeed, the multinational enterprise is relegated to the status of just one of several institutions of global capitalism. His work still remains 'eclectic' – but in the sense of embracing not only economics and business studies, but also politics, ethics and religion.

In his Raul Prebisch lecture, Dunning (1994) suggested that a 'G7' of the world's spiritual leaders be convened in order to 'establish common ground rules for the values and behaviour of their followers' (Dunning, 1994: 33). Despite his generally optimistic view of the impact of globalization, Dunning feared that, without some consensus of spiritual values among people of goodwill from widely different cultures, any gains in material welfare which global interdependence might bring could be completely destroyed by a clash of civilisations, the like of which is 'too terrible even to contemplate' (see also Huntingdon, 1996).

Dunning argues that a synthesis of economic liberalism and strong communitarianism is required to optimize the performance of the modern global economy (see also Hood, 1998). He does not consider the dismantling of the present global system as either probable or desirable. He is clear that changes need to be made to the present order, but he remains agnostic on whether change is best effected using a 'top-down' or a 'bottom-up' approach.

This chapter argues that Dunning overlooks the way in which modern global capitalism actively undermines the moral order on which it depends for its long-term survival. A sharp distinction is drawn between the early capitalism that evolved around the time of the commercial and industrial revolutions and the global capitalism of today. Early Western capitalism was embedded in a strongly religious culture, whereas modern Western capitalism is embedded in a highly secular one. Early capitalism developed in a world of relatively slow communication, where people, goods and information all travelled at about the same speed, in contrast to contemporary capitalism, where information travels at almost the speed of light. In particular, modern mass media had not been invented at this stage: the closest equivalent to a modern satellite television channel was a local newspaper, which would carry only a limited amount of advertising.

The traditional religion that incubated early capitalism embodied important insights into human nature which have been lost in the modern secular world (Skutch, 1970). Modern elites view human nature through the lens of modern social sciences, which have popularized misleading views of human nature, as explained below. As a result, the contemporary mass media disseminate a large amount of disinformation about human nature, encoded in entertainment and 'lifestyle' advertising (Earl, 1986). Contemporary mass media amplify the distortions effected by modern social sciences by selective emphasis on those ideas that serve their private interests. This disinformation undermines the spirit of community which Dunning recognizes as being so important

for social stability. Economic liberalism cannot be combined with a spirit of community, as Dunning proposes, so long as contemporary capitalism assumes its current cultural form. Sound social policies cannot be derived from an erroneous view of human nature.

From this perspective, the problem facing the modern world is not a clash between different civilizations, based on different religious traditions, which will disturb an otherwise stable secular world built on the foundations of free trade. The confrontation in Seattle in 1999 shows that it is not divisions between East and West, or between Christians, Moslems and Jews, that are most likely to bring down global capitalism, but rather discontent among Western consumers – the very people that capitalism has made materially rich, but left spiritually poor.

### **Plan of the chapter**

The remainder of the chapter is structured as follows. The third section examines the religious context in which early Western capitalism developed. It argues that the potential excesses of profit-seeking behaviour were curbed by self-imposed emotional sanctions – in particular, by a strong sense of guilt that would be incurred by unethical business dealings. While the Protestant ethic did much to legitimate business as a ‘calling’, it established definite limits on how far businessmen could pursue profit at the expense of broader social objectives. Religious sanctions kept transaction costs low at a time when commercial law was relatively underdeveloped and competition in local markets was normally weak.

Many of the insights into human nature provided by Protestant Christianity can be discerned in other religious traditions too, as Dunning has pointed out. A common theme is that people have both a higher nature and a lower nature. The higher nature is associated with deliberate conscious decision-making, based on logic and calculation. Decisions are based on mental models, and involve the pursuit of long-term objectives, the most important of which is peace of mind. The lower nature is largely governed by subconscious decisions, in which an unexpected stimulus generates an immediate response. The objectives that govern these decisions are concerned with fulfilling a small number of powerful drives concerned with aggression, procreation, pursuit of social dominance and so on. This view has much in common with the argument of Alexander Pope’s *Essay on Man*: ‘Two principles in human nature reign, Self-love, to urge, and Reason, to restrain’ (Pope, 1733: 62).

There is an underlying rationality to the lower nature, concerned with the biological survival of a race or tribe in a highly volatile environment. The resultant behaviour is, however, badly adapted to a civilized society, where volatility is handled through complex social institutions. The power of the drives, however, is such that considerable self-control must be exercised in order to override them (Ainslie, 1992; Charlton, 1988). Moral systems punish lapses of self-control, and thereby sustain a civilized society (Casson, 1998).

Opinions have always differed, however, on the amount of self-control that needs to be applied. The fourth section of the chapter considers modern opinion on this issue, and in particular the Freudian view. It argues that the modern Freudian view of human nature is seriously misleading in certain respects. While Protestantism may have over-estimated the importance of certain forms of self-control, modern Freudianism almost certainly under-estimates it. Some people are sufficiently self-aware to recognize their need for self-control, but others are not. People who lack such self-awareness are vulnerable to manipulators, who may persuade them that self-control is not required. Manipulators have a good command of the arguments relating to self-control, and can use them to persuade others of their views. They are especially good at advancing reasons for relaxing self-control, and Freudian rhetoric is admirably suited to this purpose. It is argued that modern capitalism is based on the systematic use of mass marketing to undermine consumer self-control. The techniques used were not available in earlier times – for example, television advertising. But equally, the message would have proven unacceptable in earlier times because Protestant convictions would have caused the arguments to be rejected. The decline of Protestantism, and religious belief in general, combined with the growth of mass media, means that modern capitalism is based on a culture that is exceptionally lax in its attitude to self-control. As a result, manipulation of consumers, and consequent consumer discontent, is rife.

The fifth section examines some of the moral ambiguities of capitalism in greater detail. Ideologically, capitalism represents a systematic attempt to harness private self-interest for the public good. It tries to achieve this by constraining the pursuit of self-interest by competition and the law. It accepts that only a moderate degree of success can be achieved. It therefore tolerates a situation where entrepreneurs make exaggerated claims for their products, and bluff in negotiations by withholding information. It supports the pragmatic maxim of 'buyer beware' to cover situations in which neither competition nor the law can fully address the problem.

Socialism does not make moral compromises of this kind, but it depends on a quite Utopian view of human nature to make it work. Its morality, though in one sense secular, is even more severe than that of the strictest Protestant sect. Because of its extreme demands, well-intentioned socialist experiments often degenerate into tyrannies whose excesses are even worse than those of capitalism. Protestantism accepts that the lower nature can never be completely eradicated, and that sin and temptation are therefore ever-present realities, and capitalism accepts this verdict too. Capitalism works best, however, when it uses internal moral constraints to control the excesses of the entrepreneur, as well as the external constraints of competition and the law.

The sixth section argues that the present moral weakness of global capitalism first began to emerge more than a hundred years ago. It argues that the present moral vacuum, in which self-control has atrophied, is not caused solely by the decline of Protestant Christianity, but by the subsequent decline of alternative secular ideologies too: scientific progressivism, socialism, imperialism and so on.

The seventh to ninth sections consider the impact of globalization. A major effect of globalization has been to open up new economic linkages between low-wage workers in newly industrialized and newly liberalized economies, and wealthy consumers in mature industrial economies. This has benefited Western consumers and non-Western labour, and penalized unskilled Western labour. On balance, it has advanced international economic development significantly, when considered in purely materialistic terms.

Globalization has, however, been marred by many of the excesses of the secular capitalist economy alluded to above. Many of these excesses have been perpetrated by multinationals involved in marketing branded consumer products, and by multinational banks promoting credit. The producers have targeted inexperienced consumers, such as affluent young people in Western economies, while the banks have targeted inexperienced borrowers, such as Third-World governments.

Globalization generally has weakened the power of nation states to implement economic policies at the national level. Many of the complaints against globalization have come from those who favour the use of national industrial policies to facilitate innovation and growth. It can be argued, however, that the major weakness of national policies is the inability of governments to call advertisers and the mass media to account. The power of the multinational media in a global economy has revealed a potential weakness in modern democracy – namely, the unwillingness of party politicians to constrain the media in case the

media should take revenge by undermining their electoral prospects by using hostile propaganda.

The tenth and eleventh sections summarize the conclusions and discuss possible ways of improving the performance of global capitalism. It is argued that, in the long run, the necessary improvements in the moral basis of capitalism can only be effected by the revitalization of traditional religious views of human nature, and a consequential reformulation of certain aspects of social science theory. As a short-term measure, statutory controls should be placed on the programme content of the mass media – and on the advertising of branded products. Because of the multinational nature of the entertainment and media industries, this may require international agreements. Such agreements may be difficult to negotiate because of the opposition of certain governments, who face constitutional constraints and/or a powerful industry lobby. This may well set the scene for further confrontations of the kind witnessed in Seattle.

## **The Protestant ethic and its decline**

The development of capitalism in Western Europe is often ascribed to the influence of Protestantism (Weber, 1930). This is a controversial thesis (Robertson, 1933). It is grossly inadequate as a monocausal explanation, because it fails to take account of the growth of capitalism in late-nineteenth-century Catholic Europe – for example, in France and Italy. On the other hand, it is consistent with the prominent role of Protestant nonconformist sects in the British Industrial Revolution.

An interesting feature of Protestantism is that it undermined a traditional source of authority – namely, the Papacy – and replaced it with the direct accountability of the individual to God. It thereby discouraged conformity of thinking, and encouraged individuals to think more independently, and even to express open dissent. Individuals continued to affiliate to groups, but they now decided for themselves, as a matter of conscience, to which groups they should belong. In this way, Protestantism encouraged individualism.

Protestantism was promoted by the availability of printing, and by the translation of the Bible into local languages, which meant that people could afford to purchase and read the Bible for themselves. This in turn provided a great stimulus to literacy. The Word of God was now presented in an impersonal codified form (Dark, 2000).

Protestantism also promoted the idea of human rationality. People no longer needed to rely on a priesthood to interpret religious truth for

them: they could engage with truth directly for themselves. In other words, they could 'cut out the middleman' in their relations with God. Protestantism also presented a novel view of this relationship with God. Celebration of the Eucharist was played down, and prayer and study were played up. The net effect was to replace passive participation in a communal ritual with proactive private prayer and study.

It also became possible to interpret the Bible in distinctive ways. For example, an analogy could be drawn between a commercial contract and God's 'contract' with His Creation: God would always keep his side of any contract, and so people should keep their side of a contract too. Equally, those who did not keep their side of a contract would be punished. They would certainly be punished in the after-life, and possibly in this life as well. The contractarian interpretation of the Scriptures fitted in well with the commercial revolution that was getting underway at the time.

The spread of Protestantism was effected by conversion. Catholics were an obvious target to begin with. Protestant preachers emphasized that nothing short of genuine repentance could deliver people from their sins. Purchasing indulgences from the Pope would do no good at all. The message of repentance requires people to be conscious of their sins. They need to reflect on all the things that they have done wrong. Only when they feel guilty, and are full of remorse, are they ready to make themselves right with God. Even then, those who enjoy sinning may attempt to have the 'best of both worlds' by deferring repentance until their deathbed.

To emphasize the importance of immediate repentance, the Protestant preacher would describe the many different forms that sin can take – for example, sins of omission, which are easily overlooked, as well as sins of commission, which are normally easier to recall. He would emphasize that death is an ever-present risk, and dwell on the endless torments of Hell that awaited the unprepared. In modern parlance, the Protestant preacher was 'selling' religion. He first created the problem – sin – and then offered the solution – salvation – which was available exclusively through the Church. Unlike the Catholic Church, however, the solution had to be administered by the individual themselves, and not by a priest (or saints) interceding on their behalf. Because the cure was more onerous, the problem had to be presented as being more urgent and acute. Repentance could not be taken lightly in the Protestant Church, and so the 'salesmanship' needed to be of a high order.

The techniques of persuasion employed by the Protestant preachers were really quite modern. To market a truly innovative product it is



always necessary to explain to potential customers why the product is needed. Unless the product resolves some problem, it is pointless for customers to spend their money on it. While the problem may not be one of guilt, it is often one of shame. People may be ashamed of the spots on their face, or dandruff in their hair, or that they are not as tall as they would like to be. The answer may be a new brand of soap, a new shampoo, or a new style of shoe; in each case, purchasing the product helps to make the consumer feel less ashamed than before.

It might be said that the analogy with guilt is rather weak, because guilt is a feeling that is purely subjective while shame reflects an external social reality. But this ignores the fact that modern advertisers may create illusory problems: for example, people can be led to believe that they suffer from 'body odour' on the flimsiest of evidence, and thereby be induced to purchase unnecessary deodorant sprays. In fact, the reverse is the case: some advertisers would defend their strategies explicitly on the subjectivist grounds that their products exist merely to make people feel better, and for no other reason at all. It has been said, for example, that the housewife is the only real expert on washing powders, because she alone knows what shape and colour of box she likes her powder to be delivered in. According to this view, the role of the producer is not to educate the housewife that the colour of the box makes no difference to the contents, but to discover what colour she desires and to match it as closely as possible.

More fundamentally, Protestant preachers' emphasis on guilt may not have been as misplaced as modern opinion would suggest. It depends a lot on what a Protestant preacher wanted to make people feel guilty about. In so far as he condemned dishonesty and breach of contract, for example, his efforts will have served to reduce transactions costs in the economy (Casson, 1991). If he preached on the Fall of Man, then he may have argued that work is not merely an unavoidable chore, but is actually good for the soul. Once mankind was expelled from the Garden of Eden, there was no alternative for the great majority but to make the best of a life of toil. Making people feel guilty about idleness helps to overcome the shirking problem, and raise productivity.

But if the role of the Protestant preacher was to promote economic performance, why did he also emphasize the forgiveness of sins? Surely an enduring sense of guilt for an unforgivable sin is a more powerful deterrent than a temporary feeling of guilt that can quickly be redeemed? The Protestant preacher was, however, too good an intuitive psychologist to overlook the need for forgiveness. Many sins are committed in the heat of the moment, through a temporary lapse of self-control.

Self-control requires scarce resources, such as willpower – which are in limited supply (Vance, 1985). Thus no amount of preaching can eliminate sin altogether, as the story of the Fall of Man confirms. If one sin were enough to condemn a person for ever, then having sinned once they might as well go on to sin as many times as they liked, for the final result – eternal damnation – would be the same. By ‘cleaning the slate’, forgiveness creates an incentive not to sin again. Although it reduces the expected cost of sin, it does not eliminate it altogether, because the emotional cost of temporary guilt remains. In general, if sins are associated with antisocial activity, then a Protestant sense of guilt fulfils a useful purpose by curbing antisocial behaviour. In a Protestant community, a sense of guilt not only improves economic performance, it also improves quality of life as well.

One reason why traditional Protestant values have fallen out of favour is that guilt was associated, not just with antisocial behaviour in general, but with sex in particular. The Bible lays great emphasis on sex, since it is the first reported sin. Before the advent of modern contraceptives, associating guilt with sex outside of marriage was a highly cost-effective method of population control. When marriage was accessible only to males with the means to support a family, strict observance of the Protestant ethic ensured that children were reared by parents with adequate means to support them.

Even before the appearance of modern contraceptives, the association of guilt with extramarital sex had been attacked by psychoanalysts – notably Sigmund Freud – who argued that it could lead to subsequent problems within marriage too. More generally, it led to a repression of sexual drives that was bad for the individual’s health (Sulloway, 1979). Sexual guilt could turn potentially well-balanced people into neurotics, it was suggested. Christianity had an obsession with sex, it was suggested, and had, quite unnecessarily, turned a major source of pleasure into a major cause of guilt.

There is a problem with this view, however, which continues to cause difficulties in the global economy of today. Because the sexual impulse is so strong, control of sexual drives is a paradigm for the exercise of self-control as a whole. It is not only sexual drives that need to be controlled, but various forms of aggression too. A person who cannot control their sexual impulses may be unable to cope with anger, envy, or other emotions. The basic problem is that any sort of self-restraint can cause neurosis if carried to extremes, and so tackling neurosis simply by relaxing self-control removes an important check on aggression and undermines social behaviour as a whole (Ellenberger, 1970). Freud

himself was aware of this issue, but most of his professional followers chose to ignore it (Freud, 1930).

The weakening of self-control, and the liberalization of attitudes to sex, give modern capitalism some distinctive features compared to its earlier form. For example, an important form of self-control has traditionally related to saving. To resist the temptation to purchase consumer novelties on impulse, people often commit to long-term savings schemes – from save-as-you-earn schemes through to ‘Christmas clubs’ and the like (Thaler and Sheffrin, 1981). At the same time, business interests counter with credit cards and hire purchase schemes that allow people to consume temporarily beyond their current means. They employ slogans such as ‘Take the waiting out of wanting’ and ‘Go on, treat yourself, you deserve it’. Such advertising undermines directly the individual consumer’s self-control.

Another example is the way in which modern advertising promotes products as instruments of sexual seduction – for example, motor cars, alcoholic drinks, boxes of chocolates, bubble bath and so on. Indeed, it seems that there is hardly any product advertised on television that cannot be given a similar treatment. The difficulty here lies with the fact that only a tiny minority of consumers are offended by this genre of advertising, and that once the genre is accepted, the advertiser who exploits the sexual connotation of the product most effectively is generally the one that gains the largest market share. Regulators lack the will to interfere if consumers do not protest, since they do not wish to appear out of step with public opinion. Conversely, if consumers were to be widely offended, then regulation would be unnecessary, since advertisers would find the advertising counter-productive – people would either not watch the advertisements, or would watch the advertisements but then boycott the product.

The reason why people are not offended is that they believe that taking offence is a kind of psychological weakness (indeed, it is quite common for warnings about the contents of magazines or television programmes to be addressed to ‘people who are easily offended’). The fact that taking offence can be a valuable aid to self-control is overlooked.

A standard defence of such advertising is that it is aimed at rational individuals, who are perfectly capable of managing their own affairs, and do not require any protection from an interfering ‘nanny state’. The concept of rationality employed in this argument is far removed, however, from the concept of rationality employed in Protestant thought. Rational Protestants invest in control devices to stop their lower animal

nature getting the better of that higher spiritual one. Rationality is a higher-order function, given to Man by God to enable the control of the lower nature, and to be exercised by the act of will. This act of will allows the power of reason to prevail over the power of aggression and sexual drives. The exercise of the will stems from the individuals' commitment to their religious faith. While this commitment is emotional, it is a higher-order emotion that differs fundamentally from the emotions that dominate the lower nature.

The unwillingness of regulators to play a 'nanny' role in the modern era of global capitalism shows just how far traditional moral leadership has fallen into decay. The classic role of the moral leader was to promote personal commitment to exercise self-control. Today the people who occupy traditional leadership roles – including priests and intellectuals, as well as politicians and regulators – have lost confidence in the message about self-control. Guilt has become an unfashionable word, and forgiveness has become just an excuse for doing nothing about anti-social behaviour. The idea that perpetrators of antisocial acts should be asked to repent would seem extraordinary to many citizens of the modern global economy.

### **Modern views of human nature: an evaluation**

Few people today, therefore, agree with the Protestant view set out above. The views of Freudians, Libertarians and neoclassical economists are far more influential. Table 2.1 summarises the main differences between these modern views and the strict Protestant view described above. It also compares these views with the view of human nature advanced in this chapter.

In contrast to the strict Protestant view, a typical Freudian psychoanalyst would argue that it is the higher nature, rather than the lower nature, that is the major source of problems. Excessive self-control means that civilisation produces mass neurosis. It encourages people to be dishonest by denying the existence of their lower nature altogether. This repression forces the lower nature to surface through disturbing dreams and psychosomatic illnesses. The cure is to condemn the higher nature as being fundamentally hypocritical, to 'get in touch with the feelings', and to indulge the lower nature whenever possible. The only moral constraint is that one person's self-indulgence should not be at the expense of others.

A Libertarian would take a rather similar view. If one person's self-indulgence occurs at the expense of someone else, then the other

**Table 2.1** The rhetoric of moral manipulation: five views of human nature compared

<b>Distinguish higher and lower nature?</b>		
Protestant	Yes	Higher nature must completely subdue lower nature. A strong sense of guilt will deter sin, and so improve social and economic co-ordination.
Freudian	Yes	Higher nature may go too far by repressing feelings associated with the lower nature. This leads to ill-health. Higher nature must respect the truth regarding biological imperatives. Lower nature must be indulged, except when other people are likely to get hurt in the process.
Libertarian	No	There is a single nature. To say that it is either high or low is an unscientific value judgement. The single nature may be identified, in emotional terms, with a lower nature in search of continuous excitement through novelty and experimentation. Its powers of reason are substantial, however, and in this sense it corresponds to the higher nature. It fears the law. It recognizes the imperatives of competition. This is all that is necessary to maintain social order.
Neoclassical economist	No	For reasons of analytical parsimony it is convenient to assume that there is a single nature, to equate it with the selfish motives of the lower nature, and to assume that people are fully rational in pursuing their selfish motives. Issues that cannot be dealt with within this framework will be studied by other social sciences instead.
This chapter	Yes	The Protestant position is correct in principle, but too unforgiving. Freudianism suppresses the higher nature, and so makes people unable to cope with a legitimate sense of guilt. Libertarianism is unworkable because it ignores unavoidable imperfections in legal and market institutions. Neoclassical economics is too partial to provide a holistic approach to the issue. Freudian and Libertarian positions (and to some extent the neoclassical one) are exploited for profit by modern marketing techniques. Globalization allows these techniques to be refined to an unprecedented level.

person should be compensated through a market process. With a full set of markets, people can be completely free to experiment with any form of self-indulgence that appeals to them. For those who like excitement, the 'weirder' and 'freakier' the indulgence, the better. In fact, a typical Libertarian would assert that the higher nature can be dispensed with completely as an analytical device, because it is simply a vestige of a primitive religious age that preceded modern enlightenment. The only controls required on self-indulgence are legal ones, protecting the individual property rights on which the market economy is based. The only civil role for the state is to uphold the law, and not to act as 'nanny' by giving spurious moral guidance to its citizens.

Many neoclassical economists hold rather similar, though less extreme, views. They would argue for assuming a single rather than a dual human nature simply on grounds of analytical parsimony. They would identify this single nature with the lower nature because it is easier to model the selfish and material preferences associated with the gratification of basic drives than it is to model the altruistic motives associated with the higher nature. Furthermore, since neoclassical economics is very much concerned with competition for scarce resources, it is natural to emphasize the aggressive side of human nature that is evident in competition. Indeed, some neoclassical economists would like to synthesize their subject with sociobiology, and explain people's preferences as an outcome of a biological struggle for survival. This approach will naturally tend to emphasize the kind of motivations associated with the lower nature.

An important feature of the Freudian, Libertarian and neoclassical views is that they provide an excellent form of propaganda for those who would like to weaken the degree of self-control that is exercised within society. There are a number of vested interests that would like to do this. Prominent among these are firms producing products that are most easily sold to people who lack self-control. For example, cosmetics can be sold as devices for attracting casual sexual partners, while motor cars can be sold as aggressive weapons, encouraging prospective owners to drive them in a dangerous manner. Cheap products can be sold as 'impulse' buys, while more expensive products can be sold to impatient consumers by offering hire purchase credit. Advertising can attack the notion of self-control by showing the happy consumer as an uninhibited one – this is particularly noticeable in the promotion of alcoholic drinks. Consumers can be flattered into thinking of themselves as being rational in the higher sense, when they are only being rational in the lower sense; they can then be duped, for example, into making enormous 'savings' on items in a bogus 'sale'.

The principal types of product whose sales can be expanded through undermining self-control are summarized in Table 2.2. The left-hand column identifies six main drives associated with the lower nature, each of which calls for a particular type of self-control. Examples of relevant products are given in the middle column. The final column indicates whether the costs that arise from undermining self-control are borne mainly by the individual or by society. For example, undermining control of aggression is likely to increase outbursts of anger and violence, which will tend to damage other people even more than it damages the angry or violent person themselves, but conversely, stimulating greed and envy is likely to damage the person who becomes greedy or envious more than it damages the people whom they envy.

The fact that people are damaged directly by loss of self-control raises the question of why they willingly allow their self-control to be undermined. If it were only other people that suffered then it could be said that they allowed themselves to be manipulated for purely selfish motives. The type of people most likely to be manipulated against their own self-interest are those who lack self-awareness. They do not understand themselves, and so are willing to believe things about themselves

**Table 2.2** Who benefits most from self-control? A comparative analysis by type of control

<b>Drive</b>	<b>Examples of products whose promotion tends to undermine self-control</b>	<b>Main beneficiary of self-control</b>
Aggression	Sporting motorcars Spectator sports involving physical contact	Others
Sex	Cosmetics Pornography	Equal
Greed and envy	Status products: conspicuously expensive branded luxuries Addictive products, e.g. alcohol, cigarettes	Self
Impatience	Consumer credit 'Impulse' buys, e.g. snack foods	Self
Fear and anxiety	Insurance purchased on impulse	Self
Rest and relaxation	Passive activities: watching TV, social drinking	Self

that are not true. Another factor is low self-esteem. They may believe that there is something wrong with them, and feel that they do not know what it is. They look to others to provide an answer. They look, in particular, to people who appear confident and cheerful, because they suppose that these people know how happiness is achieved. It follows that people who appear confident and happy, and who have a good command of the rhetoric of self-control, can influence other people. These confident-looking people are potential manipulators.

## **The moral ambiguity of capitalism**

It would be a great mistake to suppose that, before the advent of modern mass communication, the morality of capitalism was impeccable. Capitalism has always suffered from serious moral ambiguities (Knight, 1935). To put the present situation in its proper historical context, it is important to appreciate where these moral ambiguities lie. While the morality of capitalism has declined during the age of globalization, it has declined from what has always been, at best, a mediocre level.

Markets are the focus of activity in the capitalist system. Market equilibrium harmonizes individual decisions. Markets have ideological significance because of the claim that they harness self-interest for the public good. In Bernard Mandeville's (1729) *Fable of the Bees*, Private Vices promote the Public Virtue because the market rewards people for supplying other people's wants, while according to Adam Smith's (1776) principle of the Invisible Hand, the discipline of competition constrains the exercise of market power. Markets emerge naturally because opportunities for 'buying cheap and selling dear' encourage entrepreneurs to set up shop, permitting goods to be traded more conveniently than before (Kley, 1994). In pursuing their private profit, entrepreneurs unintentionally benefit everyone else as well.

But entrepreneurship is a morally ambiguous role. To maximize their profit, entrepreneurs may drive hard bargains with their customers and suppliers. They do not tell their customers the prices at which they purchased the goods they are re-selling, and they do not tell their suppliers the price at which they can re-sell. They are allowed to bluff about these issues if they wish (Casson, 1982). Bluffing is not considered to be lying, although the effect is much the same: with successful bluffing, the buyer pays more than she needs to, and the seller receives less than she could get (Bok, 1978). The constraint on bluffing is not an ethical one, but rather a practical one. It is competition from other entrepreneurs, who enter the market when the profit margin is too great. The competitive



system works because rival entrepreneurs cannot be trusted to keep out of the market when profits are higher than elsewhere. Thus the buyers and sellers can trust the entrepreneur only because the entrepreneur cannot trust his fellow entrepreneurs not to collude. No one can trust anyone else, and the system works only because everyone plays off everyone else against each other!

For many consumers, quality is just as important as price. Once again, the entrepreneur has an opportunity to bluff. For example, many consumer products are addictive – either for biological reasons, such as tobacco and drugs – or because there is a lifestyle that reinforces habitual consumption of the good – for example, gambling (Becker and Murphy, 1988; Warburton, 1990). Consumers' higher natures would warn them off such products, if information about the dangers of the product were to hand. But the entrepreneur can withhold information on addictive properties; indeed, the product may even be promoted with special introductory offers designed the 'hook' the inexperienced consumer.

Consumers can also be manipulated through flattery. The neoclassical economist's notion of the fully rational consumer is very useful to entrepreneurs from this point of view. Consumers are told that they are sophisticated and cosmopolitan, and are complimented on their choice of the firm's product. This puts them off their guard, and increases their willingness to commit to a purchase. The fact that economic agents are only fully rational when they are fully informed, and that advertising often does little to inform the customer, is quietly forgotten in the process.

Another kind of quality problem arises when individual items of a product are defective. This is connected, not with promotion of the product, or negotiation of price, but with the enforcement of contracts. Reputation can sometimes be used to solve such problems. It relies on the entrepreneur's enlightened self-interest, but only works well when she has regular contact with his/her customers. Competition alone cannot solve this type of problem. In the absence of reputation effects, enforcement requires a system of law. When the law itself is weak, the maxim is 'buyer beware'. Under these conditions, the market becomes a place that is safe only for the 'streetwise' customer.

To protect the naïve consumer, a variety of institutional checks and balances have been set up at different times and places, including consumers' associations, and statutory regulatory bodies. Growing suspicion about employers was a major factor in the growth of trade unions in the late nineteenth century. It is recognized more generally that naïve people may be manipulated into entering all sorts of contracts on terms that they may later regret (Moore, 1962). In extreme cases, people

are prevented from entering into contracts at all, on the grounds that if they enter these contracts they are probably being manipulated. This explains the widespread prohibitions of slavery and prostitution.

The idea that the market economy is a place for streetwise people is most apparent where stock markets are concerned. The valuation of stocks and shares provides an opportunity for people to pit their wits against others by speculating on the future. Opportunities for bluffing are enormous where stock market trading is concerned. Professional traders can manipulate market opinion by disseminating disinformation to naïve investors, while keeping genuine information to themselves. This disinformation causes people to underestimate risks, and exposes them to serious capital losses. Many critics of capitalism have focused on the instabilities created by stock market ‘bubbles’, and the crises that occur when they collapse, in which many innocent people suffer, such as the employees of bankrupt firms who lose their jobs.

It is evident that manipulation is very much at the core of market capitalism. It is involved in bargaining and negotiation, especially where competition is weak. It is involved in advertising lifestyle products, and withholding information about addictive properties. It is involved in engineering stock market bubbles, where naïve investors are enticed into buying shares in firms they know little about.

Manipulation can involve either withholding information, supplying disinformation, or deliberately undermining self-control. All three aspects can often be combined in a single message. The marketing of lottery tickets, for example, may involve playing down the risk of addiction, exaggerating the chances of winning, and promising instant euphoria to the winner as well.

Manipulation is not, of course, a monopoly of market capitalism. All social systems involve manipulation of one sort or another. The distinguishing feature of market capitalism is that manipulation is decentralized, and that selfish manipulation is condoned. Table 2.3 identifies

**Table 2.3** Two dimensions of a socioeconomic system: degree of decentralization and degree of altruism

<b>Degree of responsibility for others (level of trust)</b>	<b>Centralized manipulation (collectivism)</b>	<b>Decentralized manipulation (individualism)</b>
Selfishness (Low trust)	1. Tyranny	3. Market capitalism
Altruism (High trust)	2. Utopian socialism	4. Protestantism

two dimensions of a social system, according to whether manipulation is centralized or decentralized, and whether it is supposed to be selfish or altruistic. Intuitively, the decentralization dimension, which appears on the horizontal axis, measures the extent of individualism in the system, while the altruism dimension, which runs vertically, measures the degree of trust between ordinary people. Market capitalism emerges as an individualistic low-trust system. Socialism, in its purest form, represents a collectivist high-trust system, although in practice, as its leaders become corrupt, it tends to degenerate into tyranny – the collectivist low-trust form. Protestantism supports an individualistic high-trust society, which explains why, historically, it has provided a useful antidote to the moral excesses of pure market capitalism.

The moral excesses of market capitalism stem from the way in which everyone is encouraged to manipulate everyone else for their own gain, and the way that smarter people are allowed to keep the profits they win from the naïve. These profits are treated as legitimate because all the participants in the market game are assumed to be sufficiently rational to look after themselves. The problem is that many people are neither so well informed, nor so self-aware, as they believe, and as a result they are ‘easy prey’ for selfish manipulators.

### **Antecedents of moral decline**

The moral basis of capitalism, as it stands at the time of writing, reflects the profound secularization of Western society during the twentieth century and onwards. The intellectual origins of this secularization can be traced back to the impact of Darwin and Lyell, whose scientific researches served to undermine the literal interpretation of the Bible on which popular support for Christianity in general, and Protestantism in particular, was based. This decline increased the problems caused by the moral ambiguities of capitalism, as described above.

Darwin’s evolutionary theory highlighted the biological and, behavioural similarities between animals and humans, thereby emphasizing humans’ lower nature. It provided an intellectual justification, of sorts, for the growing hedonism of the ‘naughty nineties’, and of bohemian intellectual society in the Edwardian period just before the First World War. By identifying the ‘self’ with animal appetites, *avant-garde* artists could flout convention and breach sexual taboos, on the grounds that they were merely being ‘true to themselves’. The manner in which ‘science’ appeared to have defeated ‘religion’ also reinforced the rationalist view of human nature, which was already well developed in France.

The higher nature became identified with reason, and the lower nature with emotion. The role of the higher nature was to indulge the lower nature in such a way as to maximize pleasure and minimize pain. Morality became purely prudential. Enlightened self-interest became the criterion by which actions were judged. Within these prudential limits, individuals pursued a hedonistic lifestyle through utilitarian calculation.

This culture was very similar to modern Western culture, and it is tempting to argue that modern culture has simply taken up where Edwardian culture left off at the outbreak of the First World War. Matters are not quite so simple as this, however. At the start of the twentieth century, secular replacements for religion were on hand to offer hope for the future:

- Science provided a basis for utopian schemes in which poverty could be abolished for-ever. Technological developments in the field of electricity and chemistry seemed to offer unlimited potential for the future. Science became a noble calling, offering exciting careers to young people who, in an earlier generation, would have been destined for the Church.
- Socialism offered a scientific basis for social and economic reform. Although anti-clerical and pro-scientific, there were moral similarities to Protestant Christianity. Socialist intellectuals dedicated their lives to building a 'New Jerusalem' to replace the old one (Pick and Anderton, 1999). The excesses of capitalism, when freed from the constraints of Protestant self-control, were already evident in the monopolistic practices of the great cartels and trusts. 'Muck-raking' journalism had exposed the venality of 'fat-cat directors'. Parasitic bourgeois capitalists were doomed – they would be swept away by efficient state-owned enterprises run in the interests of society as a whole. By participating in this revolution, idealistic young supporters would win themselves a place in history – the nearest thing to immortality available in the secular world.
- For those who did not subscribe to the scientific or socialist agendas, Imperialism was on hand. Exporting parliamentary institutions and honest government to 'primitive' societies was a noble calling too – even if some of the 'beneficiaries' lost their land rights in the process. The excitement of foreign travel, coupled with the security of a career in government service, made diplomacy and administration a rewarding challenge.
- Finally, for those who were not of an intellectual turn of mind, there was war. As imperial rivalry among European nations led to military

conflict, there was plenty to excite the patriotic imagination. Prior to the 'industrialization' of warfare, it was still possible to contemplate a glorious death on the battlefield with some degree of equanimity.

These different ideologies were not as incompatible at the time as they might seem today. Although many socialists disapproved of international warfare, they were still prepared to contemplate class-based civil war in the interests of 'the revolution'. Although many scientists also disapproved of war, others found it a major stimulus to invention. Imperial expansion provided scientists with new data on plants, races and societies, and provided reformers with an outlet for philanthropy and missionary work.

One by one, these secular ideologies became discredited:

- The unprecedented loss of life in the trenches of the First World War, followed by the aerial bombardment of civilian targets in the Second World War, undermined the perceived legitimacy of war. In the nuclear stand-off of the Cold War, many Europeans came to believe that it was 'better to be Red than Dead'. Vietnam provided a similar turning point in the USA. Enlightened self-interest, rather than patriotic fervour, came to dominate attitudes to war.
- Imperialism succumbed to socialism. Indigenous leaders from the colonies who went to study in Western universities were quick to see the relevance of socialist doctrine to their country's situation. The exploitative class was clearly the colonial capitalist, and the exploited were the indigenous people. The fact that indigenous people were often excluded from the higher echelons of management and administration in their own countries only made the socialist scenario appear to be an even better fit. The historical links between colonization, slavery and military conquest persuaded the imperial elites that their position was morally untenable, and twenty years after the end of the Second World War, decolonization was virtually complete.
- Socialism could not save itself, either. It was based on an intellectual critique of capitalism, and was largely untried in terms of practical policy. The socialist leader commanded enormous power, and therefore needed enormous self-control. The ideology of altruistic collectivism quickly succumbed to tyranny. Post-colonial socialist states suffered from government corruption and civil wars. In the developed world, the post-war Western experiment with socialism focused on the creation of the welfare state. But when services were provided free, it became difficult to limit demand. Because of the heavy fiscal

burden of social security payments, taxes were seen as unfair by those who worked hard. The final 'nail in the coffin' of the post-war socialist experiment was the demise of the Soviet system, as symbolized by the fall of the Berlin Wall.

- Finally, science – the great hope of the late nineteenth century – also became discredited. The causes are complex, and the process may yet be reversed. Some of the expectations were clearly excessive – for example, that nuclear fusion would make energy free – and so disillusionment was inevitable. Other concerns arose because science exceeded expectations, rather than falling short – for example, advances in genetics provided opportunities for social engineering that threatened the traditional fabric of society (Bruce, 1997). As pollution rose, and 'wilderness areas' disappeared as a consequence of global industrialization, environmentalism became the new creed. Environmentalists began to challenge professional scientific opinion rather than deferring to it. There was a growing suspicion that the pursuit of scientific knowledge for its own sake was being perverted by powerful vested interests in government and industry.

All these ideologies suffered from the problem of trying to deal with highly complex issues in a very simple form. Because they over-simplified key issues, it was only a matter of time before their weaknesses were exposed. The intellectuals of the late nineteenth and early twentieth centuries thought that they had dethroned traditional religion and put something modern and scientific in its place. Although they often disagreed about what replacement was required, they did not for a moment doubt that it would take a modern scientific form.

But with so many intellectual failures occurring in so short a time, a sense of despair about the value of great social scientific ideas took hold. Intellectuals were forced to admit that they did not always know best. The sense of failure was particularly great in France – the leader of socialist thought in the mid-twentieth century. It seemed that the only acceptable theory was that there was no theory – at least of a modern scientific kind. Thus postmodernism was born. There was a crisis of authority: truth became relative, not absolute, because there was no one to turn to who was sure to be correct. The opinions of an ordinary layman became just as valuable as those of the intellectual. Ordinary citizens could regard themselves as experts on everything.

Without a reputable body of experts to back them up, politicians began to lose confidence. If the public believed that it was always right, then politicians might as well pander to this belief. Populist politics

became fashionable as politicians increasingly 'led from behind'. This crisis of authority provided great opportunities for the press and media. The press became self-professed experts on the state of public opinion, and began to mount their own single-issue campaigns, claiming public opinion as their authority. Their ability to manipulate opinion through selective dissemination of information gave the 'press barons' considerable power. Yet many of their campaigns turned out to be misguided; they showed that the press were no better at solving problems than were the politicians themselves. It seemed that nobody could be trusted – neither official authority figures, nor the unofficial opinion leaders who mounted campaigns against them.

### **Globalization of commodity trade and factor movements**

Market capitalism, as described above, has inherent global tendencies. These stem directly from the central role of trade in a market system. The tendency of trade to promote globalization can be seen in the empires of classical antiquity as well as in the globalization that occurred in the Age of High Imperialism before the First World War (Prior, 2000). This age was the culmination of almost a millennium of incremental development, in which local markets became integrated into regional trading systems, and these trading systems were in turn integrated across continents as a consequence of transoceanic voyages of discovery. This integration of markets is a defining characteristic of globalization.

Market capitalism also encourages the globalization of finance, and promotes the mobility of labour. Large financial markets offer investors greater liquidity, and more competitive pricing of stocks and shares, combined with greater legal security. This leads to the agglomeration of economic power in major metropolitan centres where financial dealings predominate. Peripheral regions of the integrated economy are plundered for their raw materials, or farmed intensively to feed the urban areas, or relegated to unskilled, labour-intensive work. This is simply the imperative of efficiency-seeking in a world of constant change.

This discussion provides a suitable framework for examining some of the major complaints levelled at the World Trade Organization at their 1999 Seattle meeting. The substance of the complaints appears to be that:

- the progressive reduction of trade and investment barriers leads to loss of jobs;
- an accelerating pace of technological change leads to greater insecurity of jobs, and to the end of the lifetime employment system;

- inadequate environmental standards lead to increases in pollution which are incompatible with sustainable development;
- greater income inequality emerges, both within countries and between them, creating new social and political divisions;
- destruction of local communities is caused by an extension of global linkages;
- cultural diversity is reduced, because culture is homogenized by standardization on modern Western values;
- national sovereignty is threatened, and the power of the state is undermined; and
- deregulation of industry and services leads to increased uncertainty, and to greater opportunities for stock-market speculation.

Little can be done to address some of these objections because they hit directly at the logic of the capitalist process (Rugman, 2000). For example, the dynamics of the market system mean that old jobs are destroyed at the same time that new jobs are created, and, as this process accelerates, jobs become progressively more insecure. Many of these objections can be addressed fully only by changes that would reduce the long-run efficiency of the capitalist system dramatically. It is perfectly possible, for example, to insist that the metropolitan trading centres be deglomerated, thereby redistributing entrepreneurial profits to more peripheral regions. But the costs of transporting and distributing commodities would increase, and consumers as a whole would be worse off. Similar measures could be applied to deglomerate research and development (R&D) from major clusters like Silicon Valley to a host of minor ones, but again there would be efficiency losses in terms of innovations forgone. Moreover, it is likely that plans for enforced deglomeration would quickly become distorted by local politics, so that any redistribution of income would favour corrupt officials in the main.

Indeed, contrary to the claims of the Seattle protestors, globalization confers important benefits. As Table 2.4 indicates, the opening up of trade frees domestic workers from the need to produce for subsistence and allows them to specialize, if they wish, on export production. Provided that they work in a free society, they will switch to export production only if they perceive a benefit from doing so. There is little direct evidence that local producers are duped systematically into producing for export markets through selfish manipulation, although it is often alleged by critics of free trade that this is what local money-lenders and export merchants do.



**Table 2.4** Winners and losers from the globalization of capitalism

	<b>Winners</b>	<b>Losers</b>	<b>Factor</b>
Labour	Labour in newly industrializing countries	Labour in mature industrialized countries	Reductions in transport costs and tariffs for manufactured goods
Profit earners	Owners of successful globalized firms, or of the firms that supply them	Owners of firms that fail to globalize, or of firms dependent on them	Reduced communications costs facilitate international transfer of proprietary knowledge
Government	Non-interventionist governments with strong respect for property rights	Interventionist governments with weak respect for property rights	Reduced transport and communication costs give increased scope for international specialization and exploitation of agglomeration economies, providing firms with a wider choice of political regimes from which to operate

While some of the objections are invalid, however, others have substance to them. The moral ambiguities of the capitalist system generate a range of problems connected with negative externalities of one sort or another. No set of market contracts can cover all the issues involved in co-ordinating a complex global economic system – except at prohibitive transaction cost. It is wrong to suggest that nothing can, or should, be done about these problems. Consider, for example, the issue of financing mineral industries in developing countries. In a world where entrepreneurial greed was constrained by Protestant guilt, profits in resource-based industries would be sacrificed voluntarily to render development more sustainable. Bankers would think twice before lending large sums of money to inexperienced borrowers, such as the governments of less developed countries. In a more secular society, issues of sustainability and manipulative lending practices can be addressed through statutory

regulation, but this requires a high level of intergovernmental co-operation. The institutions of inter-governmental co-operation are often slow and bureaucratic, creating considerable impatience among activists awaiting a policy response. It is inherently wasteful to operate a capitalist system that encourages selfish profit-seeking behaviour, and to then establish a cumbersome inter-governmental bureaucracy to restrict it. Regulating profit-seeking through self-restraint is, in principle, a much cheaper option, provided that the moral infrastructure is in place.

### **Globalization and the nation state**

It is undoubtedly true that globalization undermines the power of the nation state. Historically, the nation state has played almost no role at all in developing international trade. Long-distance trade in Europe first flourished in an age of minor principalities, where merchants obtained safe conduct to attend major fairs. The main role of the state has been to inhibit trade in the interests of national self-sufficiency – often linked to programmes of forced industrialization and military conquest (Gellner, 1983). Free trade, by contrast, tends to promote peace, by increasing the economic interdependence of economies and improving communication between them. Those who support the capitalist system therefore see little to regret in the weakening of the nation state, since this makes protectionism harder to sustain, and thereby advances the gains from trade.

There is, of course, much more to government policy than the regulation of trade. Nevertheless, whatever the field of policy-making, it can be argued that globalization will, on balance, tend to improve the quality of government rather than reduce it. Bad governments tend to suffer most from globalization, while good governments may not only suffer less, but may actually benefit from it. One of the advantages of globalization is that migrants can move from bad states to good ones, thereby improving their economic prospects and quality of life. The consequential loss of tax revenue suffered by bad states, and the increase in tax revenue achieved by good states, provides an incentive for bad states to improve their policies, and this encourages the diffusion of good government throughout the world. Similarly, private capital will flow out of countries where property rights are insecure, and into countries where they are secure. In so far as a prime responsibility of the state is to guarantee property rights, this also penalizes bad government and rewards the good.

Many writers who are critical of globalization believe that the state has an important role to play in building up national economic power. Like the Mercantilists of the seventeenth century, they seek economic growth through government-led industrial development. Globalization creates problems for such interventionist industrial policies. For example, the benefits of subsidizing the education of scientists and engineers are rendered null and void if the graduates emigrate to higher-paid jobs overseas. Again, the global diffusion of technology means that subsidies to R&D offered in one country may be used to develop new products, which are produced in other countries. The efficiency of internal markets for know-how within multinational firms allows knowledge to diffuse more quickly than ever before.

From a global perspective, however, the promotion of national economic growth makes no more sense than does the promotion of regional growth from a national perspective. Taking a moral view of the problem, it could be argued that a more appropriate global objective is international development. From this broader perspective, most of the problems identified above disappear. The enlightened nation state educates people in skills that will serve the global economy rather than the national one. It regards the state-educated workers who emigrate as part of its contribution to world development. The diffusion of R&D is regarded in a similar light. What each government can afford to contribute to international development is dictated by the number of skilled workers it can retain as its citizens, since these constitute a major group of tax-payers. If the government taxes land – either directly, or indirectly, through an inheritance tax – then it can finance development from this source as well. Countries that are well endowed with natural resources, or occupy a natural entrepôt situation, will perform well in this respect.

Not every nation can realistically expect to attract large numbers of skilled workers, or to become an international centre for R&D. Indeed, if every nation were to try to match every other nation in this respect, then economies of agglomeration would soon be lost. Small nation states must come to terms with the fact that, in a modern global economy, they are no more viable as units for subsidy-based industrial policies than were regions in the past.

## **The globalization of communications**

The growth of long-distance communication is an aspect of globalization that has profound cultural effects, because it permits the rapid diffusion

of the low-trust capitalist culture described above. Long-distance communication takes two main forms. The first is person-to-person communication – such as by telephone – while the second involves broadcasting to a wider public. Radio and television broadcasting allow one person, or a small group of people, to communicate with a very large, geographically dispersed audience.

The cultural consequences of broadcasting are much greater than those of the telephone, because so many people can be influenced at the same time. This is particularly true of television. A visual medium is highly effective for gaining and keeping attention, and so its messages can be conveyed in a very powerful way. Television is an ideal medium of mass manipulation.

Television provides mass entertainment as an alternative to local socialization (Etzioni, 1988; Putnam, 1993). Television appeals to people in search of passive entertainment. These tend to be the same sort of people who are easily manipulated. The more they stay in watching television, the less they go out, and the more their view of the outside world is dependent on television, thus it is easy for them to obtain a distorted view of human nature. Television has created its own fantasy world of weekly ‘soaps’, the friendly faces of newsreaders and chat-show hosts, and so on. Television drama provides a continual diet of people losing self-control through violence, sex, greed, envy and the like.

Advertisers too want television to attract and retain the attention of the more manipulable people. Commercial pressures therefore encourage what intellectuals would consider to be the ‘dumbing down’ of entertainment to maximize the number of viewers from the socio-economic groups targeted by the advertisers.

Television has enormous potential for achieving positive social outcomes. It can disseminate expert opinion, and promote high-quality debate of major issues. In practice it rarely does these things. To maximize market share, the owners of major channels consider it necessary to turn debate into entertainment by structuring it as a quick-fire contest between people of extreme opposing views. The professional manipulator knows that, under these conditions, it is not the argument but the memorable ‘sound bite’ that wins the day. Competition between ideas does not work in the same way as competition between products when played according to the rules of the television audience game. The correct idea is not necessarily the most profitable one, for an incorrect idea may serve to lower consumer resistance to a product, and so command more value. Where viewers are passive and uncritical, and seek entertainment rather than truth, then the truth or

falsity of an idea cannot be inferred from its popularity with the audience.

Not all viewers are so lacking in self-awareness, however. Those who possess both self-awareness and self-control are likely to behave in a distinctive way – they are likely to turn the television set off. At any rate, they will be highly selective in their viewing. So far as television advertisers are concerned, this only reinforces their incentive to ‘dumb down’ their programmes, since they know that the most active people will not be watching in any case.

The self-aware viewer could be forgiven for contemplating the contemporary world of global capitalism with a certain amount of despair. The combination of violent dramas, superficial reporting, documentary exposures and trivial advertising suggest a world that has been totally corrupted by selfish manipulation. The cynical viewer may feel that the public is no longer a group of citizens served by honest politicians, but rather a collection of faceless people manipulated by the media. Behind the media stand vested interests who give an ‘angle’, ‘slant’ or ‘spin’ to every issue in order to present their own interests in the best possible light. They hide their true identity, so that even when people suspect that they are being manipulated, they cannot discover who by.

Under these conditions, the truth is concealed behind the deliberate distortions of those who provide the information. Even if, by accident, a person heard someone speaking the truth, they probably would not recognize it, because they would be bombarded by so much erroneous information at the same time that they would not be able to filter it out.

Fortunately, television is not the only medium in which ideas can be debated. There are other media which seem to be more suitable for this purpose. E-mail is a good example, as it combines the options of both private (one-to-one) and public (one-to-many) communication. This flexibility explains its popularity in large, dispersed organizations. In particular, e-mail facilitates the development of ‘cyber-communities’ based on shared interests. Strategic use of e-mail capabilities is almost certainly a major factor in the success of many pressure groups. Enterprising individuals with strong moral commitments can organize people in different countries around political, social and religious issues. When formalized as multinational non-government organizations fighting single-issue campaigns, they have proved formidable adversaries for slower-footed governments. Effective governmental response on global issues requires intergovernmental co-operation and, as noted earlier, this is often slow because it is channelled through cumbersome bureaucracies.

E-mailing is an ideal activity for people who have specialized interests, and have better things to do in the evening than watch television. E-mailing is not necessarily incompatible with local community involvement, because it provides a suitable means for local groups with common interests to keep in touch with similar groups elsewhere. The cyber-community is an ideal institution for active people who are not prepared to become the passive recipients of television advertising. It is hardly surprising, therefore, if the political agendas of many cyber-communities are strongly opposed to global capitalism.

### **Protests against global capitalism reconsidered**

The secular ideologies reviewed in the sixth section, above, provided an outlet for creative talents throughout much of the twentieth century, and their demise has left a serious vacuum. The protesters at Seattle were struggling to find a relevant language in which to express their discontent. Their demonstrations showed that they did not trust existing international institutions to make the changes that they believed were required. They sensed intuitively that there is a lack of restraint by those who hold economic power – namely, by those who influence key decisions about future policy regimes in the global economy. In this sense, their attitudes simply reflect the low-trust culture that modern capitalism has created.

Admittedly, many of their criticisms are not new – they echo the criticisms of international capitalism advanced by socialists in the past. Some of their claims may also be misguided. It was shown above, for example, that low-wage workers in developing countries can benefit substantially from global capitalism. But there is always a tendency for people who are making a point to support their position with as many arguments as they can find – good as well as bad. Groups that wish to engage in collective action often have to promote an eclectic position in order to mobilize support as widely as possible.

The analysis in this paper suggests that the protesters' accusations of bad faith against modern capitalist enterprises may have some substance. Some marketing techniques probe systematically for ignorance and lack of self-awareness among the consuming public. Popular brands are targeted at poor consumers, offering them subjective rewards, such as higher status, at a price they cannot afford to pay. Children and young people make easy targets, especially when advertisements can be designed skilfully to undermine parental veto power. When people find the time to relax, and reflect on their experience as consumers, their

higher nature intuitively alerts them to the problem. But they cannot articulate their feelings easily because they have been brought up to believe that they are rational all the time. Even if the products they buy seem useless in retrospect, it has to be admitted that shopping for them seemed like fun at the time (see Frank, 1999). Shopping becomes an end in itself – exercising the impulse to buy being the immediate source of pleasure – and the product is just the excuse. Products then have to be thrown away because otherwise storage space would limit indulgence in the shopping experience. On this view, it is when shopping palls, and the meaninglessness of the impulse to buy becomes obvious, that protests become attractive instead. People become angry when they finally have to face the fact that they have been manipulated systematically by the producers of the branded trivia of the modern capitalist system.

## **Conclusions**

This chapter has highlighted some of the moral ambiguities that lie at the heart of the capitalist system. Capitalism is a system based on private property in which the enlightened pursuit of self-interest plays an important role. It is a system in which people are expected to bluff in negotiations, unless constrained by competitive forces, and are liable to default on transactions, unless constrained by the law. Capitalism accepts the biblical view that mankind has a 'fallen' nature, and attempts to 'make the best of a bad job'.

Historically, capitalism has played an important role in the economic development of civilized society. In itself, however, it has not been the driving force of civilization. Civilization is ultimately a moral concept, and the major civilizations of history have derived their moralities from an organized religion or some sense of collective destiny. The modern concept of a society based on the individualistic gratification of material desires is linked, historically, not to the growth of civilizations, but to their decline.

The social cost of excessive individualism is increased by the unprecedented opportunities for marketing products through global television advertising. Contemporary individualism is characterized by apathy towards traditional morals. Contemporary values provide a convenient justification for a vegetative existence in front of a television screen. Aggressive individualism dismisses all arguments for self-control. From this perspective, globalization merely accentuates problems that are already present in the capitalism system. Globalization itself is morally neutral. In principle, it is ethically sound from an international

development perspective, because it allows workers in poorer countries to develop new markets for their products. In practice, globalization means that the excesses of market capitalism become greater than they would otherwise have been.

There is a major discrepancy between the private rewards to moral manipulation faced by television advertisers and programme makers on the one hand, and the social benefits on the other. Private rewards are maximized by undermining consumer self-control, while social rewards are maximized by increasing it. The social rewards reflect both the benefits to individual consumers – less disappointment with their lifestyle, lower debt, and so on – and the benefits to society as a whole – lower amount of crime, greater vitality of community life, and so on.

It is often suggested that nothing can be done to influence the multinational mass media. It is certainly true that the position of a national regulator is often weak – for example, in respect of satellite TV broadcasting. But regulation is not really the main issue. Even in a self-contained economy, regulators may be unwilling to intervene unless they feel that public opinion is behind them. If the media are sufficiently powerful to mobilize public opinion against any form of ‘censorship’, then regulation may not be applied even when it could be effective.

From a long-run perspective, the real issue concerns the way in which public opinion is formed. Members of the public cannot make up their own minds on every issue that concerns them, and so naturally they listen to the opinions of leaders on the issue. Because television enjoys such status, it has the power to make its own leaders, who will then promote the views that favour television. But even when other leaders get an opportunity to state their views, they rarely call explicitly for those concerned to exercise greater self-control. The subject of self-control seems to be almost ‘taboo’ in intellectual circles at the time of writing.

This brings us to the heart of the problem: that modern social science presents a misleading view of human nature, which overlooks the crucial significance of self-control. Many of the misleading views of human nature, as reflected not only in advertising, but also in art and drama, derive from intellectual currents in twentieth-century social science (Bailey, 1983; Baxter, 1988). There are, of course, many different versions of social science theory, associated with different disciplines, but this simply means that there is almost always some convenient theory available to those who wish to argue against the use of self-control. Freudian theory is the best example of this, and Libertarian economics provides another example.



When suitably popularized, these theories have great appeal. People like to believe that they are fully rational, and can indulge themselves on impulse without fear. People like to be told that they are fully autonomous individuals who do not have to rely on other people for their opinions. As a result, many people fail to appreciate the extent to which their values and beliefs are influenced by other people. By being blind to the risk of manipulation, they become extremely vulnerable to it.

In the long run, the only antidote to this regrettable situation is better social science. The analysis in this chapter suggests that the key to better social science is to concentrate on developing and refining the ideas about human nature that are found in traditional religions, rather than attempting to replace them with some radically different secular alternative.

This is an important theme in Dunning's recent work, and is completely endorsed by the analysis above. The social-scientific notions that failed the capitalist system in the twentieth century were mistakenly developed in opposition to conventional religious ideas, and so these were ignored, or even contradicted. The fact that religious tradition encapsulates insights drawn from observations of human behaviour in all sorts of countries and under all sorts of conditions over thousands of years was ignored. Modern social science was seen as a radical movement that overthrew all tradition, rather than an additional method for gaining insight and wisdom that could be added to the existing stock of knowledge. The metaphysical notions used by traditional religions to express their insights were sufficient grounds for rejecting these insights altogether. The social costs of doing so are now all too evident. Society cannot afford to throw away such valuable 'knowledge capital'. It is hoped that Dunning's recent work marks a turning point in social-scientific thought that might ultimately lead to the recovery of much of what has been lost (see also Hahnel and Albert, 1990).

Since around the 1980s, the spread of Western commercial culture as a result of globalization can be likened, in some respects, to the diffusion of a 'public bad'. This public bad – a low-trust culture, based on selfish manipulation – gained credibility from the enormous strength of Western technology, to which it appeared to be linked. The rightful reputation that Western technology enjoyed 'softened up' consumers around the world for the low-trust culture that was used to sell the products in which the technology was embodied. But it was a stern moral commitment to basic research, and not cynical individualism, that motivated the scientists who created the powerful ideas on which the new technologies

were based. Modern capitalism works in spite of contemporary cynicism, and not because of it.

The same stern commitment is required to motivate future social science research. John Dunning's own career provides a useful model in this respect. His wide-ranging curiosity and careful attention to detail have provided a worthy legacy on which his successors can build. Unlike many other social scientists, he has never divorced his theorizing from practical insights into human nature, and has never forgotten the religious ideals with which he was brought up. The need to reconstruct social science on a more reliable basis, as a guide to better global policy-making, is a worthy calling. It is one that will, it is hoped, appeal to future generations of scholars. In the study of global capitalism, they cannot do better than follow in John Dunning's footsteps.

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# 3

## Corporations and Structural Change in the World Economy\*

### Introduction

The major agents of change in the world economy are corporations. Firms do not act in a vacuum and the context – set by the government, consumers, suppliers, the level of extant technology and the culture of the countries in which the firms operate – plays a key part in determining the outcome of the changes they initiate. Further, firms are reactive as well as proactive. They react to the context and to other firms. This chapter examines current controversies in comparative economic structure, including the nature of competitiveness, the nature of the ‘Asian miracle’, the public/private sector divide, the role of trade blocs and the notion of the competition of cultures. These issues are presented as ‘new stylized facts’ which need to be explained by successful models of multinational enterprises (MNEs) (Buckley and Casson 1976, 1985). Finally, extant models of multinationals are discussed and extended by questioning traditional notions of ownership, exchange, competition and information.

The foregoing discussion enables us to examine the stylized facts listed below as key issues in the changing global economic structure and to subject them to a process which leads from (i) overall trends to (ii) specific market changes and (iii) an analysis of the competences which firms need to meet the challenges of these changes. This will lead to (iv) changes in the optimal boundaries of firms, and finally to (v) changes in the internal organization of firms.

### Comparative economic structure

What has changed in the world economy since the 1980s? What are the new stylized facts that need to be explained by models of multinational

enterprise? A number of key stylized facts are presented here in order to confront the challenges to the theory of the multinational enterprise as we enter the twenty-first century.

The key updated stylized facts may be broken into empirical and conceptual issues: four empirical issues and four conceptual issues demand attention.

Empirical issues:

- (i) The rise (and relative recent decline) of Southeast Asian economies;
- (ii) The lack of development in the poorest countries;
- (iii) The change in the balance between private and public sectors, with the former in the ascendant; and
- (iv) The dominance of trade blocs in the world economy: the integration of markets internationally and the trend towards 'globalization'.

Conceptual issues:

- (i) The conceptualization of competitiveness (is this a phenomenon that can be described meaningfully at the aggregate (national) level?);
- (ii) The integration of culture into (economic) models;
- (iii) Welfare; and
- (iv) Ownership as a signalling process.

## **Empirical issues**

### *The rise of Southeast Asian economies*

International business theory has a tradition of responding to (incorporating) 'stylized facts'. The most profound incorporation is the response to the rise of Japan, whose distinct culture and non-Judeo-Christian tradition meant that simplistic theories of the dominance of 'the West' had to be rejected. This development led to the refutation of models of the world economy which posited 'the West' as a singular exemplar of development and the rest of the world as 'other'. A critical outgrowth of this recognition was much soul-searching that led to an outpouring of concern over 'competitiveness' – a relative term, since there was now something to be relative to! In addition, it led to the search for differences between 'successful' Western economies – bank-based versus market-based financial systems, unitary versus federal states are examples.

The rise of Southeast Asia (generally considered as a conceptual term covering Hong Kong, Taiwan, Korea and Singapore (the four little tigers or dragons) and recently including a second wave – Malaysia, Thailand,

Indonesia, to be followed by Vietnam and the huge somnolent dragon, China) has caused further intellectual frissons.

The revisionist view of Krugman (1996) is essentially that this was an accident waiting to happen. His view is that this involved a transfer of labour from the traditional (agricultural) sector to the modern (industrial) sector but that, crucially, total factor productivity in the modern sector has not improved.

For international business scholars, the rise of these new competitors raises interesting new issues concerning the international transfer of technology and changing competitive strategies. Many firms in East and Southeast Asia have achieved the transfer of technology from advanced countries without the necessity of accepting foreign direct investment (FDI). Indeed, they have found ways of circumventing the need to pay market prices for proprietary technology. One method has been to initiate best practice by hiring consultants from 'the West' to send their best human capital abroad for training. Thus a transfer of technology has been achieved without inward investment. Methods such as sending key personnel to be trained in Western universities circumvents proprietary control of technology. Emerging country competitors have found institutions which underprice technology and have created mechanisms to transfer this technology relatively costlessly, to their own emergent multinational firms. Advanced countries' established multi-nationals are now faced with a problem of non-appropriability of technology and management skills. This is a far broader issue than the classic 'foreign direct investment versus licensing' issue, and it places the knowledge transfer and appropriability issues right back at the heart of international business theorizing.

A second new competitive challenge lies in the new competitors' use of labour and the spin this gives to 'flexibility of labour' as a key competitive weapon. Typically, in the West, flexibility of labour implies deregulation of the labour market, removing minimum wage standards, reducing unionization and other barriers to labour mobility. This concept is challenged by the Asian company's use of flexible labour *within* the firm, rather than between firms. This intra-firm flexibility – moving workers around jobs within a firm rather than between firms – allows the building of loyalty to the firm and greater internalization of labour efficiencies.

### *The lack of development in the poorest countries*

The least developed countries in the world (LTDCs) are not catching up with the newly industrializing economies (NIEs) and, indeed, are slipping

both relative to the rest of the world and in many cases, absolutely. The LTDCs do not attract FDI in any quantity. FDI is very skewed, first towards advanced economies and then towards a small minority of less-developed countries, with a particular current bias to China.

The motives for FDI reveal why this is so. FDI is targeted on: (i) markets (preferably large and rapidly growing); (ii) key inputs, notably scarce natural resources; and (iii) plentiful cheap labour. Although motive (iii) would seem to favour LTDCs, it does not do so because these typically lack the key complementary inputs – a good (transport) infrastructure, political stability, good educational standards and a culture of hard work and compliance with multinational firms' standards. Countries which are resource poor, small in GDP terms and landlocked are particularly disfavoured.

### *The change in the balance between public and private sectors*

Transfer of assets from the public to the private sector has become a widespread panacea for governments seeking to increase efficiency and growth. However, this policy of privatization has only been tractable where well-established property rights exist. Frydman and Rapacynski (1993: 13) suggest that the meaning of privatization in East Europe 'has turned out to be complex and ambiguous. Instead of the clarification of property of a capitalist society, the privatization process has, so far, led to a maze of complicated economic and legal relations that may even impede a speedy transition to a system in which the rights of capital are clearly delineated and protected'. This is quoted by Williamson (1996: 324), who points out that getting property rights correct is too narrow a conception of institutional economics.

The privatization of whole swathes of previously publicly-owned assets has set in train the creation of a set of emerging multinationals in telecommunications, railways, utilities (water, electricity distribution, power generation, refuse collection and so on). Some will argue that new principles are required to explain these 'new (new) multinationals', but the analysis below shows that this is unnecessary.

### *The dominance of trade blocs in the world economy*

The success of the European Union (EU) in achieving greater European integration, the deepening and extension of the North American Free Trade Agreement (NAFTA) and the rise of free trade areas such as MERCOSUR, point towards an accelerating trend in world trade – the growth of trade blocs. These trade blocs are also investment and technology blocs, encouraging closer ties between member economies.

The concept of globalization has become devalued by the ascendancy of use over meaning. Perhaps we should return to markets to give meaning. Broadly, if we envisage three levels of markets – financial markets, markets in goods and services, and labour markets – we can envisage each of these moving at differential speeds towards global integration.

Financial markets are already very closely integrated internationally, so much so that no individual ‘national market’ can have an independent existence. Goods and services markets are integrated at the regional level, and this co-ordination is largely policy-driven through institutions such as the EU, NAFTA, ASEAN and so on. Labour markets, however, are functionally separate at the national level and here integration is largely resisted by national governments (the UK’s opt-out of the EU Social Chapter to 1997, examples from NAFTA).

The beneficiaries of this differential speed of integration are multinational firms. They can raise capital at the lowest possible cost, reap economies of scale in regional goods and services markets, and segment labour markets by choosing least-cost inputs for different spatially separate activities (Buckley, 1997).

It is somewhat ironic that issues of economic geography have not been to the fore in international business theorizing. Perhaps this is because of the difficulty of modelling in this area (Krugman, 1995) or an unfortunate by-product of the academic division of labour. However, spatial issues should not be underrated in constructing more satisfactory and comprehensive approaches to international business theory.

The key to progress is to elide from geography to the spatial division of labour. Geographical barriers (mountains, deserts, large land masses with no sea coast) represent difficulties of transportation (which vary with historical time because of technological innovations in transportation) that inhibit trade and the emergence of specialization and co-operation in effecting a division of labour. The political division of economic space into nations results in countries having an internal division of labour which differs from that prevailing externally. Primarily, this difference is mediated through trade and so the existence of an *entrepôt* becomes a crucial factor in stimulating exchange and development (Buckley and Casson, 1991).

In the modern world economy, this *entrepôt* function is provided by the MNE. In this sense, the MNE compresses space by its organization – the mountain comes to Mahomet. The internal and external divisions of labour meet at the boundary of the multinational firm. The spatial boundaries of the state are crucial in international trade, but in a world



economy dominated by MNEs, this boundary becomes much less important. The borderless world (Ohmae, 1990) results from exchange across the different divisions of labour, becoming spatially internal to every national member of the global economy. Mediation of different divisions of labour is no longer trade through an entrepôt but through the mediation of the different resulting price signals by the managers of multinational firms. This gives rise to issues such as the 'Who is us?' issue posed by Reich (1990). Is 'us' British firms wherever they are located, or all firms in Britain whoever the ultimate owners are? On this issue hangs much of modern economic policy.

Perhaps the permeable boundaries of multinational firms have relegated the importance of geography, as have technological developments in telephony which make the management of spatially diverse entities, such as the multinational firm, so much more efficient. If so, this puts much more emphasis on the co-ordination problem. The importance of the multinational firm arises from the fact that it is a system for integrating and co-ordinating intermediate product flows arising from activities concentrated at different locations. It is in this sense that the multinational firm represents a real challenge to the nation state, which attempts to co-ordinate activities within a given spatial area defined by politically and historically determined national boundaries (now completely permeable to intermediate product flows of information by telegraphic communications).

## **Conceptual issues**

### *The conceptualization of competitiveness*

Competitiveness (or 'international competitiveness') is an elusive concept which has generated controversy among commentators on international business. Obviously, competitiveness is difficult to measure, for numerous practical reasons, which make quantification problematic, including the measurement of quality, taking into account changing exchange rates, purchasing power parity deviations and differences in ends as well as means. There are two important issues in clarifying these problems: one is the essential comparative component of competitiveness, the other is the multifaceted and dynamic nature of the concept (Buckley *et al.*, 1988).

There are essentially three methods of assessing competitiveness – by reference to the past (the historical comparator); to another area of economic space (spatial comparisons); and by reference to a counterfactual position (what would have happened if some crucial event had not

occurred or some crucial decision not been taken). Competitiveness has to be measured against some other state of the world – over time, across space or against a well-defined ‘straw man’. The critics of the way that competitiveness is presented in more ‘popular’ versions (Thurow, 1992), such as Krugman (1996), object largely to the concept being applied to countries (or aggregations larger than the single firm) – ‘firms compete, not countries’. Krugman’s attack is well grounded. It points to the essentially benevolent outcome of free trade based on comparative advantage and the welfare-enhancing nature of specialization and trade – going back in the tradition of David Ricardo.

This is, however, to take a narrow view of the situation. The international business literature, here as elsewhere, scores in terms of its wider remit. Countries do, in fact, compete in that they provide public goods on which firms located so as to take advantage of this provision can draw. This might be location-specific (subsidies to R&D in their territory, for example) or might provide a base for launching an attack on the world market (education and training for managers). The difficulty for governments is to create public goods for ‘our’ firms, but to prevent leakage of these benefits to ‘their’ firms. The creation of such ‘selective’ public goods not available to outsiders is a major dilemma – as is the decision as to which firms are ‘our’ firms (Reich, 1990). The creation of the oxymoron ‘selective public goods’ emphasizes this problem and is the essence of the analytic difficulties on which Thurow and others have seized imperfectly.

Perhaps this issue is best dealt with by distinguishing between transferable and non-transferable assets. If firms located in a given territory are highly competitive in ways that do not depend on cheap labour, then they are drawing on intangible assets. Competition based on assets that are not transferable from the ‘home’ territory will predispose the firm to move towards integrating forward into distribution or backward into long-term contracts for raw materials and key inputs to maintain the home base. Examples of the latter include Japanese backward integration into raw materials and colonization in Africa. Thus these non-transferable resources in the home country lead to an export base in the home country that needs complementary resources. This leads to an ‘export platform’ type of development with integration both backwards and forwards, maintaining control of a vertically integrated global structure. Contrast this situation with firms reliant on transferable resources. Such firms can substitute FDI for exporting from the home base by the transfer of technology or expertise to a cheaper labour country, leaving the home base with a vertically disintegrated economy,

**Table 3.1** Comparative measures of competitiveness

	Firm	Nation
Historical comparisons	1. ✓	2. ✓
Spatial comparisons	3. Inter-regional and international comparisons	4. Problems of international comparability. 'Firms compete, not nations'
Counterfactual comparisons	5. Conceptually possible, but difficult	6. Possible, but very difficult at the aggregate level

subject to the vagaries of shifting, footloose FDI, and dependent upon depressing wages to attract new inward FDI and keep existing firms from exiting. Thus competitiveness of nations is an issue – and one that existing international business (IB) theory can illuminate.

These points are well taken. However, as Table 3.1 shows, there is an aggregation problem when we move to Cell 4, where it is difficult to compare nations spatially. It is possible to track the competitiveness of a nation over time (Cell 2), leading to notions of a 'loss of competitiveness' but there are myriad problems in comparing, say, Japan with Germany, at a given point of time. Similarly, the counterfactual comparison is difficult within a firm (what would have happened if you had not invested in a new plant?), but the order of magnitude increases dramatically when we examine counterfactuals for a whole nation (what would have happened if you had not increased the education budget?).

The second difficulty concerns the wide-ranging nature of competitiveness – it is clearly more than simply performance; it must contain the idea of sustainability. After all, the easiest way to gain world market share is to give your product away! Thus some measure of future potential (investment) must be incorporated. Given that there are trade-offs between performance (consumption) and potential (investment), the concept must include some element of choice of ends (objectives) and not just means. Because there has to be a balancing of ends and means, management becomes important.

Competitiveness thus requires a blend of hard data and more judgemental inputs, which makes modelling difficult.

*The integration of culture into models*

If the above section is correct, it provides a crucial insight into the current preoccupation with culture in international business. This is

because a shared culture, through its role in reducing transaction costs, can determine the relative efficiency of alternative types of organization – firm and nation are two such examples. The injunction ‘render unto Caesar what is Caesar’s’, may be opposed by ‘render unto Toyota what is Toyota’s’. In the case of cultural affiliation, the balance may have shifted, and be shifting to the firm rather than the political entity.

There can be no gainsaying the fact that culture is not amenable to simple modelling. Its holistic nature demands attention, as do the awkward attempts to ‘draw lines’ from a box with ‘culture’ written on it to a box with ‘economy’ or ‘firm’ written on it! Buckley and Casson (1991) attempted to examine ‘scientific outlook and systems thinking’ and ‘competitive individualism versus voluntary association’ as key determinants of development, and to link them to geographical aspects of a trading system. The key links here are the development of a sustainable specialization through a division of labour, and falling transaction costs through repeated interactions and shared cultural values (see also Fukuyama, 1996).

### *Welfare*

Economic models permit judgements about efficiency to be made. The efficiency calculus is generally based on maximizing consumer welfare using market-determined prices to value individual satisfaction. This measure of efficiency has become a moral imperative for economists who have stood accused of regarding individualist hedonism as the only criteria for judging human society (Buckley and Chapman, 1996). However, the core assumption of economics – that people optimize – leaves open what enters into their objective function. Since people cannot optimize meaningfully unless they can rank alternatives in order of preference, it is assumed that optimization is with respect to a well-behaved objective function. It may simply be consumption goods; alternatively, it may not be selfish materialistic wants. The utility function can represent altruistic feelings and emotional needs (Buckley and Casson, 1993).

Another feature of the welfare function is that it is usually specified where everything in it is controlled by the individual concerned. There is no interdependence, such that one person cares about something that another person decides: there are no vicarious components. Selfishness is thus a convenient assumption for economic modellers, because it is feared that the additional complications of altruism would undermine the theory’s predictive power. However, the inclusion of preference interdependence is often a straightforward means of modelling issues

such as morale and motivation (Buckley and Casson, 1993). This has strong links to informational issues in welfare (Casson, 1997; Buckley and Carter, 1996).

### *Ownership as a signalling process*

In models of multinational enterprises, ownership has been conceived largely as a management governance mechanism. Where transactions cost configurations so dictate, hierarchy (ownership) will be preferred to market transacting. The transfer of ownership to foreign countries creates multinationals.

Ownership may be conceived of in an entirely different, but complementary, fashion. The ownership of an enterprise may be seen as a signalling mechanism, drawing on characteristics associated with the parent firm, and often therefore on characteristics associated with the country of origin of the parent firm. Thus, when the Rover car company of the UK was taken over by BMW of Germany, Rover took on the characteristics of style, efficiency and engineering quality of its new parent by osmosis. Similarly, the establishment of a greenfield plant by Toyota conveys to the new (potential) workers, investors and consumers the kudos of quality and reliability of product, and the view that it will be managed in a Japanese style (concerned, democratic, and using modern techniques of personnel management). To some extent, these are myths. Ownership signals, like any other asset, though, require investment. It is incumbent upon MNEs to instil precisely those qualities which ownership signals presage.

In this respect, ownership is akin to branding, patenting and image making. It confers a premium upon paper issued by a firm that possesses it – thus a higher price will be paid for the same income stream issuing from Rover when it is owned by BMW. This is a microeconomic version of Aliber's multiple currency theory of FDI (Aliber, 1970, 1971). In this crude version, it relies on investor myopia, because, of course, rational investors would see that the firm retains the same income stream. Some degree of consistent improvement of performance, and more importantly the expectation of this continuing into the future, must underpin this belief for it to be a sustainable hypothesis.

We can take this further by relating the reputation for maintaining and increasing value to the issue of who takes over whom. A reputation of this kind creates 'blue chip' status for a company which can be leveraged to ensure that the financial markets back firms with such a reputation against those without one. We can build this into a theory of acquisition and account for the stylized fact of the growing importance

of mergers and acquisitions as a means of foreign market entry and development by examining the nuances of 'the way assets are managed' as a reputation capable of being leveraged. Such a reputation reflects the broad-based perception of a firm's management. This is subtly different from the value of goodwill, physical assets, brands and patents, because we are now putting value on the managerial system for extracting values from given assets. The quality of the system of internal co-ordination and entrepreneurship is more difficult to value than the assets enumerated above.

## **Models of Multinational Enterprises**

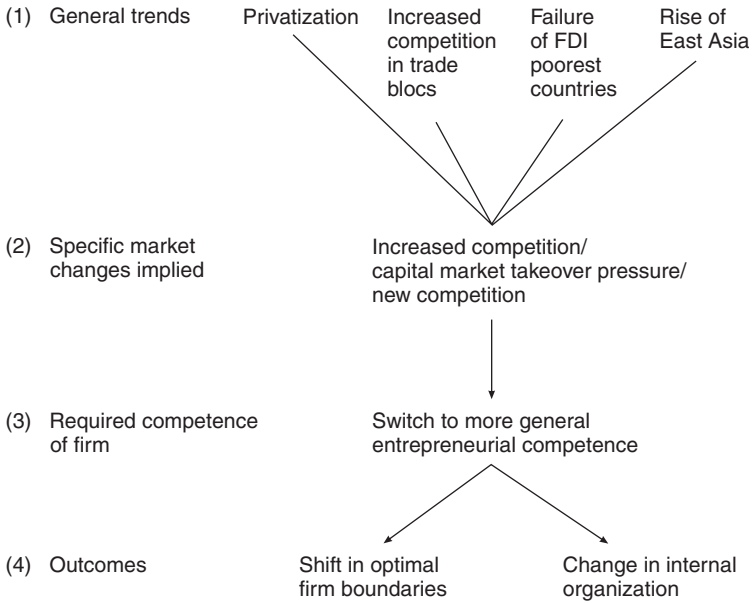
### **The modelling process**

As signalled above, this chapter illustrates the process by which we can move from the analysis of general trends to specific propositions (see also Buckley, 1988).

Several major trends were identified in the section on comparative economic structure above. These trends (the rise of East Asia, lack of development in the poorest economies, privatization, and trade blocs) have induced specific market changes. These changes include: new competitors in mass production and high technology sectors from countries such as Korea and Malaysia; the failure of import-substituting investments, for example in Africa; new competitors and competitive structures in newly privatized industries; and, combined with the driving down of transport costs (through containerization and so on) the result is the possibility of new competitive strategies such as just-in-time production internationally.

The specific market changes require new competences from companies facing these challenges. In general, the competences required are of the more general entrepreneurial type than the previous generation of technological skills required for efficient mass market production. In final product markets, more competition is experienced. In intermediate product markets, the transport cost revolution makes dispersed activities more feasible, and in labour markets the adoption of policies of deregulation means that more aggressive management policies can introduce increasing flexibility to labour management. In capital markets, the mushrooming of stock markets means that the increasing threat of hostile acquisition puts more pressure on company managements to perform above the norm.

These specific market changes affect the boundaries of the firm and have an impact on the internal organization of the firm.



**Figure 3.1** Modelling trends in the international economy

Figure 3.1 shows that the *principles* of the analysis are timeless, but that the context differs and so does the empirical outcome of the given trends. The process can be traced through a variety of potential scenarios, given well-established stylized facts. New theories are not required, but the intelligent application of well-established models and frameworks are necessary.

**The choice of contractual arrangements**

The forces outlined in Figure 3.1 can be expected to have a major impact on the current and future institutional arrangements in the international economy. This chapter suggests that international business theory leads to several predictions of changes in the global economy. These will include a greater share of international business activity being focused on mergers and acquisitions; increasing volatility of foreign direct investment based on cheap labour seeking; differential success of firms, and firms of given nationality; creating value from a reputation for managing assets; leveraging of generalized skills to create powerful globally integrated groups; and competition of national territories to create non-transferable asset bases.

This will lead to the configuration of the world economy as depicted in Figures 3.2 and 3.3. Quadrant 1 of Figure 3.2 represents the situation where the country of location is competing on labour costs (or labour flexibility in the external market sense), interacting with firms which have asset skills (physical assets, patents, brands). This leads to a vertically disintegrated structure with a volatile 'home' economy where the firms' transferable skills can combine with cheap labour at home or elsewhere. Quadrant 2, similarly, has a country of location competing on low-cost labour but this time interacting with firms which have appropriable generalized management skills. This leads to a mix of outward FDI seeking locationally fixed public assets, together with a fluctuating flow of cost-seeking inward investment. Quadrant 3, which combines locationally fixed public goods with firms with asset skills, will represent prime targets for inward takeovers of indigenous firms. Quadrant 4 represents the powerful home base of a vertically integrated structure, both forwards and backwards.

*Asset ownership by firms*

		Conventional assets	Appropriable skills
<i>Country of location</i>	Labour costs	1. Vertical disintegration volatile home economy	2. Mixed outward FDI and inward labour cost-seeking FDI
<i>Competitive base</i>	Public assets	3. Inward investment – home firms as take-over targets	4. International vertically integrated structure with powerful home base

**Figure 3.2** Interactions between country of location and the ownership of assets by firms

*Asset ownership*

		Conventional assets	Appropriable skills
<i>Country of location</i>	Labour costs	Less developed countries of Africa, Asia and Latin America in low-tech industries	UK industry 'old European industries'
<i>Competitive base</i>	Public assets	British car industry	Japanese export platform and <i>keiretsu</i> companies

**Figure 3.3** Examples of interaction between country of location and the ownership of assets by firms



Figure 3.4 examines the implications of the changes identified by plotting their effect on the change of contractual arrangements made by multinational firms. East Asian and other ‘new’ multinationals favour non-contractual means of acquiring assets and knowledge, and have a penchant for joint ventures with foreign-owned multinationals. In their outward involvements, they favour greenfield ventures, often on a wholly-owned basis, but also using joint ventures. They are insufficiently integrated, so far, into the world capital market and are culturally unfamiliar with take-overs, so that the acquisition mode favoured by Western multinationals does not appeal to them. The newly privatized companies have had recourse to inward licensing and joint ventures in order to acquire skills and technology previously unavailable to them (or of which they previously had little need, such as generalized marketing skills). They have also come under the acquisition spotlight, as foreign predators see them as ripe targets because of their undervalued assets and unreleased potential. In their outward activities, they have favoured licensing and joint ventures to access capabilities they do not possess, but some have sought complementary packaged assets by acquisition.

Finally, the development of trade blocs has facilitated and been facilitated by joint ventures and acquisitions between multinational firms.

Thus we can observe a different emerging configuration of modes of doing international business (compare Buckley, 1981). Non-contractual modes are increasing in importance as (covert) means of technology

	Rise of new economies		Privatization		Trade blocs
	Inward	Outward	Inward	Outward	
<i>Non-contractual modes</i>					
Imitation	✓				
Educational transfers	✓				
Piracy/counterfeiting	✓				
<i>Contractual modes</i>					
‘Licensing’			✓	✓	
<i>Control modes – FDI</i>					
Joint ventures	✓	✓	✓	✓	✓
Greenfield ventures		✓			
Acquisition			✓	✓	✓

**Figure 3.4** The changing configuration of modes of international business activity

transfer, but in areas where higher levels of competitiveness and market development exist, joint ventures and acquisitions are in the ascendant because these are key means of acquiring capabilities.

### **Implications for the organizational structure of multinational firms**

The pressures analysed in this chapter will have a profound impact on the organizational structure of multinational firms. They are presented with two key imperatives – to create appropriable assets, especially those based on generalized management skills (and, by analogy, to prevent leakage of returns from assets where appropriability is difficult) and to derive rent by internalizing locationally specific public goods. These imperatives require radical restructuring and will alter the scope of such firms.

Leakages in appropriability can be stemmed in two ways: by moving into assets which do not leak, and by stopping leakages in conventional assets (Buckley, 1983). As Figure 3.4 showed, non-appropriability is a key issue in 'non-contractual transfers'. Largely, because of institutional difficulties, multinationals have hitherto found it difficult to control these transfers – they are mainly occurring under the auspices of governments, universities and other non-commercial entities, and through grey and black markets. Our analysis leads us to expect that multinational firms will seek increasingly to control these areas. This will involve political action to internalize some governmental activities (or at least quasi-internalize them by representation in government and on the governing bodies of non-commercial organizations) to seek to extend patent rights, licensing arrangements, copyright, branding design and technological protection, and to clamp down on piracy and counterfeiting.

Our analysis further suggests that acquisition, in particular, and joint ventures will become more important as FDI modes. Acquisition results from companies capitalizing their general entrepreneurial skills – backing their valuation of what these skills can achieve with post-takeover assets against the market valuation of this value. This will lead to a new breed of financier, whose key skills will be to value generalized entrepreneurial and management skills residing in a firm's system of control. Company valuation will become even more of an art, and even more well rewarded for those at the successful apex of activity. One key part of these skills will be cultural sensitivity, because foreign acquisitions require this quality in abundance in order to release the value promised to the financiers in the post-acquisition integration phase.

## Conclusion

This chapter has examined the process of modelling multinational enterprises. It has sought to show that the significant stylized facts of the global economy at the start of the twenty-first century can be explained satisfactorily by a combination of timeless principles together with a careful and judicious selection of special assumptions suited to the local and temporal situation that is to be explained.

The five-stage process outlined in Figure 3.1 enables analysts to make progress while working to a common paradigm. Specific models with different specialist assumptions can be developed, and these can compete to explain and predict changes in the global economy as they are confronted with empirical evidence. So, working from general trends to the specific market changes implied by these changes, to the required competences of the firm and the implied impact on the firm's optimal boundaries and changes in internal organization, a clear modelling procedure can be followed. Given the rapid rate of change in the world economy, it is likely that adaptations of models will be needed frequently. We should beware of jettisoning key principles while this is occurring.

## Note

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# 4

## Alternatives to Decline, Threat or Scarcity: Exit, Voice, Loyalty and Institutional Response\*

This chapter examines alternative strategies facing firms subject to decline, threat or scarcity. Four alternative strategies are suggested: exit, voice, loyalty and institutional reorganization. These strategies apply both to internal activities (within the firm) and to external relationships, most particularly with suppliers and customers.

The next section presents the perspective and background to the analysis. This is followed by an overview of the alternative strategies, and then by an analysis of each strategy in turn.

This chapter is unusual in that it examines exit, voice, loyalty and reorganization as *active* strategies of the company, not simply as responses to external pressure.

### **The analytical perspective**

The key concepts of the analysis derive from Albert Hirschman's path-breaking work *Exit, Voice and Loyalty* (1970), in which the three key concepts were introduced as responses to decline in firms, organizations and states. This chapter attempts to tie in these concepts to notions of organizational change. It also examines both the internal and external implementation and ramifications of the key management strategies.

The critical innovation made by Hirschman was to focus attention on *repairable* lapses of economic actors. Economists had hitherto paid little attention to this because of the key assumption of 'fully and undeviatingly rational behaviour or, at the very least an *unchanging level* of rationality on the part of the economic actors' (1970: 1). But, as well as changes in demand and supply conditions, there could also be some 'loss of maximising aptitude or energy' within the firm. The question is, how can

such a loss be repaired? In addition, given the assumption of a competitive economy, recovery from any lapse is not essential – a new firm or other existing firm will take up the slack. Resources are reallocated in accordance with the new conditions, and equilibrium is restored. Competition and the exit mechanism is thus one major mechanism of recuperation.

However, there is another key mechanism. Effective ‘voice’ means that management searches for possible cures for dissatisfaction. The firm’s customers, suppliers or workers express this dissatisfaction through voice, and management can engage in negotiations leading to remedial action.

The presence of loyalty makes exit less likely to the extent that (i) customers, members or suppliers are willing to trade off the certainty of exit against the uncertainties of an improvement in the deterioration of product, service or conditions; and (ii) the estimate that customers, members or suppliers have of their ability to influence the organization. Hirschman notes, ‘in the choice between voice and exit, voice will often lose out, not necessarily because it would be less effective than exit, but because its effectiveness depends on the *discovery* of *new* ways of exerting influence and pressure towards recovery. However ‘easy’ such a discovery may look in retrospect the chances for it are likely to be heavily discounted in *ex ante* estimates, for creativity always comes as a surprise. Loyalty then helps to redress the balance by raising the cost of exit. Loyalty or specific institutional barriers to exit are therefore particularly functional whenever the effective use of voice requires a great deal of social inventiveness while exit is an available, yet not wholly effective, option’ (1970: 80). Loyalty thus raises the cost of exit. Its usefulness depends on the closeness of the available substitute. If the gap between two firms (price and quality) is huge, there is a great deal of scope for the use of voice in the course of the progressive deterioration of one of them before exit occurs. Thus, there is not much need for loyalty. However, the closer the substitution possibilities between two firms are, a small deterioration in one of them will result in exit (of customers and members). Therefore ‘loyalty is at its most functional when it looks most irrational, when loyalty means strong attachment to an organisation that does not seem to warrant such attachment because it is so much like another one that is also available’ (Hirschman, 1970: 81).

The interactions between exit, voice and loyalty thus require careful consideration. The reorganization of companies, particularly their formal control systems, might be regarded as a fourth response to decline, threat or scarcity. It also contains elements of the other three strategies. The key issue, which this fourth dimension adds, is the *connectedness* of activities. Given interdependencies between different areas of the firm,

voice might prevail over exit not only because of loyalty, but because activities are intimately connected. On the other hand, if the exit options is overwhelming, then connectedness may bring other activities down with it.

**The model**

The model used to analyse the strategies open to firms is in two stages. In the first stage, an archetypal external relationship with a key customer is analysed. In the second stage, internal relationships are examined.

**The firm and its customer**

We begin with a stable state scenario. ‘Our’ firm is supplying a large key customer which may be incorporating our output into its production, or it may be a key service user (perhaps it is a government body).

Then, a shock occurs. This may be because our management gets the quality wrong and underperforms in its delivery of the required quality of output. Alternatively, the customer retools, incorporates new technology or simply no longer requires our inputs into its improved processes.

The question now is: what strategies will the customer adopt towards our firm? The above analysis suggests three choices: exit, voice, loyalty – see Table 4.1 (see also Helper, 1995). Exit is straightforward – the customer simply shifts its purchases to a competitor of ours. Voice is defined, following Hirschman (1970: 30) as ‘any attempt at all to change, rather than to escape from, an objectionable state of affairs, whether through individual or collective petition to the management directly in charge, through appeal to a higher authority with the intention of forcing

**Table 4.1** The firm and its customer

<b>Customer’s strategy</b>	<b>Result</b>	<b>Our firm’s response</b>
Exit	Our firm loses order	
Voice	Our firm has the opportunity to respond	Implement quality improvement strategies. Reorganize
Loyalty	Customer sticks with us (for a time)	More time for us to implement changes. Extreme loyalty – customer may accept some of the costs of the change

a change in management, or through various types of actions or protests, including those that are meant to mobilise public opinion'. This is the political dimension of action.

*Exit*

Exit requires the closure of facilities. This may be a minor part of the firm under threat, or may involve the whole firm. Generally speaking, this will usually result in laying off members of the firm – although it may be possible in multi-product firms to transfer them to divisions of the firm not facing similar pressures (this strategy was the preferred scenario in large Japanese firms). The exit option can also be exercised by members of the firm – switching to other employers, or even leaving the employment market altogether. In the case of key workers in scarce supply this may have extremely deleterious effects on the company and may ultimately threaten its existence. The responses of members of the firm under the three strategies open to them are shown in Table 4.2.

Exit will have an impact on suppliers and customers. For suppliers, two exit cases can be envisaged – ‘involuntary exit’, where the principal switches suppliers, moves to in-house production by internalizing the intermediate market or substitutes an alternative input, often as the result of technological change. Voluntary exit will be contrasted with the use of voice later.

For customers, exit means that supply is ended. They have to move to the closest available substitute. Closure of one product offering in multiproduct companies can have a negative knock-on effect, through loss of goodwill, on other product lines. Customers may be wary of purchasing from a company that has a reputation for interrupting, or ending, supply.

**Table 4.2** The firm and its employees

<b>Employee's strategy</b>	<b>Result</b>	<b>Our firm's response</b>
Exit	Loss of key employees	
Voice	Express dissatisfaction with firm Attempt or demand negotiation	Search for cures for dissatisfaction – internal negotiation (redistribution of rewards)
Loyalty	Employee toleration (for a time)	Work to keep employees – ‘fair dealing’, trust



### *Voice*

The exercise of voice by the customer gives our management the opportunity to improve – to implement quality improving strategies and/or to reorganize. It may be, however, that our customer will go even further than the voice option in giving us an opportunity to put our house in order. They may give us time to put things straight. In an extreme form of loyalty they may even accept some of the costs of the quality improvement of our production. Thus loyalty could involve a voluntary shifting of the costs onto the customer. This loyalty will have been earned by our past relationship and good performance.

The customer's response may well be conditioned by the type of contract between the firms. In the simple case ((which is fairly rare) Buckley and Chapman, 1997)) of arm's-length contracting, then exit, severance of the purchasing relationship, will be the only option. Exit of a major customer may require the closure of facilities. It may result in the ending of a product line in a multiproduct facility. Closure of one product offering in a multiproduct company can have a negative knock-on effect, through the loss of goodwill, on other product lines. Customers may be wary of purchasing from a company which has a reputation for ending the supply of one of its products.

The voice option allows our management the time to sort itself out, in contrast to exit, where it is already too late. In connection with a supply contract, voice involves a response to an offer to renegotiate or re-contract. Sato (1993) called this relationship 'obligational contracting', as opposed to arm's-length contracting. Indeed, it is alleged that Japanese superiority in supply chain management is the result of a greater use of obligational contracting than in Western (European and American) dealings with suppliers. Practically, voice provides an opportunity for management to put things right, although the sanction of exit remains.

Management can only indulge itself if, in the past, it has created loyalty. With loyalty, customers will (temporarily) allow lapses from agreed levels of performance. The role of loyalty is to hold exit at bay and to activate voice. There is, however, often a price to be paid for excessive (or misplaced) loyalty, in that below-average firms can be retained when they should exit.

### **The firm and its members**

The second stage of the analysis examines the internal aspects of an external shock. A company can only provide a good service and retain

good customers if it has good employees. If this is the case, and then an external shock, such as the loss (or threat of a loss) of a large external contract occurs, the company is faced with a similar strategy threat by its employees. Key workers and subcontractors can be particularly influential in affecting the company's prospects.

However, if workers choose voice rather than exit, then the company can begin to search for cures to the dissatisfaction. Internal negotiations can take place, rewards can be redistributed – perhaps in return for new working practices, and workplace relations can be reorganized. The voice option requires the managers of the firm (or the owners in negotiation with the managers) to listen and to take remedial action. Voice has implications for management style. Consultation, negotiation and attention to the needs of members of the firm are essential if the voice option is to be effective, and is to be seen to be effective. The exit of key workers and managers may threaten the company's competitiveness seriously. The cost of exit of scarce workers may be prohibitive, hence the importance of voice. In situations of scarcity of key groups of workers (international managers, research scientists, for example), bargaining and responding to 'voice' may be a constant process for the firm, until its costs exceed the exit option.

It should be noted at this point that, while the 'voice' strategies presented here have a good feel to them, they could proceed in parallel with policies of raising switching costs. Thus the firm can reduce the exit option by tying employees in with pension schemes, bonuses and team building. Similarly, suppliers can be tied in by being required to invest in specific assets, technology and skills which are largely non-transferable to other principals. This can be reinforced by tied loans, cross-shareholdings and management control, so that switching becomes near impossible by the supplier. Customers too can face increased switching costs where branding is used, where product compatibility requires using the whole of one company's product line, and where tied retail and distribution outlets restrict choice.

The role of loyalty is to hold exit at bay and activate voice. Policies to foster loyalty include involving employees in decision-making, 'fair dealing' and fostering trust and a reputation for trustworthiness. Similar attributes are necessary to keep suppliers, and 'customer care' programmes are an attempt to retain customers. There is a premium on retaining employees: 'Loyal workers build long-term relationship with their customers. Loyal customers, in turn, enable businesses to keep their employees, partly by paying above the market average' (*Economist*, 1996). Training costs and the loss of the tacit knowledge of employees

are two key reasons for retaining staff. New staff also impose heavy search and recruitment costs. There is, however, often a price to be paid for excessive (or misplaced) loyalty, in that below-average firm members and suppliers can be retained when they should exit (or be exited).

We can thus construct a two-stage analysis using exit, voice and loyalty as responses to decline (a) from the point of view of a firm in response to a threat (here from withdrawal of a key customer); and (b) from the point of view of an employee within a firm where that firm faces decline.

## **Reorganization**

### **On reorganization**

We trained hard, but it seemed that every time we were beginning to form up into teams we would be reorganized. I was to learn later in life that we tend to meet any new situation by reorganizing, and a wonderful method it can be for creating the illusion of progress, while producing confusion, inefficiency and demoralization.

Petronius Arbiter

In observing modern business practice, it is difficult not to notice the response of reorganization to threat and decline. Successive waves of reorganization have involved divisionalization, the use of matrix structures and strategic business units, and business process redesign (Buckley and Casson, 1992). Changes in formal control mechanisms are seen as a key response to external challenges by many companies. Many of these strategies are complex and involve a mix of exit and voice. They all risk damaging the loyalty of members, suppliers and customers through potential disruption. However, they recognize that the firm needs to pay attention to the complementarity of activities. Perhaps the best example of attention to complementarities in business is business process redesign (formerly business process re-engineering). The crucial observation underlying this programme is that complementary activities in companies are frequently separated by organizational barriers arising from the firm's administrative heritage.

One of the critical organizational barriers in multinational firms is the divide between national subsidiaries. This barrier is both organizational and cultural, and the two issues (organizational structure and cultural distance) often reinforce the problems of the firm. Many firms are currently tackling this issue as a matter of prime importance, and

the building of effective cross national teams is seen as a crucial issue in achieving international competitiveness (Buckley and Carter, 1998). Partly, this is a question of combining the complementary knowledge within the firm in an optimal fashion, and partly it is a question of a constant search for an organizational form that best matches external threats and opportunities (Buckley and Carter, 1996, 1997).

## Conclusion

Exit, voice, loyalty and institutional reorganization can be analysed as alternative active strategies facing firms. This framework applies to both the firm's external relationships (with suppliers and customers, for example) and to management's relationship with employees. This chapter has presented simple models of strategies using Hirshman's framework. It is clearly capable of future development. In particular, the approach is capable of linking models of knowledge management with analyses of entrepreneurship and innovation.

## Note

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# 5

## Egypt at a Crossroads: MNEs and Economic Development in a Global Environment

*with Stephen Young*

### Introduction

A study of Egypt is appropriately included in this volume because it is genuinely at a crossroads, facing the same dilemmas as many of the transition economies around the world. Egypt is positioned at a strategic crossroads within the North African, Middle East and West Asian regions and has substantial opportunities to influence and to exploit the regional economic potential of the area. At the same time, the country is at a critical crossroads in its own economic strategy: thus it is seeking to switch from inward-oriented economic development to an outward-looking, export-oriented policy, in which multinational enterprises (MNEs) will inevitably have a focal role. But this is against the backdrop of fears of social and political unrest stemming from job losses associated with market reforms and privatization; and a lack of understanding of the potential benefits of foreign direct investment (FDI) and, indeed, fears of MNE domination. The aim of this chapter is to highlight the roles that FDI and MNEs currently play in the Egyptian economy, and to discuss some ideas for policy reform that would *inter alia* create greater integration between Egypt, MNEs and the global and regional economies. (This chapter draws substantially on UNCTAD (1998)).

In 1914, Egypt was a totally open economy, with trade, finance and industry overwhelmingly concentrated in foreign – mainly French, British and Belgian – hands. In 1956, however, the open door closed, and in

the following years all joint stock companies were nationalized and state control was extended throughout the economy. With the ending of the Nasser regime in 1970, a more liberal system of trade, investment and pricing was reintroduced, and many restrictive legislative rules were abandoned. State ownership is still overwhelming, nevertheless, and the legacy of state intervention in terms of institutional rigidity, centralization and public-sector domination has remained.

Following the adoption of Sadat's open-door policies, Egypt achieved rapid economic growth in the period up to 1985, aided by significant increases in foreign assistance, workers' remittances, and FDI. This period of growth ended in 1986, partly as a consequence of the decline in oil prices, and partly because of the maintenance of an inward-oriented growth strategy. Severe macroeconomic imbalances developed subsequently, causing unemployment and increased poverty. After this period of stagnation, the immediate goal set by the new government in 1991 was to achieve rapid private-sector-led outward-oriented economic growth. It introduced and implemented successfully the Economic Reform and Structural Adjustment Programme (ERSAP I) with the support of the International Monetary Fund IMF and the World Bank. A further programme of structural reforms (ERSAP II) designed to reduce the public-sector concentration of the Egyptian economy and to foster growth was introduced in 1996.

Policy objectives identified by these reform programmes were as follows:

- *Maintain a stable macroeconomic environment and increase the rate of economic growth.* Improved macroeconomic stability has been achieved by ensuring fiscal and monetary discipline and by strengthening monetary policy tools. However, GDP per capita remains low because of population growth, and the government of Egypt has set a target of over 7 per cent GDP growth by the year 2000. This objective is believed to be attainable, despite the risks associated with it, but structural reforms are essential.
- *Open the economy.* The government has recognized the need to remove obstacles to trade, promote exports, and develop new export markets to invigorate the outward-oriented growth strategy. However, the process of trade liberalization needs to be deepened and accelerated. Necessary reforms include actions to improve trade transportation, to simplify customs procedures, and to improve national quality control systems and standards. Actions to forge buyer-seller links and to foster an export mentality are also important.

- *Privatize and enhance competitiveness.* Privatization has been identified as one of the main elements of the economic reform programme. At the macro level, privatization provides substantially increased government resources and reduces the government's financing requirements. At the micro level, it improves the performance of enterprises, both directly and indirectly. Privatization also improves the business climate by sending a signal of confidence to both domestic and foreign investors.
- *Create a business friendly environment* through establishing a comprehensive and transparent set of business regulations, including the judicial, legislative and regulatory environment for investment.
- *Develop capital markets.* The government has identified the need to increase competition in the financial sector, and to strengthen financial market institutions and the Capital Market Authority.
- *Enhance government support for the market economy,* where needs have been identified in a wide range of areas, including improvement and development of infrastructure; human resource development; and improvements in the legal system, the commercial judicial system, and tax administration.

This list represents a formidable range of challenges for Egyptian policy-makers, and progress to date has been mixed. At the macro level, Egypt's performance has been impressive, whereas the extent of privatization has been limited (recognizing that it only began in 1996) and bureaucratic obstacles remain strong. Included within the list of policy objectives is the attraction of FDI, which is viewed as important in increasing the level of private capital inflows in total domestic capital formation; in providing technology and improving management and marketing techniques; and in increasing and diversifying manufacturing exports.

### **Egypt's foreign direct investment position**

With a population of 60 million, stable macro economic conditions and a wide industrial base, Egypt has considerable potential as a location for FDI. Yet during the 1990s when the developing world as a whole was attracting much higher inflows, FDI into Egypt lacked a significant upward momentum (see Table 5.1).

Historically, the bulk of FDI has been in extractive industries, particularly energy, with relatively few instances of downstream processing. Data for 1996/7 on approved projects show a shift to manufacturing

**Table 5.1** World foreign direct investment inflows in Egypt and other developing economies, 1990–6 (billions of dollars)

Rank/Country	Average 1990–6	1996
More than 10 billion:		
1 China	22.6	42.3
More than 5 billion:		
2 Brazil	3.2	9.5
3 Singapore	5.6	9.4
4 Indonesia	2.9	7.9
5 Mexico	5.9	7.5
6 Malaysia	4.3	5.3
More than 3 billion:		
7 Argentina	2.3	4.2
8 Peru	1.3	3.5
9 Chile	1.3	3.1
10 Colombia	1.4	3.0
More than 1 billion:		
11 India	1.0	2.6
12 Hong Kong	1.8	2.5
13 Thailand	1.8	2.5
14 Korea, Republic of	1.2	2.3
15 Vietnam	0.8	2.1
17 Nigeria	1.2	1.7
18 Philippines	1.0	1.4
19 Taiwan, Province of China	1.2	1.4
20 Venezuela	0.9	1.3
More than 0.5 billion:		
21 Egypt	0.6	0.7
22 Pakistan	0.4	0.6
Total developing countries	73.4	128.7

Source: UNCTAD, 1998.

which represented 45 per cent of total value, although much of this is likely to represent assembly or packaging for the domestic market; tourism 27 per cent; services, including petroleum 18 per cent; and finance 8 per cent.

The USA has the largest share of FDI stock in Egypt, with the UK, Germany and Italy having significant, albeit much smaller, shares. Middle Eastern investors are very prominent, especially in construction.



Most FDI has taken the form of joint ventures, the level of foreign equity participation in all projects approved up to 1997 being about 30 per cent.

Recent statistics suggest that both domestic and foreign investors have responded very positively to improvements in economic performance and in the business climate, with investment projects approved for 1995/6 and 1996/7 being larger in number than total approvals for the previous two decades. The investment potential, therefore, appears very favourable.

As indicated above, much FDI is domestic-market-oriented, reflecting the legacy of import substitution strategies at country level. Because of this, Egypt's exports reveal a dependence on agricultural commodities, minerals and metals, with a relatively low representation of manufactured exports. Among FDI sectors, only the chemical industry is a significant exporter.

The patterns and performance of FDI in Egypt thus reflect history, economic strategy and, until recently, relatively low business attractiveness. In the context of this volume, Egypt has been a bystander on the world stage, as globalization pressures have led to increasing integration of both companies and countries elsewhere in the world.

## **Analysing Egypt's attractiveness for FDI**

### **Conceptual framework**

A starting point for assessing Egypt's attractiveness for FDI is an analysis of the strategies of MNEs. On the basis of a comparison of Egypt's attributes with the determinants of FDI, it could be possible to find appropriate niches that Egypt might exploit. Only a limited amount of conceptual work has been undertaken to identify the links between MNEs' strategies and export-oriented development in host nations. Following Casson (1986), who draws on Vernon (1966, 1979) and Wells (1983), five separate structures of industry, trade and FDI can usefully be identified: namely, new product manufacturing industry; maturing product manufacturing industry; rationalized product manufacturing industry; resource-based industry; and trading services industry.

It is unlikely at this stage that Egypt can find a niche in new product manufacturing industries (Type 1) where production and consumption takes place in the advanced, high income economies. Trade and the world market is confined to developed countries, and is supplied by exports from the innovating source country.

In maturing product manufacturing industries (Type 2), production costs fall and the mass market increases. Technology is more easily

codified and can be transferred internationally to foreign affiliates. Import-substituting production begins in other countries, and exports of finished products from the source country declines. However, MNEs begin the outward FDI process and export specialized capital equipment to foreign affiliates which may be complemented by exports of key components. Markets may be serviced from foreign affiliates which are closer to these markets than is the parent country, and so 'regional product mandates' may be conferred on particular subsidiaries. There may be possibilities for Egypt to develop a niche in these industries, but the crucial issue is that of moving beyond import substitution into exporting.

Within rationalized product industries (Type 3), MNEs exploit the economies available from redesigning the product for assembly from standardized and versatile components. These components are designed to be transported at low cost. The location of production of each component is specialized, in order to exploit both increasing returns and differences in comparative advantage between locations. Individual affiliates may be mandated to product particular 'components', with MNE divisions in less developed countries producing labour-intensive components and undertaking assembly (and possibly distribution activities). There would appear to be significant opportunities for Egypt in rationalized product industries: outward processing activities in textiles are a primary example; other industries include jewellery manufacture.

In resource-based industries (Type 4), the major source countries for raw materials produce output which moves through a vertical sequence of extraction, purification, refining or processing, and then fabrication or compounding. At some stage, this intermediate product is exported. Tourism, whose primary activity is fixed locationally, can be analysed as a resource-based industry.

Finally, trade in services (Type 5 industries) is a growing part of the global economy, and Egypt has opportunities here. Suez Canal fees provide service income, and financial services is one area of services among many that are capable of MNE involvement to a far greater extent than currently achieved levels.

In seeking niches in export-oriented industries, one consequence is much greater competition from other potential locations around the Mediterranean. For domestic-market-oriented FDI, internal market size and growth is the major investment determinant (Guisinger, 1985).

### **Opportunities and illustrations**

Table 5.2 translates the discussion above into specific opportunities for attracting FDI to Egypt. The evidence available (see Box 5.1 on Glaxo

Egypt) suggests that MNEs in Type 2 industries will only evolve into exporting over time. An interview with the Swiss MNE Nestlé confirmed this view, commenting that MNEs 'should not set up a manufacturing operation with an export orientation initially because it is too risky'. Opportunities also seem to exist for labour-intensive, export-oriented FDI (Type 3 industries), associated with low labour costs and Free Zone incentives. In Egypt, most Free Zone investment to date has been in the textile sector, with only a limited presence in electronics (semiconductor assembly); the latter is particularly important because it represents an access point into the fastest growing industry in the world.

The framework presented above perhaps pays insufficient attention to the role that Egyptian partners may have in FDI attraction, and the

**Table 5.2** Opportunities for FDI in Egypt

<b>Domestic market-oriented manufacturing FDI</b>	<b>Labour-intensive export-oriented FDI</b>	<b>Resource-based and services FDI</b>	<b>Partnerships</b>
<b>Key FDI determinants</b>			
Domestic market size and growth	International market size and growth	Domestic market size and growth	Resources and know-how of domestic enterprises
Import barriers	Access to regional and global markets	Access to regional markets	Domestic market size and growth
Consumer preferences	Labour and other costs	Natural and human resources	Foreign enterprises' international networks
Incentives	Export transaction costs	Physical infrastructure	
	Free Zone incentives		
Examples: Pharmaceuticals, food, automobiles, consumer electronics	Examples: Clothing, leather, PCB assembly, construction materials	Examples: Hotels, tour operators, software development, financial services	Examples: Metals, software development, food and confectionery, pharmaceuticals

**Box 5.1 Glaxo Egypt S.A.E.**

The British pharmaceutical MNE Glaxo Wellcome exported to Egypt via agents from 1928 until the industry was nationalized in the 1950s. The US MNE Squibb re-entered the market in 1980 with President Sadat's Open Door policy, but it was not until 1990 that Glaxo acquired a minority shareholding in a local pharmaceutical company; the Glaxo equity stake has subsequently been increased to 90 per cent through capital investment, and is valued at £140 million. The significant investment in Egypt reflects the Glaxo view that entry into an emerging market is a long-term commitment and needs substantial support to overcome problems of infrastructure, distribution and suppliers.

Glaxo's early years in Egypt involved substantial restructuring as well as investment. The employment in the company at entry was 741, but the public-sector, 'jobs for life' culture proved highly problematic. Thus, although employment has subsequently been increased to 1,000, 380 workers have been made redundant and 700 hired. A large-scale programme was instituted, to retrain and reorient existing workers, and enable them to assimilate the technology, with a major shift of emphasis from assembly to other operations. Both manufacturing facilities and the distribution system have been totally rebuilt.

Development of the Glaxo Egypt operation has had three major components. First, efforts to achieve a total quality management system. Second, the company established a development laboratory in 1995 with the principal objective of developing products off-patent. Four people are involved in development and forty in quality assurance and control. Third, the company has taken its first steps into exporting and is the first pharmaceutical MNE in Egypt to market outside the country. Approval has been given to supply Qatar, Yemen and Nigeria. There are hopes that Glaxo Egypt will be granted the regional mandate to become one of two supply sources for Glaxo Wellcome for the Middle East and African market. However, while Egypt is the largest supply source in the region, the company also has facilities in South Africa, Kenya and Saudi Arabia. No decisions have yet been taken on any reallocation of market and product franchises to individual countries; and the operations are strongly country-centred at present. In the short term, exports from Egypt will focus on markets that

**Box 5.1** (Continued)

are small or fragmented, where the maintenance of one manual production line in the factory facilitates short production runs. Some bureaucratic obstacles have been faced in export procedures.

Glaxo is still in the early stages of a large development programme in Egypt, and its strategic plan envisages continual upgrading of existing facilities and capacity expansion. The labour force in Egypt is regarded as loyal, inexpensive and productive, and there is a ready source of graduates – for example, all 350 Glaxo representatives are pharmacy graduates. Problem issues for the company and the pharmaceutical industry as a whole concern rigid government pricing policies; patent protection which relates only to the process; and weak laws on intellectual property.

issue of partnerships is important in the final two opportunity sectors shown in Table 5.2 (see also Boxes 5.2 and 5.3 below). There is substantial potential for tourism projects in Egypt, and Box 5.2 presents the case of Accor Hotels S.A.E., a joint venture involving the French Accor Group. Despite the joint venture relationship, the continued involvement of the foreign partner is crucial in terms of brand name, ensuring quality of service and quality of physical infrastructure. It should be noted that joint ventures are less common in the international hotel industry than management contracts, where the foreign partner provides the management expertise and quality assurance. Software development is a further potential source of FDI: the large number of university graduates in Egypt, along with the fact that all the main international computer software companies are already active in the country, suggest a very positive outlook for this sector.

A final category concerns the potentially important area of partnerships. While a number of Egyptian private-sector enterprises have developed a strong competitive position based on dominance of the domestic market, their future expansion requires the technological upgrading of processes and products, and eventually support for their own internationalization. Partnership arrangements with overseas-owned MNEs offer opportunities for mutual benefit: Box 5.3 presents the example of the Ezz Group, which took the initiative in establishing a joint venture with the Italian corporation Danieli, while Box 5.4 shows a different illustration from the pharmaceutical industry, where, unusually, the US partner reduced its stake in the Egyptian operation from 40 per cent to 10 per cent.

### Box 5.2 Accor Hotels S.A.E.

In 1992, the Accor Group of France took over the Wagon-Lit Group and its business in Egypt. Established in August 1980 under Investment Law No. 43, 1974 and known as *Compagnie Internationale Des Wagons-Lits et Tourism – Égypte*, its business in Egypt comprised management contracts for a number of hotels and the onboard catering and sleeper car services provided for the Egyptian railway network. To develop and expand its operations in Egypt, the Accor Group invited collaboration and active investment from the Egyptian private sector. The El Maghraby Group joined forces with Accor, and in July 1994 Accor Hotels S.A.E. was launched as a joint stock venture specializing in the field of hotel management and tourist development.

The company currently has capital employed of US\$9 million. The tourist group manages twenty-two hotels, owns three hotels and is a part shareholder in four hotels under construction. They have a 300-bed medical (mainly optical) hotel, and a number of optician outlets.

The company employs 4,755 workers, and their sales reached a value of US\$ 74 million, which was expected to increase to US\$ 86 million in 1998. They have also allocated substantial investments reaching LE 90 million to a number of projects including building a 120-room extension to the existing Winter Palace Hotel in Luxor, and renovating the Sofitel Old Winter Palace Hotel and its gardens. They also plan to build a 152-room extension to the Novotel Sharm El Sheikh Hotel, and to renovate the Novotel Dahab Hotel and other projects.

In October 1997 Accor Group of France and Accor Hotels S.A.E. signed a Master Franchise Agreement for a further thirty years, extending Accor Hotels S.A.E.'s entitlement to operate all the hotel management brand names owned by Accor Group of France: these are Sofitel, Novotel-Ibis and Mercure. It also entitles them to the establishment of a joint investment fund between the two groups, and other international and Egyptian private-sector investors. The input from the French partner is largely in the form of hotel executive human resources training, as well as access to the brand names.

The management believes that FDI flows into Egypt are likely to grow significantly over the coming five years from a tourism perspective. The key issue is the quality of services, and this depends on the quality of training of service personnel. It is believed that the way forward is to develop two-centre holidays mixing cultural tourism with resort tourism, to develop resort areas, and encourage business travel with conference business and golfing holidays.

**Box 5.3 The Ezz Group**

The Ezz Group has been the leading private Egyptian company in the iron and steel sector over the last two generations and is probably the largest private steel producer in the Arab world. The company's primary activity of steel rolling is complemented by commerce and transport, and by ceramic tile production. The latter, together with the company's new steel rolling plant, are located in Sadat City, 100km away from Cairo.

The company started in the 1920s and operated as a supply, contracting and shipping enterprise until the 1980s. With strong import and export links to Eastern Europe, at one time the Ezz Group shipped around 1 million tons of steel locally and internationally on an annual basis. This business stagnated but was reactivated with the establishment of a steel rolling mill in Ramadan City in 1991, and a further facility in Sadat City in 1996. Employment in the sector now totals 1,300 people.

The first ceramic tile line went into production in the late 1980s and rapid expansion led to a growth in production capacity from 1–12.5 million square metres over a six-year period; employment expanded from 100 to 1,200 in the same period.

The Ezz Group has a commitment both to the use of state-of-the-art technology and to best business practices. The company has been reorganized twice using the Arthur Andersen and Booz-Allen consultancy firms. There is also a strong commitment to training: 200 personnel are fully funded for two-year training programmes; the company has established its own training institute in collaboration with an overseas university; and thirteen people are on full-time sabbaticals studying for MBAs in the USA and Europe.

An interesting recent feature of the group's expansion has been the establishment of a joint venture with the Italian company Danieli. The two private enterprises had worked together over a ten-year period on three projects involving technology and equipment importation from Italy. Through this collaboration, both firms were able to understand each other: for Danielli, it meant an understanding of the quality of Ezz Group personnel and of the ethics of the company, as well as knowledge of the Egyptian environment. The joint venture involved a steel project that was too large and technologically sophisticated for Ezz to handle on its own. It is regarded as the first of a series of such ventures to assist the technological upgrading of the Ezz Group and its expansion, both in Egypt and overseas.

#### Box 5.4 R. P. Scherer Egypt

R. P. Scherer is an American pharmaceutical company that has a dominant share of the world soft gels production. Scherer had a long export relationship with Egypt which ended when the Socialist period prevented importation, but it began again in the early 1970s. The current company is a joint venture with 10 per cent US and 90 per cent Egyptian ownership (this changed from 40 per cent/60 per cent). Scherer has twelve factories worldwide, and its Egyptian partner, Pharco, has other pharmaceutical interests, notably in anti-tropical disease drugs.

Scherer's contribution was to bring in technology, brand names and training methods. Many of the employees have been seconded for three months' training to the UK and French plants of Scherer, and Scherer personnel have visited Egypt for training purposes. The sophisticated machinery employed produces very low reject rates, and the plant currently operates 7 days a week, 24 hours a day. The Egyptian plant exports 15 per cent of its output to some thirty-five markets. The major export market is Romania (where there are twenty-five sales representatives) with Yemen, Saudi Arabia and Uruguay featuring strongly.

The Egyptian parent, Pharco aims largely to satisfy the domestic market, and part of its mission is to specialize in tropical diseases such as bilharzia. The future investment plans of the Egyptian company include an entry into biotechnology – some work has begun and the company hopes to begin patenting. Expansion of the company is greatly facilitated by workers and middle managers remaining loyal to the company and 'growing up with it'. Staff turnover is not a problem and recruitment can go forward on this firm base.

Managers within the company see Egypt as having a comparative advantage 'if a good foreign partner can be found who can run the company to international standards'. Major assets include the price of land, manpower and electricity. Running costs are thus low, and these can be combined with machinery and raw materials 'whose price is the same all over the world'.

This case illustrates inward technology transfer to an Egyptian plant given a *de facto* regional product mandate (Middle East, Africa and part of Eastern Europe). The domestically-oriented part of the company has the opportunity to expand, building from a strong and growing domestic market to develop export potential.



### **Egypt's attractiveness**

There have been numerous reports on Egypt's attractiveness as an investment location, particularly comparing it with Turkey, Israel, Morocco and Tunisia, which are assumed to be its major regional rivals. Such studies are very specific to a particular point in time, and the (often subjective) rankings can change quickly. For example, the World Economic Forum (*Wael Competitiveness Report*, 1997) ranked Egypt twenty-eighth out of fifty-three countries. On the positive side, the country ranked highly in terms of the investment protection schemes that are available to investors, its geographic location, exchange stability and labour costs. Problems identified, however, concerned the size and efficiency of government, the country's openness to trade, a lack of management skills, an inflexible labour market, and poor quality institutions supporting commercial activity. In an additional survey within the Global Competitiveness Report, international business executives were asked whether changes to government policies in a country had improved competitiveness in the preceding year; Egypt was ranked first of the fifty-eight nations included.

UNCTAD's survey of business executives (UNCTAD, 1998) highlighted favourable expectations by foreign investors of potential market growth in Egypt. Factors linked to cost, availability, skills and productivity of labour and capital costs also received positive ratings. However, other business transaction costs were identified as disincentives to FDI. Considering Egypt's potential attractiveness over the next five years, factors believed to be important included a continuance of political stability, the availability of skilled labour at competitive wage rates, and the signing of trade agreements with the European Union (EU) and USA which would enhance opportunities to expand markets, particularly abroad.

Egypt's attractiveness to incoming FDI is damaged by the high level of transaction costs that were frequently referred to by company executives there. High levels of transaction costs inhibit effective supply chain management when an Egyptian unit is part of the chain. This results from unreliability in delivery, quality and cost performance, as, for example, in some areas of textiles and in fabrication. Long lead times and a lack of flexibility (high adjustment costs) are also features of indigenous Egyptian operations. The business culture of Egypt can be extremely clannish, and this tribal attitude to business operations can present serious obstacles to the foreign investor or to the principal firm in subcontracting or other contractual arrangements. Institutional and transport barriers compound these difficulties.

## **Policy analysis and recommendations**

It is apparent from the discussion above that multinationals could have a central role to play in integrating Egypt into the global economy, and in supporting the country's export-oriented development efforts. Improving the attractiveness of the economy for FDI is, however, bound up integrally with the wider process of market reform and privatization, and the all-embracing nature of the required reform would seem to provide a daunting prospect for policy-makers. On the optimistic side, Egypt has many characteristics in common with other emerging economies around the world, and the large MNEs, at least, have experience in operating in numerous such environments. Observations by MNE executives in Egypt interviewed as part of this project stress the necessity of strong financial support from parents when entering emerging markets; the danger of expecting too much too quickly; the lengthy time to achieve profitable business; and, overall, therefore, the requirement for a long-term commitment. But there are big opportunities in Egypt, and committed MNEs have generated significantly profitable businesses.

From a policy perspective, an emphasis on FDI and specifically MNEs has two advantages. First, it requires and encourages a holistic view of public policy because of the links to investment flows, trade, technological development and technology transfer, and managerial innovation. Second, it necessitates a focus on the corporation as a mechanism for achieving economic benefits in each of these areas. It should therefore be possible to use multinationals as a driver of reform in Egypt.

Table 5.3 sets out an agenda for policy innovation in Egypt focusing on FDI attraction. Policy reforms are required at different levels. At the international level are issues relating to support for organizations such as the World Trade Organization (WTO) and adherence to the principles of international trade and investment rules. At the regional level, progress with the development of a Free Zone within the Middle East is important if MNE activity is to be encouraged: even more significant is the signing of the European – Mediterranean Partnership with the EU, which is designed to create a free trade area and build economic and financial co-operation among the twenty-seven countries by the year 2010. This was under negotiation in mid-1998. Within Egypt itself, required policy reforms are identified at the macro, macro-organizational and micro levels.

A distinction is also made in Table 5.3 between policy areas namely: legal, institutional, promotional and infrastructural issues. There is, in

Table 5.3 Policy reform for FDI attraction in Egypt

Policy level	Legal	Policy area		Infrastructural
		Institutional	Promotional	
<b>International</b>	Support for WTO and key principles of national treatment, MFN and non-discriminatory treatment		Targeted international marketing by country, sector, company	
<b>Regional</b>	European-Mediterranean Partnership agreement Arab Free Trade Zone	Collaboration with foreign investment agencies in EU Accelerating technology transfer through co-operation with MNEs and international co-operation agreements	Targeted regional marketing by country, sector, company	
<b>National</b>				
Macro	Maintenance of stable economic environment Opening the economy and promoting privatization			
Macro-organisational	Competition policy	Creation of attraction-oriented foreign investment agency, with general authority and/or general co-ordinating authority		Education and training focusing on investor needs

	<p>IPR laws and action against counterfeiters</p> <p>Improvements in company law</p> <p>Improvements in incentive systems, and evaluation of tax holidays</p>			<p>Transport and communications; for example, ports, road and rail, telecommunications</p> <p>Science and technology – to enhance commercialization</p>
Micro	<p>Improvements in judicial system and in litigation</p> <p>Removal of key blockages, for example, company incorporation and registration, land allocation, building permits, and operating licences</p>	<p>Support for investors to overcome bureaucracy and red tape</p> <p>Action-oriented MNE forum</p>	<p>Marketing inside country to prospective investors</p> <p>Use of existing successful MNEs in demonstration role</p> <p>After-care services</p> <p>Internal marketing – educating the public and policy-makers</p>	

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fact, a further overriding dimension which concerns attitudinal factors and bureaucratic behaviour: the mentality of state-ownership and control, and suspicion of foreign multinationals, will be a fundamental barrier to change. Such problems are recognized in the context of privatization in Egypt, where programmes have been undertaken to prepare the public and workforces for change; the slow pace of privatization to some extent reflects the need to overcome public resistance. In a similar vein, the World Bank (1997) has recommended action to educate the public and create an 'export mentality'. To date, however, there have been no such programmes to educate the electorate and state officials on the merits of FDI: attitudes to MNEs are ambiguous at best. Welcoming attitudes could create a much greater tolerance of regulatory and institutional barriers, at least in the short to medium term.

With such a wide agenda, there is a danger of trying to do too much too quickly, and in the process, for example, introducing new laws which are unsatisfactory and create further uncertainties; or making legislative change without adequate consultation and with short time-scales for its introduction; or failing to co-ordinate policy reforms across different government departments and between different objectives. The way ahead suggested here is, first, to focus on institutional reform, on the grounds that a strong body supporting FDI may be a driver for change in other areas; and second, to prioritize reform measures linked to the targets for FDI attraction proposed earlier.

### **Institutional and promotional dimensions**

A major problem historically, for investors in Egypt has derived from the number of governmental authorities responsible for issuing certificates, licences, authorizations and incentives, employing large numbers of employees and overlapping with other similar authorities. Procedures for establishing investment projects in Egypt have been extensive and time-consuming: in terms of time cost, it can take up to three months for investment proposals to go through the approval and establishment phase in Egypt; other countries in the region take as little as a few days to grant approval, and at most six weeks.

A large number of regulatory agencies in Egypt have had an involvement in investment projects. The principal ones are the General Authority for Investment and the Free Zones (GAFI), and the General Organization for Industrialization (GOFI). In the past, the activity of GOFI was mainly that of granting business licences, and registering and monitoring industrial investment in Egypt. Approval and monitoring by GOFI was a cumbersome, time-consuming and inefficient

procedure. At the time of writing, the mandate of GOFI is in the process of being reoriented towards identification of projects and opportunities, enhancing the relationship between technical institutes and industry.

Until 1996, GAFI was a regulatory body reflecting the inward-looking industrial policy orientation of the country. Its size – GAFI has approximately 1,400 employees with branch offices throughout Egypt – emanates from this regulatory role. In the later 1990s, attempts were made to reform GAFI into a facilitating and promoting body for FDI rather than a regulating and controlling one as in the past.

Investment Law No. 8 of 1997 is the key legal instrument governing investment, enacted to replace a plethora of earlier rules. For companies registered under Law No. 8, the official view is that there is no approval process *per se* for foreign direct investment, with only notification being required; tax exemptions are provided automatically; inputs can be imported without registration; capital inflows and profit remittances are not monitored; and permission for new projects is no longer required. Similarly, the previous vetting and authorization process no longer exists for expansion of existing projects, increases in capital, changes in product mix, or the start-up of a new production line. The role of the GAFI board of directors is to discuss policy.

The reality of this apparent openness is untested. And despite the redefinition and restatement of GAFI's role, Egypt's Civil Service Reform Secretariat is working on plans for a new body and structure which could involve investment service offices ('one-stop shops') at the regional level. These would be staffed by project officers with responsibility for pre-establishment information and contacts, the facilitation of permits and clearances, and post-establishment information and contacts. Key blockages (including company incorporation and registration, land allocation, building permits, and operating licences) have been identified, together with possible solutions.

Accepting that decisions have not yet been taken on institutional reform, Table 5.4 highlights the broad functions of a foreign direct investment agency as operated in other parts of the world (Young and Hood, 1994; Young *et al.*, 1994); and shows the necessary changes in orientation and activity to move from a regulatory to an attraction orientation in Egypt in the new era of export-oriented development. Screening and approval procedures would basically be abandoned, with the core functions emphasizing investment promotion and attraction, the granting of incentives (as an attraction mechanism) and after-care services. The type of body needed to undertake these new functions is

**Table 5.4** Functions of foreign direct investment agency in Egypt

Key issues	Regulatory orientation	Attraction orientation
Role of agency	Central body, but extensive independent involvement of other ministries, organizations, etc.	Central body, with general authority for FDI and/or general co-ordinating authority
Policy formulation	Strategies for regulation and control within inward-oriented development strategy	Strategies for attraction within export-oriented development strategy
Investment promotion and attraction	Limited to some missions and exhibitions No marketing inside the country	Marketing information and intelligence Marketing planning and targeting Marketing and promotion programmes abroad Marketing inside the country
Investment screening and approval	Ownership conditions Sectoral conditions Operational conditions	None, or limited to informal commitments on employment, foreign exchange, etc., linked to granting of incentives
Incentives and assistance	Extensive but regulatory orientation and bureaucratic implementation	Extensive; designed to attract investment
After-care services	None, or limited to approval processes for new projects, etc.	Significant; designed to encourage expansion projects and plant upgrading

fundamentally different from the GAFI it would replace, in respect of the characteristics shown in Table 5.5.

To fulfil the basic marketing and promotion function effectively, the new body must have a strong private-sector orientation; that is, the professional staff should be able to talk to MNE executives in terms that they understand and appreciate. If not a private-sector organization, therefore, the new agency should at least be quasi-governmental: namely, established outside the normal civil service rules and practices. With screening procedures removed, staffing levels would be reduced substantially. Similarly, the educational background

**Table 5.5** Organization of Egyptian foreign direct investment policy

Organization	Governmental	Quasi-governmental
Size (number of professionals)	1 400	50–100
Educational/professional background of employees	Administration, law, economics	Marketing, business administration
Previous experience of employees	Government sector	Private sector
Performance evaluation	Time-span for project approval	Effectiveness of marketing programmes, for example, number of enquiries, number of site visits, number of new projects, jobs created, level of financial assistance per job created and so on

and professional experience of the agency staff would be very different, as indicated above. Finally, performance measures would change from time-scales for project approval (since no approval would be necessary) to the effectiveness of marketing programmes. To ensure that this organization is a driver for reform, it would need to be headed by a senior director with access to, and support at, cabinet level in the government.

### **A phased approach to policy reform**

The policy agenda set out in Table 5.4 encompasses three broad areas: namely, the investment framework, private sector development; and regional co-operation. Although the government has accepted the challenge to take action in these areas, the time scales will inevitably be lengthy. There is a case, therefore, for short-term actions, such as those cited below, to try to make an immediate impact on Egypt's attractiveness for FDI.

#### *Internal marketing*

Educating the public and policy-makers, and changing the mindset of state bureaucrats is not a short-term task; and reorienting attitudes towards MNEs must be part of a wider programme of promoting the market economy and private-sector development. Nevertheless, the



task of retraining and reorientation is highly important, and possible priority actions include the following:

- A media campaign to explain the contribution of MNEs to economic development in Egypt. This should be encompassed within an informational and publicity framework supporting the private sector and export orientation more generally. Support may be available from some MNEs themselves which are portrayed as successful models;
- Short, intensive training programmes for politicians and policy-makers – beginning at the highest level – to demonstrate the economic benefits of MNE-led development. Case studies of successful MNEs in Egypt and successful policies in neighbouring competitive countries will prove valuable; and
- Public seminars on the attraction of FDI and its economic contributions. These should be oriented towards positive aspects rather than impediments to FDI in Egypt, with contributions from Egyptian nationals and developing country-focused organizations.

#### *Investor support at the firm level*

Given the numbers still employed in the public sector, attitudinal change among mid- to low-level state officials is an enormous task. In the short to medium term, circumventing and overriding bureaucratic procedures is a necessary way ahead. In other work (World Bank, 1997) recommendations have been made for simplifying customs procedures, by, for example, establishing a 'green channel' for imports to allow exporters to import raw materials and capital goods. Issues of wider institutional reform for FDI attraction are discussed above, but even this is going to take time to implement. To reduce bureaucratic discretion and the costs of bureaucracy, early consideration might be given to the appointment of a cadre of executives (who will become employees of the proposed new FDI agency) with the authority to ensure fast-track approvals for MNEs at time of entry and establishment and for up to two years after start-up. Given the size of the problem, it is doubtful if each executive could be responsible for more than a few multinationals on a continuing basis; it would be sensible if they were based in the company premises. There would have to be some restrictions on the nature and size of investment for which this support would be available.

#### *International marketing*

Research has shown that developing countries of the Mediterranean basin tended not to be included in prospective investors' lists of possible

investment sites because they were considered to be too risky; and that, in terms of business climate rating, Egypt was at the lower end of countries in the region. Along with other actions to improve the business climate, 'image-building activity' (Wells and Wint, 1990), designed to improve the image of Egypt as a place to invest, is clearly necessary. Probably the bulk of international marketing expenditures should be focused on image building, given the negative perceptions, especially in the West, of the Arab world as a whole. Successful foreign investors can have a very positive demonstration effect in this regard; conversely, action is necessary to reduce the perceived harassment that tourists receive from street vendors in Egypt, since tourist attitudes work through to business attitudes. However, some initiatives should also be launched in 'investment-generating and targeting activity'. Because of their lengthy international experience and ability to take the long view, there is a significant group of MNEs that would tend to have an FDI presence in most countries of any size. This group is an obvious first target for marketing activity. Related activity could entail targeting those large MNEs with a presence in neighbouring countries but not in Egypt: the intention would be to encourage the corporations to set up in Egypt with a product line not yet manufactured in the region. Thereafter there is scope for well-planned initiatives in targeting sectors and companies, as discussed previously. Part of this international marketing should entail marketing Egypt to Arab investors as a location for manufacturing or service investment as opposed to investment in real estate.

### *Liberalization measures*

Within a planned programme of reform for the longer term, there is a case for undertaking a series of bold, high-profile (even if limited in scope) liberalization measures that are well publicized both internally and externally. This recognizes the need to take action in respect of liberalization, but also the problems of poorly drafted legislation. Liberalization measures which may be targets for action include: clarification of land ownership rights; elimination of apparent discrimination in favour of domestic and Arab investors over non-Arab investors; improvements in the judicial system and in litigation, to eliminate the situation whereby companies include arbitration clauses in contracts but then find that, for example, traffic offences are covered by Egyptian law; and the creation of an action-oriented MNE forum which guarantees foreign investors direct access to a senior politician.

## Conclusions

The pace of market reform and economic liberalization in Egypt has been much slower than in some other countries studied. Yet the requirement for integration into the world economic system is extremely pressing given the low levels of income per head in the country and rapid population growth. At the micro level, the economy requires the capital investment, the stimuli to managerial efficiency and worker productivity, the technology transfer and the trade links to the regional and global economies that MNEs can bring. And while the policy agenda to achieve these economic benefits is an extensive one, even modest reforms along the lines outlined earlier could enable the country to attract substantially higher inflows of FDI. This optimistic scenario, of course, assumes political stability within the Middle East and internal security within Egypt.

There is also a need to overcome the legacy of suspicion of foreigners and fears of MNE domination and exploitation, and the tradition of a highly centralized and authoritarian state, which work through into high transaction costs for business. But both issues are bound up integrally with market reform, privatization and FDI liberalization. The crucial question concerns the relative merits of a 'gradualist' versus 'big bang' approach to reform. Egypt has chosen the former route. This recognizes the social and political problems of large-scale redundancies in a country which lacks a proper social security system, and where unemployment and poverty can be exploited by Islamic radicals.

The case of GAFI provides an illustrative microcosm of the Egyptian economy as a whole. The World Bank (1997) recommended privatizing the entire FDI business by giving it to a small group of experienced sales professionals who worked to specific and agreed targets. And the chairman of the General Authority for Investment has stated that 'if I were to start up this office, I would need about 50 or 60 people to run it efficiently. But I have 1,400' (*Financial Times*, 'Survey of Egypt', 12 May 1998). A 'big-bang' approach is probably not realistic for GAFI, nor is it for the economy as a whole. Nevertheless, ways have to be found to improve the efficiency of the inward investment attraction effort (and economic efficiency for the country as a whole) within a framework of gradualism. At the time of writing, at least, the globalization of MNE activity has scarcely had an impact on economic development in Egypt.

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## **Part II**

# **International Economic Integration and Multinational Enterprises**

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# 6

## Foreign Direct Investment and Europe

*with Jeremy Clegg and Adam R. Cross*

This chapter seeks to tackle the issue of foreign direct investment (FDI) and Europe – in particular the European Union (EU)<sup>1</sup> – within a synoptic view of international business writings. The short-term economic factors are relatively well discussed, but the historical, cultural and political dimensions are rarely touched upon in mainstream international business. It is not our purpose to do this thoroughly here, but simply to take a step back and put the economic factors in perspective. It transpires that the familiar economic influences appear part of a more permanent and pervasive system. With this perspective; the issue of foreign direct investment and Europe appears part of the natural establishment of an interlocking economic system.

The world business system is an interaction of regional subsystems, each with its own internal dynamic. In some cases, the driving forces are best examined at the single country level, as in the case of the People's Republic of China (PRC). In other cases federations of states are the most important units of analysis – the EU and, arguably, the North American Free Trade Agreement (NAFTA), are cases in point. Finally some subsystems are best analysed in terms of geographic regions – examples here are Central and South America. Each of these different units of analysis are aggregations of disparate subunits in terms of level of development (Beijing versus Gingham, Estonia versus Kazakhstan, Paraguay versus Argentina) and in terms of cultural differences, geographical centrality and external links. However, they are tractable in terms of relatively homogeneous responses to the world system, although some units contain centripetal tendencies which are a key element in dynamic change.



Despite the pace of change in the world economy, many underlying cultural and language boundaries remain unchanged. Determining the stability of several 'anchors' of the system is an important role which analysts can play. The remarkable stability of language boundaries is exemplified by the boundary in Europe between Latin-derived languages and those of German dialects. The Romance–German dividing line was established before the eleventh century AD and persists, virtually unaltered, to this day, despite centuries of war, conquest and social upheaval (Southern, 1987). Regional integration in the EU, not so much for its economic as for its political and cultural agendas, therefore represents a unique collaborative excursion.

Within and between nations, regions and blocs ranges the multinational enterprise (MNE). It is an oft-repeated fallacy that such firms are above individual nations and owe their allegiance to none. But every multinational can, in fact, be identified with one key home country. The question is, how does a firm derive its nationality? Is it from its management, its (share) ownership, its yardstick currency, or its legal residence? This is a fascinating issue, but one which must be left aside for our present purpose. It is clear that the bulk of MNEs still derive from, and own primary allegiance to, one nation-state (two in a tiny minority of cases) even when ultimate control may be shrouded by tax haven residence. What is clear is that the intensity of intra-EU FDI discussed in this chapter raises the real prospect of European MNEs that owe more to being European than being part of any particular EU nationality. It may be no coincidence that the move towards a single currency within Economic and Monetary Union (EMU) will create a swathe of MNEs with a common yardstick currency, and thereby reinforce an element of common nationality.

As it stands, however, most MNEs worldwide are controlled from a major metropolitan state, the majority from the advanced EU countries, Japan and the USA. It is therefore already possible to view MNEs as being related strongly to the 'triad' of advanced blocs (USA, EU, Japan) interpenetrating each other as well as extending into less developed regions. There are preferences in the direction of expansion of MNEs, some of which are clearly based on historical, cultural and linguistic ties. Instances include investment in Latin America by Spain and Portugal (respectively, in Spanish-speaking Argentina and Portuguese-speaking Brazil), and FDI by the USA into the UK. However, a more widespread interpenetration is moving at a rapid rate, and Japanese investment in the USA and EU has been an important advanced guard in the reorientation of the existing pattern.

## **The role of international business theory**

### **The research agenda**

The scope of the theory of international business is continuing to widen. Early strands were the theory of international trade, the international management literature, the theory of international investment and finance, and the (economic) theory of the multinational enterprise. These areas retain their vigour. They have been joined by studies of the impact of foreign direct investment on host countries, macro studies of international competitiveness, comparative (cross-national) studies, the analysis of joint ventures and other co-operative forms of business activities, and research into special areas of international business, such as service industries. The relevance of these strands of theory to regionalization and economic integration in the world economy is an important issue.

Technically, the strategic trade literature is highly congruent with economic theories of multinational enterprise, because it introduces imperfect competition into the highly unrealistic perfectly competitive models on which trade theory had been grounded. Attention to the important phenomenon of intermediate product trade (Casson, 1985) provides further links. It is readily apparent that these are the tools that are required to address the complexities of economic integration in Europe, as well as in North America. The essence of the economic rationale of regional integration is the influence it exerts over the location of economic activity.

It is perhaps disingenuous to refer to studies of the impact of international investment and multinational enterprises on host and source countries as a relatively new area, because this has been a major concern since such activities began. It is clear that a more rounded debate is now taking place, and that a substantial shift in attitudes has occurred on the part of host countries. In the context of Europe, it is evident that the symbiotic role between economic integration and FDI has yet to be fully analysed, and more so, the issue of policy towards MNEs. We are already a long way forward of the time when the debate on inward foreign investment was highly polarized between the proponents of foreign investment as an engine of development and the critics who based their arguments on Marxist or 'dependencia' analyses. There is now a much more welcoming attitude among host governments (Dunning, 1991) in a world where competition for investment capital is rife. This shift is also reflected in academic writings. However, there has yet to appear a new generation of thought extending this literature to

the regionalized and globalized economy and, in particular, to what the EU's own position should be on the MNEs, which it both hosts and generates.

### **The search for competitiveness**

In the 1980s, a major concern was the international competitiveness of countries, industries, firms and individual products. For example, Buckley *et al.* (1988) reviewed the range of measures of competitiveness employed to proxy the key elements of this multifaceted concept. The 'competitiveness debate' was wide-ranging. At that time, the most macro level considered was the national economy, and questions related to the national organization of resources, policy objectives of government, government management of the economy, and (purported) trade-offs in national economic goals. The approach of, for example, Scott and Lodge (1985) concentrated largely on the perceived trade-off between national competitiveness and social goals. It is now reasonable to say that the unit of analysis for many purposes must be the region, followed by the country's place within the region. Again, this is borne out by the experience of the EU, and the movement of non-member countries to join the Union.

Differences in competitiveness are legitimate concerns of national governments. However, these problems increasingly have to be approached from within a regional framework in which the region is the global champion securing an appropriate share of world activity on behalf of its members. This regional strategy follows from the increasingly interdependent world economy. Needless to say, this must place constraints on the effectiveness of single government actions. Moreover, certain policy tools may be ineffective or misguided when the profound nature of interdependency is taken into account. The strategies of national firms, and of national and regional governments to secure competitiveness, may no longer be congruent.

Concern for competitiveness has been a stimulus to comparative work in international business for competitiveness is *par excellence* a comparative concept. Comparative work had been given a major stimulus by the entry of Japan as a first-rate economic power. There was the promise, for a while, of discovering a new benchmark. The task of comparative research has always been a hard one, because of the considerable amount of work involved. Comparative data rarely come unbundled from the investigators' own analytical viewpoint, and problems in collecting two or more sets of 'clean' observations often render it impractical. However, the great virtue of comparative work is that it provides a carefully

specified 'counterfactual'. Although comparative research has been grist to the mill of international research for a long time, it is unlikely to be further boosted in the future. Indeed, its value is degraded as the interactions rise between formerly separate systems.

The implications of this for the EU, and for European integration in particular, is that there is no clear beacon of best practice at which to aim. The advanced developed countries collectively face the prospect of having to reinvent themselves. The only vestige of the comparative methodology that remains is the notion that Europe must come to emulate the efficiency of the USA. It has been this reasoning that largely underpins the idea of European economic integration. The point that nothing stands still has been made very effectively by the rise of North American integration, itself partly a response to the success of integration in Europe. Had it not been for this 'matching action', a plainer view would have been possible of the long-run impact of the Single Market programme (SMP) on the EU's share of global FDI.

With new global and regional structures has come the growth of new forms of international business. In particular, studies of international joint ventures have been part of the advanced guard of research stimulated on co-operative modes of business ventures. These joint ventures and 'new forms' of international co-operation, including strategic alliances (Contractor and Lorange, 1988) are very much the fellow travellers of regionalization and globalization. Co-operation across the traditional boundaries of the firm has marched in step with the co-operation across the traditional boundaries of the state.

The following sections aim to prove the relevance of the theoretical rubric by analysing the regional subsystem of the EU. It will be seen that, although international business theory represents a coherent whole, the weighting of the different parts of the theory is different according to the subsystem in question. The patterns of, and motivations for, FDI that we encounter in Europe are, accordingly, distinctive.

## **The integration of Europe**

### **The path to European integration**

At the inception of the EU, the share of world trade and the proportion of total trade that occurred between the members were paramount performance indicators. By the 1980s, the EU's share of world FDI was the more pressing issue. It had become apparent that integration was a policy tool with which to secure an enhanced share of world investment, and

therefore of output, trade and employment. Understanding European integration is therefore central to grasping the evolving link between FDI and Europe.

European integration in the modern context began in the aftermath of the Second World War. Founding members of the Community first pooled their heavy industries. They then set about creating a single market in which goods, services, people and capital could move about as freely as within one country. In practice, for many years, trade was the main route that most member states, and EU officials, visualized as being fundamental to European integration. The integration process has been, and continues to be, a gradual one, covering political and social as well as economic and trade dimensions. The first major act of integration was the complete elimination of all tariff barriers on intra-European Community trade (as it then was) by July 1968, between the six founding members. The Single European Market was deemed to come into being in January 1993, although the actual degree and pace of integration of individual goods and services market differs widely, and the implementation of liberalization is a long and ongoing process. In the modern context, European economic integration is more about outcomes than means. The hallmarks of market integration are the extension of effective competition and price convergence on a market-wide basis.

With the benefit of hindsight, and borrowing and extending from Hine (1985) we are able to see that European integration can be viewed in at least four different stages:

- (i) 1958–68: The Transition Phase;
- (ii) 1968–74: The Emergent Phase;
- (iii) 1975–85: The Recession Phase; and
- (iv) 1986–: The Market Integration Phase.

The *Transition Phase* was the one in which the founding members of the EU actually began to function as an economic unit, through the conclusion of the first act of ‘deepening’ of the economic relationship between the members. The *Emergent Phase* was the period when the European Community embarked, in its new role as a fully-fledged customs union, upon redefining itself by embracing new members, through the first enlargement of 1973. This was the first act of widening of the membership. The *Recession Phase* was that period when European integration temporarily lost its way, there being no major acts of deepening or widening on the agenda. This is notwithstanding the

significance of the accession of Greece (in 1981) and the mixed success of the Exchange Rate Mechanism (ERM) within the European Monetary System. The significance of the accession of Greece was considerable, not simply for historical reasons, but because it established that European integration was not to be confined to the northernmost and most developed countries. The beginning of the *Market Integration Phase* coincided with the accession of Spain and Portugal, confirming the willingness of the Community to look outwards. Subsequent enlargement, including the reunification of Germany in October 1990, confirmed the intention also to look to the east, as well as north (with the accession of Austria, Finland and Sweden). By the conclusion of the 1990s, it was clear that the EU was an inclusive, rather than an exclusive, club.

Overlaying, but linked to these phases, are the economic developments that have been found to be integral to FDI and the EU (Dunning, 1997a, 1997b). It is common to distinguish Mark I and Mark II integration, which the Single Market has developed. Mark I integration began in 1957 and extended until the mid-1980s. It concerned the establishment of the Common Market and its subsequent enlargements to twelve members in 1986. It involved the eradication of tariff barriers and quotas affecting manufactures trade, with only limited attention to the existence and growth of non-tariff distortions. The Single Market Programme is often known as EC92 (or simply '1992') or Mark II integration, and is reckoned from 1986 or 1987 onwards (with the establishment of the Single European Act). Mark II Integration concerns the programmed removal of non-tariff distortions. A third phase began with the Maastricht Treaty. This took effect on 1 November 1993. It was seen as preparing the way for economic and monetary union (EMU), a single currency, and to give extra power to the European Parliament (possibly leading to political union). The term 'European Union' at this point came into use to describe the wider Maastricht framework in which all these activities take place.

The importance of Mark II integration, beginning with the Single European Act (SEA) 1986, for FDI cannot be underestimated. In the early 1980s, the competitiveness of Europe fell behind that of the USA and Japan. This manifested itself in the EU as a slow-down in absolute output, high rates of inflation and unemployment; slow growth in investment and productivity; a lagging behind in new technologies on which global economic business seemed to depend; and the preservation of national (rather than EU-wide) objectives. In response to these problems, the SEA sought to remove (especially non-tariff) barriers to trade and, significantly, to investment. Barriers to investment were by then

understood to limit market integration, especially in certain service sectors, the worst cases of which were enshrined as state monopolies. This new wave of integration was non-discriminatory, as it lowered or eliminated non-tariff barriers (NTBs) to the benefit of non-EU and EU investors alike.

### **The motives for FDI in the EU**

Here we avail ourselves of the classification of four strategic motives for FDI as a response to economic integration, identified in UNTCMD (1993):

- Defensive import-substituting FDI (tariff-jumping FDI) – a response to the trade diversion<sup>2</sup> effects of a customs union. Firms attempt to maintain market share via FDI;
- Offensive import-substituting FDI – investment in anticipation of improved market access and market growth;
- Reorganization FDI – a response to the trade creation<sup>3</sup> effects of FDI. FDI is a response to the scope for resource reallocation according to comparative advantage; and
- Rationalised FDI – a response to market growth. Scale economies become available, so leading to the locational specialization of production in key stages.

### **Mark I integration and firm strategy**

Non-EU, especially US, firms' business strategies initially involved defensive import-substituting FDI to protect market shares built up through exports to EU markets. Despite this, there were two reasons why US (and other non-EU) MNEs were in a better position to promote EU market integration, and to benefit from it, compared with native EU firms:

- (i) Non-EU firms were not encumbered by entrenched market positions, and so were able to choose the most efficient production locations that became available; and
- (ii) Non-EU (especially US) MNEs were typically larger than their EU counterparts; thus potential gains from corporate integration were commensurately greater. US firms also enjoyed greater organizational flexibility.

Mark I integration allowed non-EU (especially US and Japanese) MNEs to attain scale economies in production at the pan-European level. Even so, EU markets were often treated as separate because of non-tariff distortions, particularly in marketing and service activities.

## Mark II integration and firm strategy

The removal of NTBs in the EU enabled companies to treat the EU as a single domestic market. This gave all firms (both EU and non-EU) active in the Single Market opportunities to increase output and generate scale economies, and provided them with a more efficient operating position.

In such an environment, the location of production becomes critical. Production will move to regions with a relevant comparative advantage, and where production occurs most cost-effectively. For example, a golden triangle has been recognized, consisting of northern Italy, northern Spain, southern Germany, central France and the south-east of the UK, which is forming the economic hub of the EU, and where centralized manufacturing and distribution (because of lower transportation costs and proximity to many consumers) is taking place.

## Empirical evidence on FDI and the European Union<sup>4</sup>

### The EU in the global context

In this section we extend the analysis to look at the apparent link between European integration and the EU's FDI position. By the late 1990s, the EU(15) was the recipient of around a third of the annual worldwide flow of FDI (which includes flows between EU members themselves). Table 6.1 reveals that this share climbed throughout the 1980s and early 1990s, from just over a quarter in the first half of the 1980s, to peak at 44 per cent of world flow in the period 1991–93. The peak absolute value of this inflow to the EU15 was some 72 billion ECU in 1990.

**Table 6.1** Share of FDI inflows from all countries, 1982–95 (percentages)

	1982–87	1988–90	1991–93	1994	1995 (est.)
Developed countries	78.1	84.6	67.0	58.8	64.5
Developing countries	21.9	15.3	33.0	38.5	31.6
European Union	28.2	42.3	44.4	28.3	35.5
As % of developed countries	36.1	50.0	66.3	48.2	55.0
USA	39.9	31.3	10.2	22.0	19.1
Japan	0.7	n.d.	0.9	<0.1	<0.1

*Notes:* Figures for 1994 and 1995 are for the EU(15).

*Source:* UNCTAD (1996) and European Commission (1996).



Even after normalizing for differences in the growth of GDP between the EU member states and the rest of the world, it is evident that the EU attracted a disproportionately large amount of global investment activity in the late 1980s and early 1990s (Dunning, 1997a). It has been estimated that, in 1995, over half (55 per cent) of all FDI inflows to the developed countries were inflows to the EU countries (UNCTAD, 1996). Reference to the available data on the stock of foreign investment in the EU reinforces this picture. By 1995, the EU12 was host to around half (50.4 per cent) of the stock of FDI in the developed countries, and to just over a third (36.7 per cent) of the worldwide stock of FDI (UNCTAD, 1996; European Commission, 1996). The attractions of the EU for inward investment by the 1990s had come to exceed those of the USA.

### **Extra-EU versus intra-EU inbound FDI**

It is plain that one should differentiate investment that originates outside the EU from investment that occurs between the member states. It is thought that MNEs from outside the EU, mainly from the USA and (to a lesser degree) the European Free Trade Association (EFTA) countries, accounted for the majority, around two-thirds, of total inbound FDI in the years 1957–84 (Dunning, 1997a). This share has since waned, primarily because of the growing importance of intra-EU FDI flows. Taking 1984 as the starting point, the first year for which official comparative data were available, intra-EU FDI rose from 41 per cent to 55 per cent during 1986–90, and then to over 60 per cent in 1991–3 (European Commission, 1996). Investment by Japan in the EU over the same period was remarkably low in comparison, oscillating between 3 per cent and 8 per cent of the EU inbound total since 1984, with the largest inflow occurring in 1990.

Prior to 1985, around 90 per cent of inbound FDI to the EU, from both within and outside the EU, was concentrated in six 'core' member states, namely Belgium, Luxembourg, France, Germany, Italy, the Netherlands and the UK. Dunning (1997a) estimates that much of this, approximately three-fifths, was located within a 500-mile radius of Frankfurt. Table 6.2 shows that the major recipients of total inbound investment to the EU in the early 1990s were the UK (with around 23 per cent of the total), followed by France (15 per cent), Belgium/Luxembourg (14 per cent) and Spain (12 per cent). Given the size of Germany's domestic economy, its share of total inward FDI flow to the EU, averaging 8 per cent during the period 1990–3, was disproportionately low. Most commentators attribute this anomaly to the fact that much FDI, both intra-EU and from the USA, has been in the form of acquisition. As German firms have proved difficult to acquire, this has

**Table 6.2** Member States' share of FDI inflows, 1986–93

	Percentage share of average intra-EU FDI flows to:			Percentage share of average extra-EU FDI flows to:			Percentage share of total FDI flows to the EU going to:		
	1986	1993	1990–3	1986	1993	1990–3	1986	1993	1990–3
Belgium/ Luxembourg	7	19	17	2	16	9	5	17	14
Denmark	0	1	1	2	4	2	1	2	2
Germany	9	7	11	3	7	5	7	7	8
Greece	1	1	1	3	0	0	2	1	1
Spain	17	13	14	15	9	9	16	11	12
France	14	18	15	19	14	16	16	16	15
Ireland	1	6	7	0	6	4	0	6	6
Italy	7	7	5	-6	7	7	2	7	6
Netherlands	18	16	12	13	4	10	16	11	11
Portugal	1	2	3	1	1	2	1	2	2
UK	25	9	14	47	34	37	34	19	23
Total	100	100	100	100	100	100	100	100	100
Share of extra-EU flows to total				41	41	40			

Source: European Commission (1996).

significantly depressed the value of FDI to Germany. Acquisition has been the preferred type of FDI entry, primarily because it is a time-saving route. This has been a very important consideration for firms striving to adopt competitive bases, and to diversify rapidly and effectively within the emerging Single Market. Along with Germany, Italy appears to be one of the least attractive hosts for inward European investment.

The UK consistently received over 40 per cent of all extra-EU FDI inflows between 1986 and 1992 (European Commission, 1996). On the other hand, the UK is significantly less important as a site for FDI from other member states, absorbing less than 10 per cent of intra-EU FDI flows in 1993. Intra-EU FDI has tended to favour Belgium/Luxembourg and France, closely followed by Spain, with the UK in trailing position.

### The impact of European integration on FDI in Europe

The task of evaluating the effects of European integration has been taken up intermittently by various researchers. The first to do so quantitatively was Scaperlanda (1967). Since that time, econometric techniques have become steadily more refined, the models more complicated, and the

list of variables considerably longer. However, the EU has more than kept pace. The list of members has grown, in the form of three major enlargements, and the integration initiatives have also burgeoned. Taking into consideration the problems of dynamics – whereby firms invest ahead of enlargements, market integration measures, and so on – not to mention the highly variable quality of the data, the econometric evidence is understandably chequered. Estimating the true impact of European integration on FDI must be conducted within an inclusive model of determinants. So far, the evidence points to both Mark I and Mark II integration as having raised the amount of FDI coming into the EU members, compared with what otherwise would have been predicted (Clegg, 1996; Dunning, 1997a; European Commission, 1998a). As for intra-EU FDI, there is little doubt that the SMP has had a considerable positive effect on cross-border FDI flows.

For the most part, the success of the EU in revitalizing a flagging share of world FDI in the mid-1980s can be attributed to the SMP. Non-EU firms, particularly those from the USA and Japan, undertook market-seeking investment in the EU for defensive import-substituting purposes (Balasubramanyam and Greenaway, 1991). By moving production to the EU, these firms responded to the perceived trade diversion effects of the customs union.<sup>5</sup> While the trade diversionary effects of the Common Customs Tariff are often grossly overstated (the ‘tariff wall’ hypothesis) together with the issue of ‘tariff-jumping’, the importance to firms of being an insider in the EU are not. With insider status comes the ability to participate in the evolution of the rules. Much investment on the part of non-EU MNEs can be seen to have substituted *offensive* import-substituting investment for defensive import-substituting investment (Buigues and Jacquemin, 1994; Clegg, 1995). This strategy reflects the relative attractiveness to non-EU firms of the single market *vis-à-vis* other investment opportunities worldwide in the 1980s. However, certain non-EU firms, most notably Japanese automobile manufacturers, continued to invest for genuinely defensive import-substituting purposes throughout the 1980s, while many Japanese suppliers to these manufacturers followed their principal customers to Europe. Because of the weight of history and past import-substituting FDI to the EU, US affiliates in particular are now so well established in the EU that in the early 1990s nearly half of the total non-domestic assets of US multinationals were concentrated in the EU (European Commission, 1996).

The UK’s ability to attract inward investment may be related to the closer linguistic, cultural, legal and institutional ties between the UK and

the leading investor in Europe, the USA. Language is also often invoked to explain FDI by Japan in the UK, but many also ascribe importance to the UK's relatively low real wages and labour market flexibility. Naturally, this means that the UK attracts a certain type of FDI, seeking relatively low-cost production within the Single Market. This corroborates the view that FDI in the EU consists of a two-stage decision-making process – the decision to locate within the EU, followed by the decision to find the lowest-cost location. It also suggests that the UK's performance in attracting FDI is only good so long as the EU maintains its world attractiveness, and so long as the UK is seen as being central to the EU market.

During the 1970s and 1980s, the continued existence of NTBs and the segmentation of national markets within the EU caused import-substituting market-seeking FDI between member states. It is evident that this market-seeking FDI from investors within the EU should have declined, as national markets are no longer serviced using multi-domestic strategies. However, more subtle barriers continue to exist. Firms face entry barriers in each of the national EU locations simply by virtue of not having an adequate presence. This also helps to account for the enthusiasm for mergers and acquisitions within intra-EU FDI. The incentives for firms to engage in integrated production activities (reorganization and rationalized FDI) within the EU to improve competitiveness is indicated by the evidence that intra-EU FDI and intra-EU trade are complementary (Dunning, 1997b). Much of the complementarity derives from the fact that the proportion of intermediate trade rises within total trade. It follows that FDI outflows by EU member states should not be expected to lead to a corresponding decline in exports, nor increases in exports to lead to a decline in intra-EU FDI. Indeed, this has been corroborated by the available evidence (European Commission, 1996; Pain and Lansbury, 1996; Agarwal *et al.*, 1995).

For these reasons, the proportion of all FDI inflows into the EU contributed by member states has grown faster than extra-EU FDI, especially since 1988. Indeed, the level of intra-EU FDI as a proportion of total FDI inflows to the EU more than doubled between the mid-1980s and the early 1990s (Dunning, 1997a). Since the mid-1980s, foreign investment flows between member states have consequently exceeded inbound investment from outside the EU for every year except one (1987). Two studies undertaken for the European Commission indicate that this growth exceeded levels that would have occurred if the SEM programme had not taken place (European Commission, 1996). This growth suggests that EU-specific factors, such as the SMP, have probably had a considerably greater impact on intra-EU FDI than on extra-EU FDI. In contrast

to the motives for extra-EU investors, the growth in intra-EU FDI probably results from the positive impact of the SEM programme on market size, income levels and the structure of economic activity across the EU rather than from the direct effect of the SMP itself (Dunning, 1997b). It has been imperative for EU national firms to secure footholds in other EU countries in order to be prepared for the intensification of competition.

It is clear that much of the increase in intra-EU FDI took place as EU firms restructured their European operations following the SEM programme. To what extent such efficiency-seeking and strategic asset-seeking activities have contributed to the growth in intra-EU FDI is difficult to ascertain. However, data on European mergers and acquisitions provide some insights (see Table 6.3).

The EU has become the focus of global merger and acquisition activity (WTO, 1996). Since 1989, of the global annual sales of assets by mergers and acquisitions, over a third has consistently involved target firms located in the EU, reaching 48 per cent in 1991 and peaking at 56 per cent in 1992 (see Table 6.3). Within the EU, most acquired firms have been located in the UK (with asset sales valued at US\$24bn in 1995) and in France (US\$10bn in 1995). At the same time, of the global annual purchases of assets through mergers and acquisitions, around half have been made by acquiring firms from the EU. Most of these EU cross-border purchases were made by British (US\$18bn in 1995), German (US\$15bn) and French firms (US\$7bn). Intra-EU cross-border mergers and acquisitions increased from US\$20bn in 1994 to US\$26bn in 1995. By the mid-1990s, just under half of the total purchases made by EU firms were to acquire firms in other member states (WTO, 1996).

Cross-border mergers and acquisitions are now the prime method of foreign market entry within the EU (Dunning, 1997a, 1997b). For both EU and non-EU firms, these mergers and acquisitions are examples of efficiency-seeking and strategic asset-seeking investments. They occur as firms seek to restructure their operations in order to strengthen their competitive position *vis-à-vis* US, Japanese and other European firms, to generate greater returns to scale in production and sourcing, and to reposition their business activities on a pan-European, rather than national level (WTO, 1996). Some Japanese firms have also acquired assets in the EU in industries in which they were comparatively disadvantaged, such as pharmaceuticals, or those that offer complementary technologies or market access (Dunning, 1997b). In northern member states, for example, cross-border manufacturing merger and acquisition activity is mainly in technology-intensive sectors such as engineering,

**Table 6.3** Cross-border merger and acquisition sales and purchases (millions of dollars)

Economy	Sales from								Purchases by							
	1988	1989	1990	1991	1992	1993	1994	1995	1988	1989	1990	1991	1992	1993	1994	1995
<b>All countries</b>	<b>112 544</b>	<b>123 042</b>	<b>115 371</b>	<b>49 730</b>	<b>75 382</b>	<b>67 281</b>	<b>108 732</b>	<b>134 629</b>	<b>112 544</b>	<b>123 042</b>	<b>115 371</b>	<b>49 730</b>	<b>75 382</b>	<b>67 281</b>	<b>108 732</b>	<b>134 629</b>
of which:																
<b>European Union</b> as a percentage of EU total:	<b>29 513</b>	<b>47 107</b>	<b>43 056</b>	<b>23 984</b>	<b>42 626</b>	<b>27 134</b>	<b>38 627</b>	<b>48 604</b>	<b>64 167</b>	<b>61 286</b>	<b>65 224</b>	<b>31 756</b>	<b>30 932</b>	<b>34 658</b>	<b>51 895</b>	<b>60 953</b>
Austria	1	0	0	1	0	1	1	1	0	0	0	0	1	0	0	0
Belgium	1	3	2	5	1	1	2	3	1	3	0	0	3	1	2	6
Denmark	0	0	1	0	1	2	5	0	0	1	1	1	3	1	0	1
Finland	0	0	0	2	0	2	0	0	1	2	2	1	0	1	1	2
France	14	12	10	11	16	14	23	22	17	31	26	36	29	17	12	13
Germany	5	10	14	11	12	6	15	11	4	12	11	15	13	9	16	25
Greece	0	1	0	1	2	0	0	0	0	0	0	0	0	2	0	0
Ireland	2	0	1	1	1	5	0	0	2	2	1	2	1	2	4	2
Italy	11	4	9	5	7	10	8	5	2	3	6	7	20	2	2	5
Luxembourg	0	0	0	0	0	1	0	0	0	0	1	3	2	5	1	1
Netherlands	7	5	3	6	12	16	3	5	3	6	4	12	5	14	5	9
Portugal	0	1	1	0	1	1	1	0	0	0	0	1	1	0	0	0
Spain	3	4	9	14	8	4	7	2	0	0	3	1	2	1	1	2
Sweden	1	2	3	4	4	12	6	2	3	3	14	3	2	5	2	5
UK	55	58	47	38	35	26	28	48	66	36	31	19	20	41	52	30

Source: WTO (1996).

transport equipment and machinery. By comparison, in southern member states, cross-border mergers and acquisitions are mainly in relatively basic products such as textiles, clothing, timber and wooden furniture (European Commission, 1996).

### **Location of FDI within the EU**

The fact that intra-EU FDI in particular tends to prefer Benelux and France as investment locations may, in part, reflect a trend towards some geographical concentration in distribution and market-seeking activity. A geographic concentration has also been observed in a few technology- and information-intensive industries (Dunning, 1997b). For example, in the financial services industry (an information-intensive sector) the UK has maintained its comparative advantage as an investment location. This is primarily because of the continued, although declining, preference for US and Japanese MNEs to invest in, or acquire institutions in, the City of London. A geographical concentration of investment activity has also been observed in the pharmaceutical industry (a technology-intensive sector). In this industry, some 91.3 per cent of the cross-border merger and acquisition activity in the EU between 1989 and 1994 involved the six core EU countries, particularly the UK and France (Dunning, 1997b). Some companies are also exhibiting a trend to relocate their headquarters in major financial centres such as Frankfurt, Paris, London or Brussels.

On balance, apart from these instances, there is little evidence of a general increase in the geographical concentration of FDI within the EU following the SMP. In fact, evidence from cross-border mergers and acquisition data indicates that there has been a slight *decrease* in the geographical concentration of FDI. For example, in technology- and information-intensive sectors such as electronic components, office and computing machinery, industrial instruments and business services, there has been a trend for production to move away from the four largest EU countries, namely France, Germany, Italy and the UK (Dunning, 1997b). There has also been a modest decentralization of investment in other sectors. These include auto components and auto assembly, with Spain becoming a major new production location for Japanese, EU and US companies and joint ventures, and chemicals, where production has moved from Germany and the UK towards the Netherlands and Spain (Dunning, 1997b).

It would therefore seem that peripheral countries such as Spain and Ireland, and certain regions of the 'core' countries, centred on the Benelux countries, are indeed attracting greater inward investment.

Much of this investment has come from other member states. As MNEs of all nationalities restructure their European operations, and move production to where it can take place most efficiently, the likelihood is that this process will promote economic redistribution in the EU and may facilitate economic convergence. The EU is planning two major initiatives – the creation of EMU and the accession of the central and eastern European countries (CEECs). Both will affect FDI in Europe. However, of the two, the widening of the EU is more readily amenable to early analysis.

## **The future of integration and FDI**

### **The steps to eastern enlargement**

In many ways, the impact on FDI of the eastern enlargement of the EU has already been felt, through the fall of Communism and through the prospect of future stability envisaged by the EU and the candidate countries. In June 1993, the European Council at Copenhagen promised that the ten associated eastern and central European countries could join the EU, if they wished to do so. The Council also stated that accession would take place as soon as a country was able to assume the obligations of membership by satisfying the economic and political conditions. The Union's capacity to absorb new members, while maintaining the momentum of European integration, would also be an important consideration. Since then, all ten associated countries of central and eastern Europe have applied for membership, and the Council has initiated the procedure of consulting the Commission, in accordance with Article O of the Treaty on European Union. These countries are (in the chronological order they submitted their applications): Hungary, Poland, Romania, the Slovak Republic, Latvia, Estonia, Lithuania, Bulgaria, the Czech Republic, and Slovenia. Also on the agenda is the candidature of Cyprus, which the European Council has included in the phase of enlargement.

In trying to assess the enlargement eastwards of the EU, we have to remember the foundations of customs unions theory, and the probability of trade creation and trade diversion. Basically, the more similar the industrial structures of the existing EU and the candidate CEECs, the more probable is overall net trade creation, and the less would be trade diversion. Of course, the EU is now a more heterogeneous group of countries since its 'southern' enlargements of the 1980s; to this extent, the CEECs are likely to be competitive with the lesser-developed countries of Europe. It is important, to consider these economic factors and the



overall scale economies that the growth of the EU may encourage, even though the new entrants will be relatively poor.

However, from an economic point of view, the rationale for enlargement does not involve simply the internal economic gains, but also the external gains. These centre on the increased weight of the EU in the world economy, and the employment of this weight in all the diverse international negotiations (for example, the WTO), in which the EU is involved continually. At the Union level, an enlarged EU would expect to gain from an improvement in its terms of trade (the price of exports over the price of imports), in both visible and invisible trade. More important in the present context, the enlarged EU would be able to exert still greater attraction of world investment resources.

### **Foreign direct investment in the CEECs**

The top five CEEC applicants will probably get the lion's share of FDI into the CEECs. One of the main drivers is the extension of the 'SMP effect', witnessed for the EU12 in the late 1980s subsequent to the announcement of the Single Market Programme. In this sense, the SMP has been a successful 'confidence trick' in the best possible sense, through increasing foreign investor confidence. This effect can clearly be extended to the CEEC, but probably on a preferential basis, in that those countries with the lowest risk and highest return will benefit first, and most.

Foreign direct investment has a special role to play in the eastern enlargement of the EU. FDI is the principal agent for the transfer of technology, professional skills and management knowledge. It therefore has the potential both to integrate the economic systems of the eastern countries with those of the West, and to make a direct contribution to upgrading industries and national development. From the few reliable figures on FDI into the CEECs, it is clear that there are already instances of extensive 'private economic integration', mediated by multinational firms, as distinct from, and supplementary to, governmental initiatives regarding formal 'European integration'. Key questions can now be posed for the future. How is the composition of motives for FDI in the CEECs expected to change according to theory (for example, efficiency-oriented, resource-based, low-wage), as well as services following MNE clients?

### **Conclusion**

At the time of the creation of the European Union, trade was seen as the prime engine of European integration. This was largely on account of the existence of a solid body of trade theory that demonstrated the

value of customs union and free trade. There was no comparable framework within which the benefits of FDI could be demonstrated. Indeed, there was no theory of FDI, as distinct from portfolio capital flows. The ability of the European Commission to grasp the importance of FDI has been long incoming. International business is a relatively young subject area, and the training of most officials for a long time pre-dated the time when the principles of international business were widely promulgated. European integration was, from 1950s to the early 1980s, conceived in practice as an outgrowth of trade, notwithstanding the promising early vision of the free movement of all factors of production.

By the mid-1980s, FDI had been acknowledged as being central to EU prosperity in the world economy, linking the EU regional subsystem to the world system. As we have seen, the SMP (despite the controversies over the magnitudes of the internal benefits) does appear to have resulted in considerable benefits in terms of increased FDI. This applies to investment from outside the EU (although trade protectionism has played a part) as well as to intra-EU FDI, much of which may have either gone elsewhere in the world, or stayed in the domestic economy. To the extent that domestic investment has been replaced by intra-EU FDI, the objective of European integration will have been served. It is evident that while intra-EU FDI has intensified, there has been a decline in levels of inbound EU FDI since its peak in 1990. This may be attributable to indirect factors, such as the recessionary phase of the business cycle. However, such a decline in inflows from outside the EU should be expected as the announcement effects of the SMP wane, and as alternative investment opportunities in the world are targeted by firms.

Foreign direct investment in Europe is now a policy target and an instrument of macroeconomic development. With the accession of lower-income members to the EU, FDI has become perhaps the leading means of effecting economic upgrading and European integration. The power of FDI is that it promises a route to achieve key policy goals without significant government expenditure. All that is required is the adequate resourcing of key policies, such as competition policy, and, in the former monopolized industries, the resourcing of industry-specific regulation. Foreign direct investment will therefore remain central to Europe's continued growth as a regional force. What are the limits of this new Europe? No treaties or reports have ever tried to define the limits of Europe. Every generation has a different view, and has defined Europe for its own purposes. This would seem to guarantee a long run for the issue of foreign direct investment and Europe.

## Notes

- 1 We refer throughout to the European Economic Community (EEC), the European Community and the European Union as the EU.
- 2 Trade diversion is the replacement of a lower-cost world supplier by a higher-cost supplier within the integrated area.
- 3 Trade creation is the replacement of a higher-cost domestic supplier by a lower-cost supplier within the integrating area.
- 4 In this section we draw on recent analysis by Cross (1998).
- 5 While not essentially discriminatory, the effect of EU market integration has been to increase the disadvantage of distance for non-EU producers. This should be distinguished from trade protectionist measures; for example, such as those faced in certain industries by Japanese suppliers to the EU (European Commission, 1998b).

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# 7

## European Integration, Regional Subsystems and MNE Responsiveness

*with Jeremy Clegg, Adam R. Cross and Heinz Tüselmann*

Firms today operate in a global economy best analysed as comprising a number of interacting regional subsystems, of which the European economy – and primarily the European Union (EU) – provides a key example. These subsystems are cemented by ties of history, culture and trade, and, notably in the second half of the twentieth century, by political institutions and initiatives. Within each subsystem, foreign direct investment (FDI) plays a central role, in both integrating the individual subsystem and in providing linkages between subsystems through the activities and policies of multinational enterprises (MNEs). Of growing concern, not only to the MNEs themselves but also to national and supranational policy-makers, is to what extent these regional subsystems and the integration processes by which they are created shape patterns of investment within and between them. The EU is an exemplary laboratory in which to investigate the interplay between FDI and regional subsystem development.

Regional integration in Europe has coincided with a substantial expansion in the flow of FDI throughout the global economy since the start of the 1980s. This has been promoted to a considerable degree by the removal of many national barriers to capital movement via privatization programmes and market liberalization, especially in developing countries, and by the continued popularity of large-scale cross-border mergers and acquisitions among firms from the developed countries (Barrell and Pain, 1999). European countries have figured highly in these global FDI flows, and continue to do so. During the 1990s, the EU as a whole consistently received around half of the worldwide inbound investment to the developed countries (UNCTAD, 1998),

from both Member-State firms (intra-EU FDI) and firms from countries outside the EU (extra-EU FDI). Individual nation-states within the EU are also major players in worldwide flows. In 1996, Germany was third only to the USA and UK as an investing nation, while the UK was the second largest host (the USA was in first position), with Germany taking a relatively minor role (UNCTAD, 1998). The question arises to what extent the relative attractiveness of these countries as investment locations can be attributed to their membership of an advanced regional subsystem such as the EU. Of course, an understanding of how regional integration reconfigures business activity, especially cross-border investment, is of considerable concern to both national and supranational policy-makers. During regional integration, the relationship between FDI and the member states of a regional subsystem undergoes radical change. It is clear that nations which comprise a subsystem both compete and collaborate in order to maximize their individual and collective shares of footloose investment, and reap the benefits that MNEs can bring, while at the same time attempting to minimize the negative externalities of divestment. Of course, it is natural that national policy should be determined by national agendas, and MNEs traditionally have exercised a profound influence on both. But as subsystems consolidate, regional policies imposed to sway investment location decisions of MNEs in a manner that maximizes for the *region* the gains from investment may well prove detrimental to individual member states, especially those deficient in requisite country-specific locational advantages. The management of this potential conflict of interest poses clear challenges to national and supranational policy-makers alike.

The aim of this chapter is to investigate the strategic response of firms, in terms of their investment behaviour, to the subregional subsystems that have emerged as a consequence of the widening and deepening of European integration. A comparative analysis is made of the annual investment flows of Europe's premier investing countries, namely Germany, France, the Netherlands and the UK, together with the most important non-European investor in Europe, the USA, and how these flows are influenced by the various phases of European integration. This is achieved in the context of certain groupings of European host nations that can be regarded, to differing degrees, as subregional subsystems. These country groupings are the EU12, the EU15, the EMU (or 'Eurozone') countries, and five of the ten central and eastern European (CEE5) countries that are candidates for accession to the EU.<sup>1</sup> We then examine more closely the significance of these flows for

Germany, highlighting certain implications for policy that shifts in FDI flow can have for member states of a regional subsystem.

### **Regional subsystems and the MNE**

The world business system is an interaction of regional subsystems, each with its own internal dynamic. In recent times multicountry subsystems have been established as a direct consequence of policy-led integration initiatives adopted by governments, but this has not always been the case. Classic instances of integration have also occurred; for example, through the interdependencies that arise from preferential trading arrangements, common institutional systems and cultural links commonly found between former imperialist powers and their previous colonies (Agarwal, 1999). Such relations highlight the fact that member countries in a regional subsystem have not necessarily needed to be adjacent, although, at the time of writing, geographic proximity is a very strong driving force in regional economic integration. In some situations, subsystems are best examined at the single-country level, as in the case of the People's Republic of China (PRC). However, in most instances, federations of states are the most important units of analysis – the EU and the North American Free Trade Agreement (NAFTA) are cases in point. Finally, some subsystems are best analysed in terms of geographic regions – examples being Central and South America. These different units of analysis are aggregations of disparate subunits in terms of level of development (Beijing versus Ginqhai, Estonia versus Kazakhstan, Paraguay versus Argentina) and in terms of culture, geographical centrality and outside linkages. However, their coherence and distinctiveness lies in the internal convergence in economic and political systems of constituent member states, and in the relatively homogeneous responses of these states to the external world system.

Within and between these subsystems of nations, regions and blocs ranges the multinational enterprise. The flow of resources from the home country of these MNEs to their subsidiaries and affiliates abroad, which are owned and controlled either completely (wholly-owned subsidiaries) or in part (equity joint ventures), is FDI. FDI typically is undertaken to expand the capacity of existing foreign operations; to create new (greenfield) capacity; to acquire new subsidiaries, or to merge with established foreign enterprises (Davies *et al.*, 1999).<sup>2</sup> Although it is often argued that MNEs are above individual nations and owe their allegiance to none, this view is fallacious – in fact, the great majority of MNEs still derive from, and owe primary allegiance to, one key nation state (or two

in a tiny minority of cases), even when ultimate control may be shrouded by residence in a tax haven. As most MNEs are from the advanced EU countries, Japan and the USA, it is possible to view MNEs as being strongly related to the 'triad' of advanced blocs, interpenetrating each other as well as extending into less developed regions. Naturally, there are preferences in the direction of expansion of MNEs, some of which are clearly based on historical, cultural and linguistic ties. Instances of this include investment in Latin America by Spain and Portugal (respectively, in Spanish-speaking Argentina and Portuguese-speaking Brazil), by UK firms in the Commonwealth countries, and by US firms in the UK. However, it is evident that a rapid realignment in the traditional flow of FDI is now underway, the scale and direction of which is determined, at least in part, by the rate of economic and political integration within individual regional subsystems. Japanese, and latterly Korean, investments in the USA and EU, and the substantial inflow of FDI to the PRC in recent years represent important advanced guards in the reorientation of traditional patterns.

International business theory has contributed much to our understanding of the cross-border distribution of business activity. One useful approach is that of Dunning (1993), who proposes that a firm's propensity to engage in production abroad is determined by the interplay of ownership-specific advantages, locational advantages, and gains from the internalization of activity in the host market. Put simply, ownership-specific advantages, both tangible and intangible, enable the firm to out-compete domestic producers in the foreign market. However, gains from internalizing these advantages are required, otherwise 'arm's-length' contract-based means (such as licensing, franchising, inter-firm alliances and technical service agreements) will be used to service the foreign market. There must also exist certain location advantages (location-bound assets that are host-country or region-specific) in the target market which, when exploited in conjunction with ownership and internalization advantages, render FDI more preferable than servicing that market by exporting from the home or third-party countries. Locational factors thus determine which aspects of a country's immobile assets attract or retain FDI (European Commission, 1998). Some of the factors influencing the location of economic activity are presented in Table 7.1. Of course, the precise role of location factors in a particular investment decision depends greatly upon the firm in question, its nationality, its industry and its motives for investing (see Dunning, 1993 for an analysis). Nevertheless, certain generalizations in the context of regional integration can be made, as in Table 7.1.



**Table 7.1** Some factors influencing the location of economic activity

<b>At the sub-national and/or industry level</b>	<b>Likely effects of deepening regional integration within a subsystem</b>
Scale or scope economies in production leading to plant specialization	Become increasingly available as access to optimal production locations improves
Localization and agglomerative effects, leading to concentration and clustering in industries (such as specialized research or training facilities and institutes, availability of specialized suppliers and subcontractors, proximity to customers)	Become increasingly available as access to optimal production location improves
<hr/>	
<b>At the national level (country specific advantage)</b>	
Production and distribution of technologies	–
Relative real costs of factor inputs	Decrease, as competitive pressures drive down prices
Local production costs	Decrease, as competitive pressures drive down prices
Government taxes and incentives	Governments retain discretion, especially regarding incentives
Size, growth and composition of markets	Increase, at both national and regional levels
Supply and sociopolitical parameters	Slow to change
Technology, communications and transportation infrastructure	Slow to change; governments retain some discretion to influence
<hr/>	
<b>At the bi- or multilateral level</b>	
Comparative real exchange rates and interest rates	Harmonize across members, in time
Push factors from home economy	–
Guidelines and codes of conduct	Increasingly determined at the regional level
Supranational agreements (such as GATT)	Greater likelihood that regional subsystem will lobby for members as a whole
Transport and communication costs (which often increase with distance)	Decrease, when internal tariff and non-tariff barriers to trade are removed and telecommunication industries are liberalized
Extent and/or form of trade restrictions on goods and services	Decrease, particularly between member states

Source: Adapted from European Commission (1998).

It is natural that, at the outset of regional integration, location advantages will not be distributed evenly across member states of a subsystem. Certain countries will be at a disadvantage as business locations compared to others. The essence of the economic rationale of regional integration is undoubtedly its ability to redirect trade and investment activity within and between subsystems, with the expectation that the location advantage of the entire integrating subsystem is augmented, relative to others, and that discrepancies in locational advantages between member states are equalized. In other words, regional integration reconfigures the distribution of locational advantages across member states of a regional subsystem, such that the realignment of economic activity *net* improves social welfare for the subsystem as a whole. Overall, regional integration should not be regarded as a location advantage *per se*, but rather, a process that serves to change key determinants of the investment decision, especially those founded on economic considerations. It follows that national markets and areas whose location advantages are enhanced during regional integration should attract greater inflows of investment relative to those with diminishing locational advantages. Of the latter, certain member states may even witness net investment outflows during the process, as levels of inbound FDI fail to compensate for the outward investment of national firms and the divestment of existent foreign-owned operations.

### **FDI and policy issues in regional subsystem development**

In the 1980s, a major concern among developed countries was the international competitiveness of industries, firms and individual products. The 'competitiveness debate' was wide-ranging, and the most macro level considered was the national economy. At that time, questions related to the national organization of resources, policy objectives of government, government management of the economy (in terms of domestic production levels, employment, investment, competitiveness, technological capacity and so on), and the (purported) trade-offs in national economic goals, especially the perceived trade-off between national competitiveness and social goals (see, for example, Scott and Lodge, 1985). It is now reasonable to say that the unit of analysis for many purposes must be the region, followed by the country's place within the region. Of course, national differences in competitiveness are legitimate concerns of governments. Nevertheless, these problems increasingly have to be approached from within a framework in which the region is the global champion securing an appropriate share of world activity on behalf of its members. This regional strategy follows

from the increasingly interdependent nature of the world economy. Needless to say, such a strategy must place constraints on the independence of individual governments' actions. What is more, certain policy tools may be ineffective or even damaging when interdependency between countries within a subsystem is taken into account. Without co-ordination, there is always the risk that the strategies of national and regional governments to secure competitiveness may no longer be congruent.

Inward FDI can inject extra investment capital into a host economy and bring transfers of technical and managerial know-how. It can also stimulate competition among local firms. Together with demonstration effects and technological spillovers, this can enhance productivity levels within local industry. Probably of the greatest concern, especially to many of the industrial economies, is that foreign firms may generate additional local employment, both directly, in the operations they establish, and indirectly, through the linkages they develop with local firms. Whether or not these potential gains materialize depends greatly on the investing firm, its industry and its mode of entry. For member states of a regional subsystem, it is also becoming increasingly recognized that MNEs help to foster closer regional integration through their cross-border, 'arm's-length' trading activities, through their intra-firm transactions between business units in global corporate networks, and through their investment and divestment decisions within and between regional subsystems (UNCTAD, 1998). With the growing recognition of the benefits of attracting inward FDI there is a much more welcoming attitude among host governments (Dunning 1997a, b). Competition for investment capital has become rife.

Within regional subsystems, countries that previously enjoyed strong locational advantages may experience an erosion of this position relative to other member states as the integration process proceeds. This raises the concern that, as business activity shifts away from their economies (for example, as domestic firms relocate elsewhere within the subsystem, and as foreign firms divest or are discouraged from investing) so domestic investment will decline, jobs will be exported and the capacity to develop new technology (often regarded as the engine of economic growth) will be impeded. A general hollowing-out of an economy may ensue. Because of such concerns, as participation in regional subsystems becomes more prevalent, the advanced developed countries collectively face the prospect of having to reinvent themselves, and to do so in an environment in which regional objectives subsume national objectives to an ever-increasing degree. The difficulty for the

European Union, and for European integration in particular, is that there is no clear beacon of best practice at which to aim. The only vestige of comparative methodology to remain is the notion that Europe must strive to emulate the efficiency of the USA. Of course, this reasoning has largely underpinned the idea of European economic integration. This drive for reinvention is exemplified by the rise of North American integration, itself partly a counter-response to the success of integration in Europe. We now observe a trend towards *competitive* regional economic integration, in which regional integration becomes an instrument for securing increased regional shares of global investment, income and employment (Buckley *et al.*, 1999).

It is clear that a symbiotic relationship exists between economic integration and FDI. This, however, has yet to be fully analysed. A new generation of thought is needed, that extends international business theory to the regionalized and globalized economy. A better appreciation is required of the precise role that MNEs play in the allocation and distribution of economic activity across a regional subsystem such as the EU. In the context of Europe, the issue is one of what the EU's own position should be towards the MNEs that it both hosts and generates. The following sections aim to prove the relevance of the theoretical rubric by analysing the regional subsystems of the European Union, in terms of trends in FDI flows. We are able to discern how the development of the various overlying subsystems of the European economy have driven the progress of FDI within Europe, and between Europe and the rest of the world. The patterns of, and motivations for, FDI that we encounter in Europe are accordingly distinctive, yet nevertheless may still illuminate the likely impact of regional integration on FDI flows to, and within, regional subsystems less advanced than those of Europe.

### **Empirical evidence on FDI and the regional subsystems of Europe<sup>3</sup>**

At the inception of the European Economic Community in 1957, the share of world trade and the proportion of total trade that occurred between the members were paramount performance indicators. By the 1980s, the EU's share of world FDI had become the more pressing issue. Understanding European integration is now central to grasping the evolving relationship between investment strategies, FDI flows and the regional subsystems that Europe now comprises. Three distinctive phases in the economic development of Europe have been found to be

integral to FDI flows in the region, namely Mark I, Mark II and Mark III integration (Dunning, 1997a, 1997b). Each phase is characterized by the degree of widening and deepening associated with the integration process, and its concomitant effect on FDI. As several regional subsystems have now been formed within Europe, investment consists of a three-stage decision-making process – the decision to locate (or relocate) within Europe, followed which European regional subsystem to enter, and finally where to locate within that subsystem.

### **Mark I integration**

The first, Mark I, integration began in 1957 and extended until the mid-1980s. It concerned the establishment of the original Common Market of six European nations and its subsequent enlargements to twelve member States in 1986 (EC12). This phase involved the eradication of internal tariff barriers and quotas affecting intra-area trade in manufactured products, and the establishment of a common external customs tariff (or CET) for the EC. Only limited attention was paid to the existence of non-tariff barriers (NTBs) that proliferated as tariff barriers were removed and served to segment domestic European markets (European Commission, 1998).

Data on the impact of Mark I integration on extra and intra-EC FDI is very patchy. However, a major review by Dunning (1997a) of empirical work provides some insight. In particular, Dunning finds that, in absolute value terms, Mark I integration had a positive influence on both extra-EC and intra-EC FDI. For Germany, the stock of outward investment to the rest of the EC, as a percentage of its total outward investment, was 36.4 per cent in 1976 and 39.8 per cent in 1986. The corresponding percentages for UK outward investment was 8.0 per cent in 1962, rising to 21.9 per cent in 1974, and 21.1 per cent in 1984. The Netherlands, on the other hand, exhibited a small decline in the proportion of its total investment flow directed to the EC member states during this period, falling from 50.6 per cent in 1973 to 46.5 per cent in 1979, and 38.4 per cent in 1984 (Dunning, 1997a). For the UK especially, these figures reflect a significant reorientation of investments by MNEs during Mark I integration from the countries of the Commonwealth to the increasingly accessible markets of continental Europe. Among many German and Dutch firms, with less extensive colonial interests and longer membership of the EC, this perspective was already ingrained. Much of the intra-EC investment by EC firms was import-substituting market-seeking FDI between member states, caused by the continued existence of NTBs and the segmentation of national markets

within the region. However, and especially for UK firms, a sizeable proportion of investment was made in distribution to enhance trading activities. Indeed, during the period 1958 to 1985, growth in intra-EC trade far outstripped growth in intra-EC FDI (Dunning, 1997a). Mark I integration almost certainly promoted the servicing of EC markets by exporting between member states rather than by stimulating a change in the location of production.

While for most member states the proportion of total outward FDI directed to other member states increased during Mark I integration, MNEs from outside the EC, especially those from the USA and (but to a lesser degree) the European Free Trade Association (EFTA) countries still accounted for the majority of inbound FDI to the EC. Although estimates vary, it is thought that extra-EC FDI flows were around two-thirds of all inbound FDI to the region in the period 1980–4 (Yannopoulos, 1992), while others suggest that for the period 1975–83, this stood at 75 per cent (Molle and Morsink, 1991). Whatever the true figure, these estimates nevertheless demonstrate that non-EC firms were quick to locate production to the emerging regional subsystem. Much of this surge was defensive import-substituting FDI; that is, ‘tariff-jumping’ production relocated within the EC in order to avoid the CET and preserve market shares accumulated previously through exports. In effect, integration enhanced the locational advantages of countries previously served by exports from the US and other non-EC countries (European Commission, 1998). Relocating production to Europe also provided non-EC firms with proximity to local markets. This lowered transportation costs and improved the flow of market knowledge and information to and from the consumer. Through direct investment, rather than licensing-out to EC firms, non-EC MNEs retained and defended their market power through the control of brand names, trademarks and other ownership-specific advantages (Buckley and Casson, 1976).

The realignment of US corporate strategy towards the EC at this time is particularly noteworthy. In 1957, 15 per cent of the global stock of US FDI was located in the EC10 countries (as of 1973), which rose to 28.5 per cent in 1972 and 35.0 per cent by 1984 (Dunning, 1997a). Japanese firms responded similarly, though not quite to the same degree. Between 1955 and 1984, the proportion of Japan’s global stock of FDI in the same countries fluctuated between 11 per cent and 17 per cent, peaking at 16.6 per cent in 1974 and standing at 12.7 per cent in 1984 (UNTCMD, 1993). For two reasons, US (and other non-EC) MNEs were in a better position to promote Mark I integration, and to benefit from it, compared with native EC firms. First, non-EC firms were not encumbered

by entrenched market positions, and so were able to choose the most efficient production locations as they became available. Second, non-EC (especially US) MNEs were typically larger than their EC counterparts. Not only were potential gains from corporate integration commensurately greater for non-EC firms, but they were also more able to surmount the transaction costs of the remaining NTBs than were native firms. In addition, US firms in particular enjoyed greater organizational flexibility (Dunning and Robson, 1988). Mark I integration therefore allowed non-EC (especially US and Japanese) MNEs to attain scale economies in production at the regional (pan-European) level. Even so, these firms often continued to treat national markets as distinct and separate because of non-tariff distortions, particularly in marketing and service activities.

Regarding the geographical concentration of inbound FDI, prior to 1985, around 90 per cent of inbound FDI to the EC, from within and beyond the region, was concentrated in six 'core' Member States, namely Belgium, Luxembourg, France, Germany, Italy, the Netherlands and the UK. EC firms generally favoured Belgium and France and non-EC firms, Germany and the UK. Spain, and to a lesser extent Portugal, also enjoyed a surge in inward FDI, much of this in advance of their accession in 1986. The geographic distribution of inbound investment to the EC by US MNEs during Mark I integration is especially revealing. Throughout the 1950s, just under 60 per cent of total US manufacturing FDI in Europe was sited in the UK, but from 1960 this share declined steadily to less than 30 per cent by 1976 (Miyake and Thomsen, 1999). While the close cultural links between the two countries will have accounted for the UK's dominant position, and that some erosion of this was probably inevitable, the timing and duration of the downward trend also coincides with the period during which the UK was not a member of the EC. Since its accession in 1973 and full integration a few years later, the UK consolidated its position as the prime location in Europe for US manufacturers, and from 1991 to the time of writing, between 25 and 30 per cent of US manufacturing investment stock in Europe is consistently found in the UK (Miyake and Thomsen, 1999). This pattern serves to illustrate the discouraging effect that non-membership to a proximate regional subsystem (or a delay in membership) can have on inbound FDI to a particular economy from other non-member states.

To sum up the effects of Mark I integration, the evidence is strong that Mark I integration was accompanied by a significant net increase in both intra-EC and extra-EC FDI, with the greater effect on the latter.

Nevertheless, in the latter years of Mark I integration Western Europe's share of total inward investment flows declined quite substantially, from 41 per cent of the world's total in 1975 to 31 per cent in 1985 (Dicken, 1998). Much of this decline can be attributed to the growing importance of the USA as an investment host location at this time (see Table 7.2), particularly for Japanese and EC firms that enjoyed enhanced ownership advantages (and so were better able to compete with US firms on equal terms in their domestic economy) and for whom US markets had become more attractive than those in the EC. Not only had appropriate investment levels already been made by EC and non-EC firms in response to the initial, and sometimes once-for-all, effects of Mark I integration, but economic stagnation evident in Europe at the beginning of the 1980s was already acting as an investment disincentive. Other determinants such as market size, market growth and relative factor costs were at least as important, if not more so, than regional integration in shaping patterns of investment inflows to the area at this time.

### **Mark II integration**

The second phase of European regional integration, Mark II integration, is reckoned from 1986 or 1987 onwards, with the adoption of the Single European Act (SEA) in 1986 and the initiation of the Single Market Programme (SMP). The importance of this phase for FDI cannot be underestimated. The deteriorating competitiveness of Europe compared with that of the USA and Japan in the early 1980s had manifested itself in the EU as a slowdown in absolute output, high rates of inflation and unemployment; slow growth in investment and productivity; a lagging behind in new technologies on which global economic business seemed to be rested; and the preservation of national (rather than EC-wide) objectives (Cecchini, 1988). In response, the SEA sought to abolish all remaining tariffs and quotas, and to remove non-tariff barriers (NTBs) to trade and, significantly, to investment. By now, barriers to investment were understood to limit EU market integration, especially in many service sectors, the worst cases of which were enshrined as state monopolies (Clegg and Kamall, 1998). Three hundred or so detailed measures were contained in the Act, which aimed to create a Single European Market (SEM) by the end of 1992, and so enable companies to treat the EC as a single domestic market. These measures included the removal of such things as frontier controls, national differences in technical regulations, public procurement bias in favour of domestic producers, and differences in national tax levels and fiscal regimes (Davies *et al.*, 1999).



**Table 7.2** FDI inflows, by host region and economy, 1984–97 (US\$m and percentages)

Host region	1984–9 (annual average)	1990	1991	1992	1993	1994	1995	1996	1997 (est.)
<b>World (US\$m)</b>	<b>115 370</b>	<b>203 812</b>	<b>157 773</b>	<b>175 841</b>	<b>217 559</b>	<b>242 999</b>	<b>331 189</b>	<b>337 550</b>	<b>400 486</b>
<i>Percentage share of world:</i>									
Developing countries	19.2	16.6	26.2	29.1	33.3	39.3	31.9	38.5	37.2
Developed countries	80.7	83.3	72.3	68.4	63.8	58.2	63.9	57.9	58.2
EU12 countries									
share of total	31.3	46.1	45.2	46.9	34.7	25.7	30.2	24.3	23.8
share of developed	38.8	55.3	62.5	68.5	54.3	44.1	47.4	42.0	40.9
EU15 countries									
share of total	32.7	47.8	49.3	47.7	37.2	29.5	35.3	27.4	27.0
share of developed	40.5	57.4	68.2	69.7	58.3	50.6	55.2	47.3	46.4
USA (share of total)	38.1	23.5	14.0	10.7	20.0	18.6	17.7	22.6	22.7
Japan (share of total)	0.1	0.9	1.1	1.6	0.1	0.4	0.0	0.1	0.8

Source: Based on data from UNCTAD (1998, 1996).

This new wave of integration was non-discriminatory, in that it lowered or eliminated non-tariff barriers to the benefit of non-EC and EC investors alike. The anticipated effect on industries and firms were twofold; a reduction in costs and a heightening of competitive pressures. The former would accrue because of the elimination of NTBs. In particular, fewer customs delays, simplification in documentation procedures at national borders, and promoted access to more efficient production locations (from which to service larger markets) would permit firms to increase output, generate scale and learning economies, and better exploit their comparative advantage. The latter would lead to reduced prices and increased efficiencies as more firms from different member states compete directly in the larger market (Davies *et al.*, 1999). In such an environment, the location of production becomes critical, and the *a priori* expectation was that production would tend to gravitate towards areas with a relevant comparative advantage, and where production could occur most cost-effectively. National borders would retain their importance, but would become more permeable to trade and investment flow (Barrell and Pain, 1999).

Table 7.2 reveals that throughout Mark II integration the EC12 (and later the EU15) attracted an increasing proportion of world investment flow (including flows between Member States). This share rose from just under a third in the first half of the 1980s to almost half by 1990, reaching a maximum of 47 per cent in 1992, before declining gradually throughout the 1990s to just under a quarter of global investment flow observed by the middle of the decade (UNCTAD, 1998). The high proportion of investment flow to the developed countries received by the EC highlights its centrality in the global investment strategy of firms at this time. For the majority of years since the late 1980s, around half of the annual FDI inflows to the developed countries were inflows to the EC12 countries, with the exception of 1992 when this figure exceeded two-thirds (UNCTAD, 1998). In absolute value terms, the period of greatest growth occurred between 1986 and 1990 (the years immediately following the inception of the SEM), during which time there was a fourfold increase in total inbound FDI to the EU12, from 17bn ecu to 72bn ecu (see Table 7.3).

Although the EC sustained its *share* of global annual FDI flows over this period, it is important to note, however, that there was a slowdown in the annual inflow of investment in absolute value terms over the final three years of Mark II integration (see Table 7.3). The recessions experienced by several of the larger member states in the early 1990s had rendered them less attractive to inward market-seeking investors,

**Table 7.3** Intra- and extra-EU12 FDI, 1984–93 (millions of ECU and percentages)

Host region	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Total inbound EU12 FDI	10 365	11 660	17 568	25 335	40 458	62 428	72 048	55 837	60 924	51 873
<i>Percentage of inbound FDI originating from:</i>										
Intra-EU12	40.6	51.0	59.5	48.7	55.2	55.2	54.5	62.5	63.0	59.5
Extra-EU12	59.4	49.0	40.5	51.3	44.8	44.8	45.5	37.5	37.0	40.5
<i>Percentage of total extra-EU FDI originating from:</i>										
EFTA	27	32	46	30	47	30	34	33	18	17
USA	48	31	37	18	14	35	28	26	52	43
Japan	6	13	7	12	14	16	17	8	8	8
Other	19	24	10	40	25	19	21	33	23	32
Ratio intra-EU12/outbound EU12 FDI	0.24	0.39	0.48	0.40	0.70	1.04	1.91	1.31	2.16	1.41

Source: Based on data from the European Commission (1995).

while economic downturn in the major home countries outside of the EC caused their MNEs to scale down or delay their investment intentions. In addition, by this time, many firms had already realized their EC investment ambitions and fears that the SMP effectively would discriminate against firms without investment in the EC had proved to be largely unfounded. These factors combined to dilute the locational advantages of the EC as an investment location, and have a negative impact on the value of inbound market-seeking investment to the region. Nevertheless, even after normalizing for differences in the growth of GDP between the EC member states and the rest of the world, it is evident that the EC still attracted a disproportionately large amount of global investment activity during Mark II integration (Dunning, 1997b).

For the most part, the success of the EC in the mid-1980s in revitalizing a flagging share of world FDI can be attributed to the SMP. Let us consider first the impact of the SMP on extra-EC FDI. Table 7.3 provides a percentage breakdown of the total extra-EU FDI by home country. It demonstrates that, during early Mark II integration, the US and Japan contributed comparatively little (less than 20 per cent from 1987–8) and the EFTA countries comparatively more extra-EC FDI to the EU12. The main period of Japanese FDI in the EC took place between 1987 and 1990, reaching a peak of 17 per cent of all extra-EC FDI inflows in 1990 before tailing off to less than 10 per cent by 1993. In contrast to most Japanese firms, because of extensive past import-substituting FDI to the EC, US affiliates had become well established in the EC and did not respond to the SMP to quite the same degree as those from Japan. Nevertheless, the contribution of US firms grew during the second half of Mark II integration, especially from 1989 onwards, so that by 1992 over half of the inflow of FDI from outside the member states originated from the USA. A similar trend is also revealed in Table 7.4, which shows the percentage of the USA's global FDI directed to the EU12 countries.<sup>4</sup> By the early 1990s nearly half of the total non-domestic assets of US multinationals was concentrated in the EC (European Commission 1996).

Much of the investment in the EC by non-EC firms was market-seeking investment for defensive import-substituting purposes (Balasubramanyam and Greenaway, 1991). These firms responded to the threat of diminution of their relative competitive positions (that is, their ownership-specific advantages) by adopting a physical presence in the region. The incentive for defensive FDI was greatest for Japanese firms, as in general they were some way short of their desired capital stock at the inception of the SMP, primarily because they were relative latecomers to the area,

**Table 7.4** Geographical breakdown of FDI flows of leading investing countries, 1986–97 (millions of ECUS and percentages)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
<b>Germany total world FDI</b>	8 504	6 951	9 365	11 365	16 434	16 239	14 378	13 853	14 488	28 066	22 239	26 222
<i>Percentage to:</i>												
EU15							69.0	72.3	59.1	61.4	47.9	43.5
EU12	36.9	24.2	36.3	60.3	67.3	69.9	64.0	66.4	55.1	55.7	34.4	40.7
EMU							51.9	58.9	39.9	38.3	34.4	32.9
EU non-EMU							17.1	13.4	19.2	23.1	13.5	10.6
CEES							5.7	8.1	9.3	7.3	10.2	7.9
<b>France total world FDI</b>	5 333	7 550	10 816	16 408	21 204	16 583	14 519	10 393	19 321	14 393	22 889	29 757
<i>Percentage to:</i>												
EU15							81.9	57.8	53.5	62.6	51.1	52.4
EU12	33.8	53.9	63.4	62.2	67.6	53.0	80.0	55.3	52.8	63.4	48.6	52.6
EMU							71.8	47.8	48.1	53.8	43.7	31.9
EU non-EMU							10.1	10.1	5.4	8.9	7.4	20.5
CEES							1.5	2.1	0.7	6.4	2.3	1.8

<b>UK total world FDI</b>	10 742	16 766	19 000	18 439	2 639	4 760	6 868	9 124	7 724	16 621	6 742	n.a.
<i>Percentage to:</i>												
EU15							92.7	48.5	65.9	30.2	134.9	n.a.
EU12	8.8	0.2	22.6	19.6	85.1	34.2	86.9	53.4	58.4	26.7	129.7	n.a.
EMU							83.3	44.1	57.5	24.8	131.7	n.a.
EU non-EMU							9.3	4.4	8.4	5.4	3.4	n.a.
CEE5							1.8	1.7	5.0	0.4	4.0	n.a.
<b>USA total world FDI</b>	8 797	9 820	3 850	22 608	6 873	12 851	20 301	35 106	41 331	34 282	20 861	50 734
<i>Percentage to:</i>												
EU15							45.1	56.8	53.5	64.2	51.0	52.3
EU12	18.2	18.4	65.2	73.2	-67.1	67.3	42.5	48.8	50.9	63.7	49.4	51.1
EMU							n.a.	n.a.	31.8	22.5	25.1	20.9
EU non-EMU							n.a.	n.a.	21.7	17.3	25.9	31.4
CEE5							n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes: Data excludes reinvested earnings; 1997 data are estimates.

Source: Calculated from European Commission (1995, 1999).

certainly compared to US and EFTA firms (Clegg and Scott-Green, 1999). By moving production to the EC, non-EU firms responded to the perceived trade diversion effects of the customs union.<sup>5</sup> For several reasons, it was likely that the SMP programme would hinder exporting to the area from a non-Member State. Although the removal of physical barriers and the reduction in technical barriers in the EC had the equivalent effect to that of an internal tariff barrier reduction, to the advantage of all firms servicing EC markets through exports, cost benefits were anticipated to be greater for firms engaged in intra-EC trade than those exporting to EC markets from a non-Member State. Firms lacking production facilities in the EC would also be disadvantaged by changes in external trade policy (such as voluntary export restraints, local content requirements, anti-dumping rules and other import restrictions). While the trade diversionary effects of the CET are often grossly overstated (the 'tariff wall' hypothesis), together with the issue of 'tariff-jumping', the importance to firms of being an insider in the EC were not. With insider status came the ability to participate in the evolution of the rules of the EC, particularly in regard to the development of product standards and the formulation of directives.

By the late 1980s and early 1990s, however, much of the investment by non-EC firms in the region, especially by US firms, was increasingly for *offensive* import-substitution purposes (Buigues and Jacquemin, 1994; Clegg, 1995). This strategy reflected the relative attractiveness to non-EC firms of the single market *vis-à-vis* other investment opportunities worldwide at this time. The SEM had generated new market opportunities and improved market access, most evident in sectors where entry barriers had previously been substantial (such as banking, insurance and in the public utilities) or where policy favoured local firms (such as the public procurement of construction services). However, certain non-EC firms, most notably Japanese automobile manufacturers, continued to invest for genuinely defensive import-substituting purposes throughout the 1980s, and many Japanese suppliers to these manufacturers followed their principal customers to Europe, again for market-seeking motives.

As Table 7.3 illustrates, Mark II integration was characterized by a general waning in the share of extra-EC FDI from the USA and EFTA, as intra-EC FDI flows surged. Taking 1984 as the starting point, the first year for which official comparative data were available, intra-EC FDI rose from 41 per cent to 55 per cent during 1984–90, and then to over 60 per cent in 1991–3 (European Commission, 1995). Indeed, the level of intra-EC FDI as a proportion of total FDI inflows to the EC more than

doubled between the mid-1980s and the early 1990s (Dunning, 1997a). Since 1985, foreign investment flows between member states has exceeded inbound investment from outside the EC for every year except one, 1987. The dramatic redirection of investment strategy towards member states by EC firms during this phase of integration is strikingly illustrated by examining the ratio of intra-EC12 FDI to outbound EC12 FDI (made by firms from member states to the rest of the world) (see Table 7.3). Between 1984 and 1988, this ratio was less than one, indicating that in each of these years Member State firms invested more equity outside the region than within it; over four times more so in 1984. However, this ratio increased from 1985 onwards, reaching approximate parity in 1989, and rose each year until 1992, by which time the flow of investment by member state firms to EU12 markets was more than twice that of investment to non-Member States.

Differences by home country can be observed in the degree to which firms realigned their investment activity at this time. Table 7.4 shows the share of global FDI flow invested in the EC12 countries by German, French and British firms between 1986 and 1992. These data exclude reinvested earnings and therefore represent new investments by MNEs. Although there is considerable variance in the data, reflecting the lumpiness in FDI flows for any given year, it is nevertheless clear that, at the outset of Mark II integration, French and German firms were directing a greater proportion (around a third) of their FDI to Member States than were their British counterparts. This share rose steadily, to reach two-thirds by 1990. Although UK firms were making substantial new investments overseas, the bulk of this was beyond the EC12 countries. In 1990, and again in 1992, UK firms did commit over four-fifths of their FDI activity to the EC12, but in both years this was a share of a much-reduced value of global FDI. In 1990, there was a dramatic downturn in the value of UK FDI, when reinvested earnings are removed from investment data. Poor performance of the British economy at this time may have discouraged firms from exploring non-domestic business opportunities. For France and Germany, however, the outward flow of FDI continued more or less unabated, and by 1992 over 80 per cent and 64 per cent of this, respectively, was directed to other Member States. A significant proportion of this was aimed at Austria, Finland and Sweden in advance of their accession in 1995.

Two studies undertaken for the European Commission indicate that the growth in both intra- and extra-EU FDI surpassed levels that would have occurred if the SMP had not taken place (European Commission, 1998). However, the investment flow data presented above suggests



that EC-specific factors, such as the SMP, have probably had a considerably greater impact on intra-EC FDI than on extra-EC FDI. In contrast to the motives for extra-EU investors, the growth in intra-EU FDI probably resulted from the positive impact of the SMP on market size, income levels and enhanced opportunities for economic activity to be restructured across the EU, rather than from the direct effect of the SMP itself (Dunning, 1997b). In order to benefit from these positive impacts it was imperative for EU national firms in particular to restructure existing market-oriented operations. For EU firms, efficiency-seeking considerations eclipsed market-seeking motives at this time. EU firms needed to secure footholds in other EU countries and establish a market position in order to be prepared for the intensification of competition that the SEM was expected to initiate (especially in highly fragmented markets), and to take advantage of scale economies generated by treating member states as a single market (Nunnenkamp *et al.*, 1994). Of course, non-EU firms already active in the region were similarly affected, but to a lesser degree, as many had already optimized their investments at the time of entry to meet the demands of the SEM.

Enhanced accessibility to low-cost production locations across Member States as a result of the SMP was expected to allow firms to relocate key stages of production to a limited number of sites from where multiple national markets could be supplied. This would take place according to the comparative advantage of Member States or areas – that is, to where it would benefit most from local factor endowments. By reorganizing their activities across intra-regional borders, firms would generate scale economies, increase output and spread risk, resulting in lower costs and a more efficient operating position. Ownership advantages would consequently be bolstered, allowing firms to compete more effectively in the SEM and beyond. When firms previously were obliged to produce inside fragmented national markets, this reorganization took the form of divestment from certain Member States and a corresponding investment in others. However, it also involved expansion through mergers and acquisitions. The locational strategies of efficiency-seeking firms would be expected to be less influenced by the size and potential of a particular market and more by its comparative advantage arising from its factor costs, technological, transport and communication infrastructure. For this reason, efficiency-seeking firms tended to be more footloose in their value-added activities (Dunning, 1993).

It is difficult to ascertain to what extent efficiency-seeking activities – as EC firms restructured their European operations following the SMP – contributed to the growth in intra-EC FDI. However, data on European

mergers and acquisitions provide some insights (see Table 7.5). During the 1990s, the EC became the focus of global merger and acquisition activity (WTO, 1996). From 1989 onwards, of the global annual sales of assets by mergers and acquisitions over a third consistently involved target firms located in the EC. This figure reached 48 per cent in 1991, and peaked at 56 per cent in 1992 (Table 7.5). Many mergers and acquisitions of EC firms occurred as firms sought to restructure their operations in order to strengthen their competitive position *vis-à-vis* US, Japanese, and other firms in Europe, to generate greater returns to scale in production and sourcing, and to reposition their business activities on a regional (or pan-European), rather than national level (WTO, 1996). Acquisition was the preferred type of FDI entry primarily because it is a time-saving route. This was a very important consideration for firms striving to adopt competitive bases, and to diversify rapidly and effectively within the emerging Single Market. A significant, although indeterminate, proportion of acquisitions also took place for strategic purposes. For example, some Japanese firms acquired assets in the EU in industries in which they were comparatively disadvantaged, such as pharmaceuticals, or those that offered complementary technologies or market access (Dunning, 1997b).

We turn now to examining the geographic distribution of inbound FDI to the region. The major recipients of total inward investment to the EU in the early 1990s were the UK (with around 23 per cent of the total), followed by France (15 per cent), Belgium/Luxembourg (14 per cent) and Spain (12 per cent). By the end of Mark II integration, an economic hub of the EU had emerged, consisting of northern Italy, northern Spain, southern Germany, central France and south-east UK, in which the centralization of manufacturing and distribution (due to lower transportation costs and proximity to many consumers) was taking place (Dicken, 1998).

The UK consistently received over 40 per cent of all extra-EU FDI inflows between 1986 and 1992 (European Commission, 1996). On the other hand, the UK was significantly less important as a site for FDI from other Member States, absorbing less than 10 per cent of intra-EU FDI flows in 1993. Intra-EU FDI tended to favour Belgium/Luxembourg and France, closely followed by Spain, with the UK in trailing position.

Much of the UK's ability to attract inward investment can be attributed to the closer linguistic, cultural, legal and institutional ties between the UK and the leading investor in Europe, the USA.

However, during this period, the UK had a programme of deregulation and state-sector privatization that was relatively advanced, certainly

**Table 7.5** Cross-border merger and acquisition sales and purchases (millions of dollars)

Economy	Sales from								Purchases by							
	1988	1989	1990	1991	1992	1993	1994	1995	1988	1989	1990	1991	1992	1993	1994	1995
<b>All countries of which:</b>	112 544	123 042	115 371	49 730	75 382	67 281	108 732	134 629	112 544	123 042	115 371	49 730	75 382	67 281	108 732	134 629
<b>European Union</b>	29 513	47 107	43 056	23 984	42 626	27 134	38 627	48 604	64 167	61 286	65 224	31 756	30 932	34 658	51 895	60 953
<i>as a percentage of EU total:</i>																
Austria	1	0	0	1	0	1	1	1	0	0	0	0	1	0	0	0
Belgium	1	3	2	5	1	1	2	3	1	3	0	0	3	1	2	6
Denmark	0	0	1	0	1	2	5	0	0	1	1	1	3	1	0	1
Finland	0	0	0	2	0	2	0	0	1	2	2	1	0	1	1	2
France	14	12	10	11	16	14	23	22	17	31	26	36	29	17	12	13
Germany	5	10	14	11	12	6	15	11	4	12	11	15	13	9	16	25
Greece	0	1	0	1	2	0	0	0	0	0	0	0	0	2	0	0
Ireland	2	0	1	1	1	5	0	0	2	2	1	2	1	2	4	2
Italy	11	4	9	5	7	10	8	5	2	3	6	7	20	2	2	5
Luxembourg	0	0	0	0	0	1	0	0	0	0	1	3	2	5	1	1
Netherlands	7	5	3	6	12	16	3	5	3	6	4	12	5	14	5	9
Portugal	0	1	1	0	1	1	1	0	0	0	0	1	1	0	0	0
Spain	3	4	9	14	8	4	7	2	0	0	3	1	2	1	1	2
Sweden	1	2	3	4	4	12	6	2	3	3	14	3	2	5	2	5
UK	55	58	47	38	35	26	28	48	66	36	31	19	20	41	52	30

Source: Calculated from WTO (1996).

more so than in other Member States. The UK also had (and continues to have) a corporate structure that promotes take-overs (unlike several continental countries) and at times had a comparatively weak currency (which lowered the price of UK assets for firms from countries with stronger currencies). UK firms were for these reasons attractive merger and acquisition propositions. Language is also often invoked to explain FDI by Japan in the UK, but many also ascribe importance to the UK's relatively low real wages and labour market flexibility. Naturally, this means that the UK attracts a certain type of FDI that is seeking relatively low-cost production within the Single Market. It also suggests that the UK's performance in attracting FDI is only good as long as the EU maintains its world attractiveness, and as long as the UK is seen as being central to the EU market.

The fact that intra-EU FDI in particular tended to prefer Benelux and France as investment locations may, in part, reflect a trend towards some geographical concentration in distribution and market-seeking activity. A geographic concentration has also been observed in a few technology and information-intensive industries (Dunning, 1997b). For example, in the financial services industry (an information-intensive sector) the UK maintained its comparative advantage as an investment location. This was due primarily to the continued, although declining, preference for US and Japanese MNEs to invest in, or acquire institutions in, the City of London. A geographical concentration of investment activity has also been observed in the pharmaceutical industry (a technology-intensive sector). In this industry, some 91.3 per cent of the cross-border merger and acquisition activity in the EU between 1989 and 1994 involved the six core EU countries, particularly the UK and France (Dunning, 1997b). Some companies are also exhibiting a trend to relocate their headquarters to major financial centres such as Frankfurt, Paris, London or Brussels.

On balance, apart from these instances, there is little evidence of a general increase in the geographical concentration of FDI within the EU following the SMP. In fact, evidence from cross-border mergers and acquisition data indicates that a slight decrease in the geographical concentration of FDI occurred. For example, in technology- and information-intensive sectors such as electronic components, office and computing machinery, industrial instruments and business services, there was a trend for production to move away from the four largest EU countries, namely France, Germany, Italy and the UK (Dunning, 1997b). There was also a modest decentralization of investment in other sectors. These include auto components and auto assembly, with Spain becoming

a major new production location for Japanese, EU and US companies and joint ventures; and chemicals, where production moved from Germany and the UK towards the Netherlands and Spain (Dunning, 1997b). It would therefore seem that peripheral countries such as Spain and Ireland, and certain regions of the 'core' countries, centred on the Benelux countries, did attract greater inward investment following the onset of Mark II integration. Much of this investment has come from other member states. As MNEs of all nationalities restructured their European operations, and moved production to where it could take place most efficiently, the likelihood is strong that this process promoted economic redistribution in the EU and facilitated economic convergence.

### **Mark III integration**

The third phase of European integration, Mark III integration, began with the Maastricht Treaty, which came into effect on 1 November 1993, and is still ongoing. In addition to the accession in 1995 of Austria, Finland and Sweden to create the EU15, this phase involves two major initiatives – the introduction of monetary union across eleven member states in 1999, and the planned accession of a number of candidate central and eastern European countries (CEE5, see Note 1). Although a timetable for their accession has yet to be agreed, an interim period is in force, in which some of the benefits of integration have been extended to these countries, through 'Europe Agreements' and through the Central Europe Free Trade Agreement (Agarwal, 1999). These provide for free trade (with greater liberalization of trade in goods than in services), liberalization in capital movements, and economic aid. Although both the deepening and widening of Mark III integration is certain to affect FDI in Europe, the widening of the EU (for which there are precedents) is more amenable to early analysis.

The rate of growth in global FDI flows accelerated dramatically during the period of Mark III integration. Since 1993 the annual worldwide inflows of FDI to host economies has almost doubled, from US\$217bn in 1993 to an estimated US\$400bn in 1997 (UNCTAD, 1998). As Table 7.2 reveals, the vast majority of investment flows continue to be made by firms from the developed countries and are directed to other developed economies. However, in recent years, this share has receded, as the developing countries attracted a greater proportion of world investment flows; from 29 per cent in 1992 this has risen steadily to around 38 per cent in 1996, with the PRC (12 per cent of worldwide flow) and Brazil (3 per cent) being major beneficiaries in 1996 (UNCTAD, 1998). Nevertheless, the ability of the EU to maintain its pre-eminent position in

global FDI flows remains undiminished. Inflows to the region increased from 55bn ECU in 1993 to an estimated 92bn ECU in 1997 (European Commission, 1999). It has been suggested that, as in the mid-1980s, following the announcement of the date of completion of the SEM in 1987, a significant proportion of inbound investment occurred in advance of Economic and Monetary Union (EMU) (UNCTAD, 1998).

Up to 1995, the EU15 countries continued to attract over a third (35.3 per cent) of world investment flows (eclipsing the most important single host nation for FDI, the USA, by almost 20 percentage points), and this has declined only modestly to an estimated 27 per cent in 1997 (UNCTAD, 1998). It is clear that the surge in investments to the developing countries has primarily been at the expense of the non-EU developed economies. A reticence to invest in the ailing economies of Asia may help to explain in part the dominance of the EU in global investment patterns, although the strong economic recovery that took place in the EU in the 1990s, and the strengthening of macroeconomic indicators prior to EMU probably contributed significantly to this performance as well. Three leading interconnected and overlying regional subsystems can now be recognized in Europe.<sup>6</sup> The first, and most obvious, consists of the fifteen member states of the European Union (EU15), which itself has grown from the smaller EU12 subsystem.

As Table 7.6 shows, the proportion of inbound FDI to the EU made by Member States during this phase of integration has remained more or less constant at around 60 per cent, the figure achieved during the latter years of Mark II integration. German and French companies in particular have repositioned themselves in Europe, especially in the advanced member states (Agarwal, 1999) (see Table 7.6). Outbound investment from these countries rose dramatically after the mid-1990s, and, of this,

**Table 7.6** Intra- and extra-EU15 FDI flows, 1993–7 (millions ECU and percentages)

	1993	1994	1995	1996	1997
Total inbound FDI to EU	55 893	57 735	80 344	69 962	92 577
<i>Percentage of:</i>					
Intra-EU15	61.5	62.5	53.7	59.3	61.1
Extra-EU15	38.5	37.8	46.3	40.6	38.9

Source: European Commission (1999).

over half was directed consistently towards other EU15 countries (although a slight decrease in this was observed in 1996 and 1997 for both countries). The majority of this intra-EU FDI has taken the form of cross-border mergers and acquisitions – now the prime method of foreign market entry in the EU (Dunning, 1997a, 1997b). Intra-EU mergers and acquisitions have tripled in value terms since 1996 (Miyake and Thomsen, 1999). Within the EU, most acquired firms have been located in the UK (with total asset sales valued at US\$118.9bn between 1994 and 1997), followed by France (US\$37.1bn) and Germany (US\$33.2bn) (UNCTAD, 1998). At the same time, of the global annual purchases of assets through mergers and acquisitions, around half have been made by acquiring firms from the EU. Most of these EU cross-border purchases were made by British (US\$26bn in 1997), French (US\$12bn) and German firms (US\$10bn) (UNCTAD, 1998). By the mid-1990s, just under half of the total purchases made by EU firms were to acquire firms in other member states (WTO, 1996). These figures reflect a continuation in the strategies adopted during Mark II integration; that is, the need to strengthen quickly competitive positions and to generate greater economies of scale. However, over this period there has also been a rise in *nationally* confined mergers and acquisitions in Europe. It is likely therefore that many pan-European mergers and acquisitions are as much driven by strategic issues and imperatives as by regional integration *per se* (Miyake and Thomsen, 1999).

The second regional subsystem in Europe consists of the EU countries that have been accepted into the EMU. These 'Eurozone' economies constitute a subsystem superjacent to the EU15 countries in so far as monetary union is likely to have a non-trivial although as yet indeterminate effect on both intra-EU and extra-EU FDI. For example, it is argued that the introduction of the EMU will lead to greater price transparency and lower transaction costs, which in turn may facilitate and accelerate capital flows to members and promote the cross-border merger and acquisition of firms located there (UNCTAD, 1998; Miyake and Thomsen, 1999). Exchange-rate stability and macroeconomic stability (for example, in respect to inflation and interest rates) may also attract extra-EU FDI to the Eurozone countries that might otherwise have been destined for non-EMU countries in the EU, such as the UK. To what extent investors to the EU will prefer the Eurozone countries to non-Members is difficult to ascertain. The *a priori* expectation is that this will only occur if exchange-rate volatility has a significant deterrent effect on trade, which would encourage both EU and non-EU firms to substitute local production for exporting; that is, as a defensive

market-seeking stratagem. However, empirical studies, though limited in number, show no such effect (Miyake and Thomsen, 1999). Cross-border merger and acquisition activity involving the UK, for example, is still at very high levels. In 1997, by which time the reluctance of the British government to participate in the first wave of monetary union had been enunciated, foreign firms acquired an estimated US\$51bn of the assets of UK firms (UNCTAD, 1998). This constituted almost 21 per cent of global merger and acquisition activity in that year, and was only surpassed by the USA, in which US\$58bn of assets were sold to foreign acquirers. Furthermore, as Table 7.4 reveals, if anything, non-EMU countries in the EU actually attracted a greater share of outbound FDI, certainly from two leading investing nations, the USA and France, in the two years preceding the EMU. There seems little doubt that other factors hold greater sway over patterns of inbound-EU FDI than membership of the EMU, though it is too early to tell whether or not this will continue to be the case.

The third subsystem in Europe consists of five leading central and eastern European countries. The recognition that these countries can be regarded as a discrete subsystem arises from the notion that policy-led initiatives adopted by governments are not necessarily prerequisites for regional integration. Economic integration can also take place independently of such initiatives, through transactions and events that promote greater interdependence and cohesion among economies (UNCTAD, 1998). In the case of the CEE countries, this has not occurred formally, but rather as an outcome of the adoption of similar policies and laws across the region in order to fulfil the terms of membership of the EU as set out in the various Europe Agreements (Agarwal, 1999). This has encouraged a degree of economic convergence and harmonization in policy, both between the CEE5 countries themselves, and between the CEE5 and the EU. Any preconception, however misguided, on the part of potential investors (especially those unfamiliar with the region) that individual CEE5 countries possess equivalent location advantages as a consequence of, for example, geographic proximity to both the EU and former Soviet markets, or potential membership of the EU, merely reinforces the view that the CEE5 countries effectively constitute a regional subsystem.

German and (but to a lesser extent) Austrian firms are the dominant investors by far in the CEE5 countries. In each year since 1992, over 5 per cent of total German FDI flows were directed to the CEE5 countries, and in 1996 this figure reached just over 10 per cent (see Table 7.4). This commitment to CEE5 markets outstrips that of the other two leading



European investing nations, the UK and France. Clearly, geographic proximity has a strong positive effect here (Agarwal, 1999).<sup>7</sup> Germany has common borders with Poland and the Czech Republic, and Austria with the Czech Republic, Hungary, Slovakia and Slovenia. Historically, Germany and Austria were large trading partners of the CEE countries prior to 1939, and the cultural barriers between them consequently are low. German and Austrian firms consequently experienced lower transaction costs and were therefore natural investors after the removal of artificial barriers to capital mobility that had been created by the former political systems of the CEE countries. In recent years, the growth prospects of the CEE countries have improved considerably, and with an improving investment climate, greater inflow of market-seeking FDI will have been promoted, despite the fact that transition-related recession remains a problem in several of these countries. The CEE5 countries also benefit from preferential access to EU markets, and from assistance from the EU with respect to investment promotion, economic and technical aid, as well as scientific, industrial and monetary co-operation at the institutional level. These policies will promote market-seeking and efficiency-seeking FDI. However, on balance, investment to the CEE is still relatively low and irregular. Obstacles to investment continue to prevail, particularly in the legal and regulatory frameworks, and the lack of experience in implementing FDI facilitation measures. Moreover, as much of the FDI to these countries is privatization-based, there is a certain degree of lumpiness in inflows, subject to the availability of suitable local companies to acquire.

Although it is difficult to capture the direction and scale of effect in econometric or other analyses, the evidence is strong that the three phases of regional integration in Europe has generally bolstered intra-subsystem and extra-subsystem FDI. A summary of the principal effects of regional economic integration on FDI, as evidenced by patterns of FDI within and to the European regional subsystems, is provided in Table 7.7.

### **FDI and policy implications for regional subsystem development**

We find that membership (or potential membership) of a subsystem does enhance the locational advantages of a nation. However, membership is not *sufficient* to achieve this. For example, Greece acceded to the EC in 1981, but has traditionally received very little inward FDI; between 0.9 to 1.3 per cent of the total annual inbound FDI to the EU from 1986

**Table 7.7** The effects of regional economic integration on FDI

Macroeconomic effect of integration	Strategic responses of MNEs	Likely net FDI effect
Intra-regional trade more effective than extra-regional trade	To replace exports with extra-regional FDI (defensive market seeking investment)	Increased investment in regionally-based foreign affiliates
New configuration of locational advantages among members of the region	To adjust existing investments in the region in order to reflect intra-regional trade (reorganization investment)	For the region as a whole, gains in FDI for some countries, losses for others
Cost reductions and efficiency gains	To increase value-adding activities within the region	increased FDI from within and beyond region as MNEs increase production in regionally-based foreign affiliates
Market expansion, demand growth and technical progress	To initiate offensive market-seeking investment	both intra-regional and extra-regional FDI replace exports

Source: Adapted from European Commission (1998).

to 1997 (UNCTAD, 1998). Italy too is a comparatively unattractive country for inward investors. Similarly, Bulgaria and Romania have yet to attract a significant proportion of FDI, even though they are also signatories to Europe Agreements. These cases demonstrate the enduring importance of location advantages as determinants in investment decisions (such as market size, institutional environment and societal issues), irrespective of the degree to which a particular host economy is embedded in any regional integration process. Furthermore, this is not necessarily a matter of national market size; Germany, for example, historically has received a disproportionately low proportion of total inward FDI to the EU, averaging 8 per cent during the period 1990–3, despite having the largest domestic economy in the region.<sup>8</sup> When combined with the continued propensity for German firms to undertake outward FDI, especially in the latter half of this decade (see Table 7.4), a net withdrawal of FDI from Germany is observed throughout Mark II and III integration (see Table 7.8). Most commentators attribute this anomaly to the fact that much European FDI, both intra-EU and

**Table 7.8** FDI flows into and out of Germany, 1983–96, DM million

	FDI inflows	FDI outflows	Net FDI (–outflows)
1983–6 <sup>(a)</sup>	2 488	14 958	–12 470
1987–90 <sup>(a)</sup>	5 635	26 458	–20 823
1991	6 785	39 276	–32 492
1992	4 158	30 499	–26 341
1993	2 944	25 344	–22 400
1994	1 118	27 032	–25 914
1995	1 2914	49 998	–37 084
1996	–4 865	41 824	–46 689

Notes: (a) annual average.

Source: Agarwal (1999).

from the USA, has been in the form of acquisition. As German firms have proved difficult to acquire, this has significantly depressed the value of FDI to Germany. However, other factors, such as language barriers (to non-EU firms), stringent national regulations, a relatively inflexible labour force, high wage and non-wage related employment costs and a comparatively high corporate tax regimes have also been put forward as contributing to Germany's relative unattractiveness as a business location.

Although popular, the argument that Germany – and other European economies – are disadvantaged because their locational advantages have been diluted as a result of regional integration is myopic. It overlooks the positive factors underpinning the decision of national firms to invest outside their domestic economy, but within the subsystem. In particular, there is the desire to exploit technological and financial strengths (and other ownership-specific advantages), to purchase new strategic assets, to service new markets or relocate production to areas and sectors where investment was restricted because barriers to capital inflows were previously high (Barrell and Pain, 1999). Home countries can benefit also from the increase in tax yields from repatriated royalties and profits, especially over the medium to long term (Agarwal, 1999). It is well established that, in principle, investment outflows can confer a net benefit on home country levels of investment and production, especially in the long run. FDI enables firms to compete more effectively and increase their foreign market share (Dunning, 1993).

Nevertheless, regional integration does weaken the ability of individual member states unilaterally to attract FDI on the basis of country-specific

locational advantages alone, or to negotiate with MNEs on the basis of such advantages (UNCTAD, 1998). In the EU, as integration deepens, fiscal regimes and the degree of market liberalization will inevitably converge across member states. So too, in time, will factor input costs. In this environment, intra-regional competition (at the subnational as well as the national level) for inward investment regarded as having net benefits for the local economy is less likely to be founded upon such market considerations, but rather upon business facilitation aspects in which the national government retains at least an element of autonomy in policy-making. Examples include promotional efforts, provision of non-fiscal incentives, reduction in bureaucratic impediments, improvements in administrative efficiency, the provision of amenities and attractions to expatriate employees and so on (UNCTAD, 1998). Within the subsystem, access to the regional market supersedes access to particular national markets as an important FDI determinant. For a member state to attract FDI in tradable goods and services, it must provide good access to the region-wide market, in respect to a harmonization in policies, physical accessibility (that is, geographic centrality), and strong transportation and telecommunication infrastructure. Member State governments have little or no discretion or powers to intervene in certain of these areas (market growth or geographic proximity to major markets), while in other areas individual government decisions had been handed over to the region. Active region-level policy is needed to ensure that the benefits of integration are shared throughout the region, and that 'beggar my neighbour' attitudes towards investment incentives do not erode any gains from investment that might accrue.

## **Conclusions**

European integration was, from the 1950s to the early 1980s, conceived in practice as an outgrowth of trade, notwithstanding the promising early vision of the free movement of all factors of production. Trade was seen as the prime engine of European integration, largely because of the existence of a solid body of trade theory that demonstrated the benefits of customs union and free trade. There was no comparable framework within which the gains (and losses) from FDI could be demonstrated. The ability of the European Commission to grasp the importance of FDI had been long in coming. By the mid-1980s, FDI had been acknowledged as central to EU prosperity in the world economy. The role of FDI as a key factor binding the EU regional subsystem to the world system was becoming recognized.

Investigating the impact of regional integration on inbound FDI is problematic; establishing the counterfactual – that is, the level and patterns of investment that would have occurred without the integration process – is difficult to achieve. Nevertheless, as this chapter shows, in Europe, the SMP (despite the controversies over the magnitudes of the internal benefits) does appear to have resulted in considerable benefits in terms of increased FDI. This applies to investment flows from outside the EU (although trade protectionism has played a part) and also to intra-EU FDI, much of which, in the absence of the SMP, may have either gone elsewhere in the world or stayed in the domestic economy of Member States. To the extent that domestic investment has been replaced by intra-EU FDI the objective of European integration will have been served. Nevertheless, it is evident that while intra-EU FDI has intensified, there has been a decline in levels of inbound EU FDI since its peak in 1990. This may be attributable to indirect factors, such as the recessionary phase of the business cycle. However, such a decline in inflows from outside the EU should be expected, as the announcement effects of the SMP wane, and as alternative investment opportunities in the world are targeted by non-EU firms. Such influences would appear to have been short-lived, however; in the second half of the 1990s a resurgence in inbound FDI to the EU, in both value terms and as a share of total global flows, surely reconfirmed the position of the EU as the dominant regional subsystem host for international production.

Foreign direct investment in Europe is now a policy target, and both an instrument and an indicator of market integration and macro-economic development. With the accession of lower-income members to the EU, FDI has become perhaps the leading means of effecting economic upgrading and European integration. The power of FDI is that it promises a route to achieve key policy goals without significant government expenditure. All that is required is the adequate resourcing of key policies, such as competition policy and, in the former monopolized industries, the refinement of industry-specific regulation. Foreign direct investment will remain central to Europe's continued growth as a regional force. What is more, the intensity of intra-EU FDI discussed in this chapter raises the real prospect of European MNEs that owe more to being European than any particular EU nationality. It may be no coincidence that the move towards a single currency within Economic and Monetary Union (EMU) will create a swathe of MNEs with a common yardstick currency, and thereby reinforce an element of common 'regionality', rather than nationality.

FDI and regional subsystem development are heavily interdependent. But it is not sufficient to study these two phenomena alone. As we have seen, other factors beyond the regional integration process shape FDI flows, both within and between subsystems. Issues of culture and geography, as well as macroeconomic factors in a regional subsystem, contribute to the shares of FDI it receives from its constituent Member States and from outside. The nature of its interdependencies with other regional subsystems also has an important part to play. Nevertheless, we have presented a partial test of a new idea – that the global economy is, in fact, a system of interrelated regional subsystems. In the exemplar subsystem – the European Union – foreign direct investment is both a key instrument and a key measure of system integration.

### Notes

- 1 The EU 12 countries are Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, United Kingdom. The EU15 countries are EU12 plus Austria, Finland and Sweden. The EMU countries are EU15 minus Denmark, Greece, Sweden and the UK. The CEE5 countries are the Czech Republic, Hungary, Poland, Slovakia and Slovenia.
- 2 The reinvestment of profits earned by foreign affiliates in local operations to achieve these objectives is also considered as FDI.
- 3 In this section of the chapter we draw on recent analysis by Cross (1998).
- 4 The negative percentage in 1990 for the proportion of US FDI directed to the EU arises because of substantial divestments reported by the Netherlands and the UK in this year (European Commission, 1995).
- 5 While not being essentially discriminatory, the effect of EU market integration has been to increase the disadvantage of distance for non-EU producers. This should be distinguished from trade protectionist measures, such as those faced in certain industries by Japanese suppliers to the EU (European Commission, 1998).
- 6 We note that the EEA and Switzerland may also be regarded as regional subsystems, but are excluded from the current analysis for purposes of simplicity.
- 7 Although the same line of reasoning could be used to explain FDI between members of any geographically confined regional subsystem, irrespective of the role and extent of economic integration.
- 8 Certain commentators attribute the low recorded inflows of FDI to Germany as reflecting, at least in part, differences in the national definition of FDI inflow by the Bundesbank (Jost, 1997), and that, in fact, levels of German inward investment are more representative of other developed countries if equivalent definitions are employed.

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# 8

## Choice of Location and Mode: The Case of Australian Investors in the UK\*

*with Ronald W. Edwards*

Two central decisions must be made by any firm seeking to enter foreign markets: what markets should it enter, and how should it service each market. In servicing a foreign market, a manufacturer may choose between three main entry modes: exporting; licensing to a local firm; and establishing a local production facility. Where firms choose to establish a local production facility they must decide whether to establish a new business or to acquire an existing one, and also, whether to pursue the venture alone or with a joint-venture partner. This chapter seeks to analyse these decision processes for Australian manufacturing firms located in the UK.

Australian multinational corporation (MNC) activity is a relatively recent phenomenon. While a small number of Australian firms have been prominent abroad for many years, large-scale investment only commenced in the early 1980s, following the removal of capital outflow controls. In fact, 90 per cent of Australia's foreign assets have been accumulated since then, with the largest share, a third, being located in the UK (ABS, 1997). Relatively little academic attention, either in Australia or abroad, has been given to the strategic decision making of these MNCs. This chapter seeks to address this shortcoming and, in particular, is concerned to analyse the location and mode choices of Australia's manufacturing MNCs in the UK. The second section will survey the relevant theoretical literature on these topics and develop hypotheses to be tested by reference to survey data supplied in the third section. The fourth section analyses the data and the fifth section offers some conclusions.

## Literature review

The academic literature dealing with modal choice can be categorized loosely into three streams. The streams, respectively, emphasize the economic (demand and cost) factors, risk factors and behavioural motivation. Each of these will be discussed.

Buckley and Casson (1981) theorized that the choice of entry mode will be determined by the demand and cost characteristics of each mode. In their model, the interaction of the variable and fixed costs associated with exporting and foreign production determine which of these two modes is chosen. The additional fixed costs involved in increasing home production to cater for exports are likely to be small. However, variable costs, including transportation costs and tariffs, will be high. Foreign production, by contrast, involves much larger fixed costs, as it requires the acquisition of new production and distribution assets abroad. Variable costs, however, will be lower than for exporting, because transportation and tariff costs are avoided. In these circumstances the most profitable mode will be determined by the level of demand. A low level of demand will not justify the fixed costs of foreign direct investment (FDI), thus exporting will be optimal for small markets. Larger markets may justify the fixed costs required for FDI, the variable cost per unit being lowest in this mode. Interestingly, Buckley and Casson projected that firms will change entry mode over time if the foreign market grows. Firms will begin by exporting and switch to licensing and FDI as market size increases.

Subsequent work (Buckley, 1983) gave greater prominence to transaction costs in the choice of mode. Transaction costs are incurred in both establishing buyer and seller relationships, and in negotiating and enforcing each transaction. The former costs are fixed in nature, whereas the latter are variable. In these circumstances, if the frequency of transactions is below a critical level, the combined profit of the buyer and seller is maximized by having the two firms owned separately, with transactions taking place in external markets. At higher frequencies, the weight of variable costs calls for internalization of the market.

Buckley and Casson's (1981) model and Buckley's (1983) extension of it were highly useful for consolidating the economic dimension of modal choice. However, subsequent literature, to be discussed below, has emphasized the role of risk assessment and global strategy in the choice and timing of modal changes. Further, Buckley and Casson assumed that sales growth is autonomous of modal choice. Subsequent studies (for example, Calof and Beamish, 1995) have shown that different modes have different sales potential.

Contractor (1990) extended and improved on Buckley and Casson's model by incorporating more potential modes, and by considering the administrative, transaction and internalization costs as well as the direct costs of each mode. He concluded that net cash flow is maximized with a foreign production facility where transaction costs are high and internalization costs are modest. If the market is working efficiently and internalization costs are significant, then the exporting mode is preferable.

Brouthers (1995) argued that, in selecting the appropriate entry mode, firms have to determine the level of resource commitment they are willing to make and the level of risk they can sustain. Exporting is a low-cost, low-risk means of entering foreign markets and can be scaled down quickly. However, it denies the firm marketing control and thus offers less sales and profit. The foreign production mode, especially a sole venture, by contrast, is a high investment and consequently high-risk alternative, but it provides a high degree of control to the investing firm.

A number of theories, mainly inspired by Johanson, Wiedersheim-Paul and Vahlne, and dubbed the 'Uppsala model', explain modal choice on the basis of a firm's experience in international markets. This model posits that internationalization occurs in stages, commencing with irregular export activity (Cavusgil, 1984; Johanson and Vahlne, 1990; Johanson and Wiedersheim-Paul, 1975). Businesses move from irregular exporting, through exporting via an independent agent, then the use of a sales subsidiary to, eventually, full production in foreign markets. Progression through the stages is driven by experiential knowledge accumulation. Each stage calls for more commitment to international markets, but enables firms to gain in knowledge, skill and confidence in foreign markets. Because the knowledge relates to the existing mode of operation, firms tend to move gradually, adopting new modes which make most use of past experience.

There are three exceptions to this incremental process (Anderson, 1993; Johanson and Vahlne, 1990). First, large firms can take bigger internationalization steps. Second, when market conditions are stable, knowledge can be gained in ways other than through experience. Third, experience in similar markets may allow a firm to generalize this experience. These exceptions allow firms to jump stages.

The Uppsala model and the literature it spawned have been criticized for failing to explain how or why internationalization starts, and for emphasizing the characteristics of firms in each stage but giving insufficient attention to the causes of modal change. Critics have argued that the model does not fully explain multi-step mode changes, or

disinvestment, and is highly deterministic in nature (Anderson, 1993; Calof and Beamish, 1995). Calof and Beamish found that 48 per cent of mode changes failed to follow this single-step, incremental pattern. Their study concluded that modal choice could be attributed to perceptions of potential sales volume in the foreign market, belief that each mode could generate a certain sales volume, and belief regarding the costs of each mode. Managerial and other resource capacity and strategic considerations could mediate mode choice.

The next issue to explore is that of locational choice. Various strands of theory, based on risk assessment, global strategy, demand factors and 'psychic distance' are present in the literature. Each will be discussed in turn.

The risk context is important in locational choice. By establishing foreign operations, companies make a longer-term commitment that cannot easily be withdrawn. FDI creates sunk costs, establishing a physical and personal link in the foreign country which remain even if the original market conditions that attracted the firm cease to apply (Buckley and Casson, 1981). Risks are likely to be higher than indirect exporting, because of the assumption of responsibility for decision-making (Agarwal and Ramaswami, 1992; Hill *et al.*, 1990). Hence firms may not be willing to commit resources to high-risk countries, preferring entry through exporting (Agarwal and Ramaswami, 1992). Not surprisingly, survey research (for example Buckley *et al.*, 1988) points to the importance of political stability and low country risk in locational choice.

Another strand of the literature on FDI emphasizes the global strategic focus of MNCs (see Kim and Hwang, 1992; Kogut, 1985). Rather than interpreting the locational choice for any one subsidiary in isolation, this strand looks to the role of the subsidiary within the interdependent network of subsidiaries belonging to the MNC. For example, a subsidiary may be established to act as a competitive scanning post in an otherwise unprofitable market, or to check the cash flow of a potential global competitor (Kim and Hwang, 1992). Consequently, an analysis of entry mode must include consideration of global strategic variables.

Firms interested in expanding sales are likely to favour markets with greater market potential. The size and growth of markets have been found to be an important determinant of foreign investment (Terpstra and Yu, 1988). Consequently, governments can influence locational decisions by altering the demand conditions within their jurisdictions through taxation, industry regulation or the supply of infrastructure (Boddewyn and Brewer, 1994; Losch, 1954). Specific trade policies including tariffs, quotas and non-tariff barriers such as voluntary export

restraints, could therefore have a strong influence on FDI. Companies may be induced to invest and produce in a protected market rather than supply it via exports (Bureau of Industry Economics, 1993: 93).

Finally, the Uppsala model has a second strand which asserts that the locational pattern of FDI is determined by 'psychic distance', defined as the costs of acquiring and internalizing relevant information about business conditions in other countries, the perception of risk and uncertainty involved in foreign operations, and the resources required to gain access to foreign networks (Johanson and Vahlne, 1977). The model asserts that the costs involved in overcoming psychic distance decline over time as a function of the experience gained by the firm. Thus firms are usually expected to enter familiar, probably neighbouring, markets first because of their historical familiarity, and then to fan out into progressively more remote territory.

However, Forsgren (1989) has argued that the psychic distance theory is only valid in the early stages of internationalization, when lack of market knowledge and market resources are constraining forces. These cease to be as important when the firm has activities in a lot of countries. A study by Nordstrom (1991), for example, found that, while psychic distance played a part, market potential was the most important explanatory factor in locational choice. Nevertheless, the Uppsala model's staging and psychic distance constructs retain wide acceptance (see Anderson, 1993; Calof and Beamish, 1995) and are the basis of this chapter's hypotheses:

**Hypothesis 1** **Psychic distance explains the locational choice of Australian investment in the UK.**

**Hypothesis 2** **Australian FDI in the UK is the result of a staged entry process.**

Having chosen to establish a business entity in a particular foreign market, the firm must decide whether to acquire an existing business or to purchase a greenfield site with the intention of establishing a new business. Once again, a range of theories focusing, respectively, on market knowledge, transaction costs, resource commitment and the nature of product demand, offer alternative approaches to understanding the decision-making involved. The behavioural theory approach emphasizes the decision-maker's knowledge of particular markets and the perceptions, beliefs, opinions and attitudes born out of this knowledge (Erramilli and Rao, 1990). This theory suggests a positive relationship between the decision-maker's knowledge of foreign markets and the

firm's resource commitments. The more familiar the market, the more likely that the firm will rely on its own resources to establish and operate the subsidiary. Firms with knowledge deficiencies, however, may try to acquire knowledge by teaming up with individuals and organizations that possess such knowledge. This means that they will show a greater tendency to license, to acquire operating firms and to establish a joint venture.

Davidson (1982) found empirical support for the behavioural model in his study of US multinationals. In the main, firms chose licensing and joint ventures to very little extent, preferring wholly-owned subsidiaries instead. However, the use of joint ventures and licences rose dramatically for entries into countries that were less similar to the US. Kogut and Singh (1988) also found that cultural distance between the USA and the host country increased the probability of choosing a joint venture over an acquisition or a greenfield, wholly-owned subsidiary.

Transaction cost theory suggests that a comparison of the efficiency of the market with that of the firm's own hierarchy will influence the decision to acquire existing businesses (Caves, 1982). Is it more efficient to hire new managers to operate a greenfield site, or to acquire an existing business with managers in place? Administrative costs depend, in part, on the level of the firm's knowledge of how to run a business abroad. The greater the uncertainty (for example, in first-time investments), the more firms are likely to enter via an acquisition as local management understand the local market environment (Caves, 1982). More experienced international firms are assumed to place a higher value on profitability and will bear greater uncertainty by pursuing greenfield investments.

Caves (1982) points out that, to start a subsidiary by acquisition, a firm must buy shares, paying a price such that an ordinary investor would get a normal rate of return. If, instead, a firm starts a new venture, it avoids paying the going-concern value for an established enterprise. Consequently, there must be some other advantage that makes a foreign firm willing to acquire other firms. The answer relates to risk. The firm is prepared to sacrifice a certain amount of profitability in order to reduce risk by acquiring a firm with an operating local management who know the market (Anderson and Gatignon, 1986).

According to Hennart and Park (1993), the nature of the firm's assets, particularly those that supply its competitive advantage, will determine whether acquisition or greenfield investment is the more appropriate. Firm-specific assets may be of two types: they may consist of superior organizational ability or technical expertise that can be separated from

the organization, or they may be deeply embedded in the firm's labour force. In the second case, the advantages may be so tightly bound to the foreign investor's organization that they cannot be combined with an acquired unit and must instead be exploited by re-creating the parent's business on foreign soil. In other words, if the investor wants to install its own management practices from the start, a likely case where the investment is based on a desire to exploit knowledge within the hierarchy, acquisition seems a less suitable method than starting a new venture (Forsgren, 1989).

The greater the degree of ownership in the entry mode, the larger the resource commitment. In joint ventures, for example, the resource commitment is shared between firms (Woodcock *et al.*, 1994). Firms that use the acquisition entry mode are procuring a new set of resources, while firms using the new venture mode are relying on their historic and previously developed set of resources. The difference between the acquisition and joint-venture modes is that firms in a joint venture share and provide access to some of their internal resources, while in the sole-venture mode no such access is provided. A firm will use the joint-venture mode to rectify a resource deficiency only if it is willing to provide access to such resources and can find a willing and suitable partner (Hill *et al.*, 1990).

Given the resource commitments required for market entry, firms are likely to employ entry modes requiring significant resource commitments only if the host market is large enough to support such commitment. Root (1987) argued that entry modes such as indirect exporting and licensing are favoured in markets characterized by low sales potential. Similarly, Hill *et al.* (1990) propose that MNCs will prefer to avoid heavy commitments in embryonic and declining markets.

Wilson (1980) suggested that firms in industries which rely on local marketing know-how, such as consumer goods, might have more incentive to purchase established companies for expansion, rather than taking the slower and more difficult path of building its own market share. Companies possessing distinctive technological resources or marketing skills and a willingness to invest in the development of new markets are more likely to start a greenfield venture. Companies entering a country at the early stages of a product's life in that market will rarely find any suitable firm to take over, while those late into a market and possessing no distinctive resources will prefer to enter by means of a take-over (Buckley and Mathew, 1980; Stopford, 1977).

In summary, the advantages of a take-over are considered to be: access to immediate market share and a local reputation; access to

production and distribution facilities; a sales organization that is familiar with the product and its customers; and management personnel who are experienced in the local environment. However, a take-over may not be preferred for the 'flying start' it offers if that start is in the wrong direction: the market may not be the one the company seeks; the local reputation may be poor; production facilities may be old or inappropriate; and management may be unable to cope with the changes envisaged by the parent. Further, the greater cost of an acquisition introduces additional risk if the investment goes badly. A greenfield entry means the investing firm will have to provide all the resource inputs from the outset, and start from such market share as may have been established by exports. The company achieves complete control and therefore an unfettered opportunity to introduce its desired methods, which may be rejected by staff in a take-over. However, it is likely to be the slowest method of penetrating a new market, and the foreign environment may introduce additional risks given that the firm's management will be unfamiliar with the new environment.

In relation to joint ventures, Hennart (1991) argues that this entry mode is efficient when markets for intermediate goods held by each party are failing, and it is more expensive to acquire or replicate assets yielding those goods than obtaining a right to their use through a joint venture. Joint ventures face the risk of loss where the partner firm seeks to maximize its gain at the expense of the venture. This can be expected to arise where the parent transfers poorly protected or ill-defined proprietary knowledge (Buckley and Casson, 1976). It may be difficult to price the knowledge or to protect its leakage beyond the joint venture, and thus there is incentive to pursue full ownership (Anderson and Gatignon, 1986). Similarly, where a company's image and reputation is a public good to all those sharing the trademark, a joint-venture partner may have strong incentives to free-ride on the reputation by debasing the quality of the products bearing the trademark. A firm exposing its critical resources either to imitation or to transfer may provide its partnering firm with a competitive advantage in the future. If firms want to protect these resources, and the perceived risks of having them transferred to the second firm are high, they should avoid joint ventures. On the other hand, a joint-venture arrangement can reduce risk by sharing the resource commitment required to pursue the investment (Agarwal and Ramaswami, 1992). Therefore, a focus on risk can lead to different mode decisions, depending on the nature of the risk concerned.

In summary, joint ventures are more likely where the investor is unfamiliar with the market; where access to assets is achieved more



economically through a joint venture than through the market; where there is minimal risk of losing core corporate knowledge; where the resource commitment is large by comparison with the home business; and where appropriate joint-venture partners are available. However, where there is difficulty in pricing the inputs of each partner, and therefore sharing the profit equitably, where there is a significant risk of the firm's core assets being dissipated or lost, where the firm has sufficient capacity to manage the new business alone or can economically acquire the necessary additional resources, the firm is more likely to enter the new market in a sole-venture capacity.

**Hypothesis 3** Firms will choose sole ventures except where access to market share or knowledge is the priority.

**Hypothesis 4** Firms will choose greenfield investments over acquisition except where rapid access to market share, productive capacity or knowledge is the priority.

### **Research methodology and details of the sample**

This chapter investigates Australian FDI abroad by analysing survey data (collected by interview) of Australian businesses in the UK. An important advantage of this methodology is that it provides direct measures of the factors that determine modal and locational choices. The UK was chosen for the study because it is the largest recipient of Australian FDI (ABS, 1997). Manufacturing companies were chosen simply to narrow the field of research. Separate surveys of service companies have been carried out, but these are not reported on here. Research assisted by ABIE (Australian Business in Europe) identified twenty-five Australian-owned manufacturers in Britain. Twenty of these agreed to participate in the survey, thereby supplying a highly representative sample of the total population (see Table 8.1). Senior managers of the sample companies, usually chief executive officers (CEOs), were interviewed. The interviews took an hour on average and allowed the interviewees to elaborate where appropriate. The survey questions were broad-ranging, designed to gain an understanding of the corporate history of the subsidiary, and focused on the central issues of concern to this chapter. Content analysis of words, themes and omissions was performed.

The companies included in the survey were diverse in scale, with company size ranging from large (1400 employees) to very small (9 employees). The few Australian expatriates employed held executive, management or specialist positions, most commonly that of CEO.

**Table 8.1** Summary of sample characteristics

	Greenfield	Acquisition	J/V	Sole venture
<b>Sales (pounds sterling)</b>				
<3 million	4	1	1	4
3–25 million	6	3	1	8
> 25 million	2	4	–	6
<b>Number of employees</b>				
<20	3	1	1	3
20–99	5	1	1	5
>100	4	6	–	10
<b>Type of goods</b>				
Producer goods	8	5	1	11
Consumer goods	4	3	1	7

The businesses were involved in producing a diverse range of products including food and beverages, chemicals, building and construction items, and household products. Most of the businesses surveyed (60 per cent) had been established since 1980. For twelve firms, the British subsidiary was a greenfield site, and eight were acquisitions. In all cases, Britain was the Australian firm's first European operation. Two subsidiaries, each having the same parent, were joint ventures, and eighteen were sole ventures. Thirteen of the companies exported to Europe from the British subsidiary, and eleven had established a plant on the Continent.

### **Analysis of survey results**

The primary motive for establishing the subsidiaries was to gain access to markets. Nineteen of the respondents (95 per cent) reported that market growth was the primary motive. No firm mentioned cost factors as a motive; however, access to technology was the key factor for one company. A number of companies reported that UK labour costs, low by European standards, had influenced their choice of region in the UK. Other secondary motives for choosing Britain included protection from tariffs (in earlier times), avoidance of Australia's trade cycle, access to raw materials, and access to processing capacity for Australian production. Thus, risk-based, strategic and internalization factors were present. However, as McKinsey and Company (1993: 32) found: 'Being close to customers and realising a market opportunity are the two main reasons firms move offshore.'

Once the general motives for establishing overseas had been identified, the firms were asked why they had chosen the UK in particular. This showed that they were attracted to the British market because of the familiarity of the language, culture, history, society and legal system. Other attractions were the high income, large population and limited geographic size of the market. Respondents were also attracted by the possibility of expanding into continental Europe. Government incentives played no role in the decision to invest in the UK, though government grants affected the specific location of some firms. Thus both psychic distance and demand factors were central in explaining locational choice. Figure 8.1 supplies sample quotes from firms to exemplify the decision-making involved.

Australian FDI in the UK's manufacturing sector is therefore consistent with the locational pattern of internationalization that is described in the psychic distance literature. We can therefore affirm the first hypothesis. However, whereas Scandinavian companies ventured into neighbouring countries first, and then into Europe and beyond, Australian firms have interpreted the psychic distance between home and the UK as being less than that separating Australia and Asia, despite Asia's geographical proximity. In every case, the UK-based companies reported that Britain

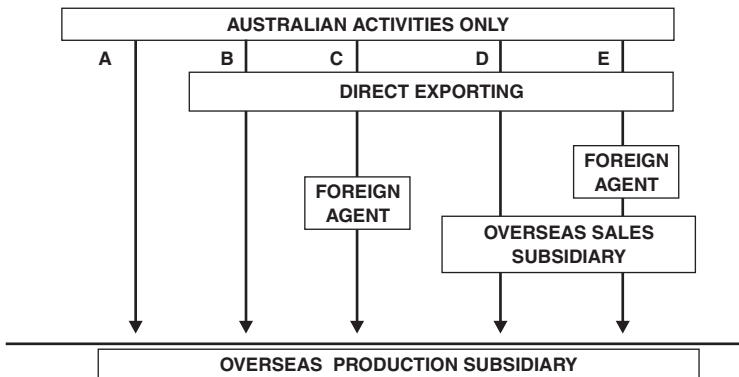
<p><b>Language, cultural and historical factors (16)</b>            It's easier dealing with people who speak English.            We selected the UK for its comfort factor.            The attraction was the language.</p> <p><b>Institutional and environmental factors (16)</b>            Historical links, similar legal system, stable political situation.            Compared to continent, Britain's market is freer. It allows for new players.</p> <p><b>Market factors (12)</b>            The British market is a manageable size. The US was too big.            The UK was a good base to expand into Europe.            The UK is an important market with a large population in a small country.</p> <p><b>Availability and cost of labour (7)</b>            There is good availability of labour here.            Labour is cheap compared to the continent</p> <p><b>Chance (5)</b>            The owner's daughter married an Englishman who came back to the UK to establish the business.            The purchase resulted from a take-over in Australia. It was an unintended asset initially.</p>
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*Note:* The numbers in brackets to the right of each category indicate the number of responses of that type.

**Figure 8.1** Reasons for choosing the UK location: sample quotes by category

had been their parent company's first foreign operation in Europe and, frequently, their first anywhere.

However, the Uppsala model's staging process was not found to be relevant for the majority of firms, leading us to reject the second hypothesis. The great majority (72 per cent) of the UK-based companies had never sold goods in that market prior to establishing their subsidiaries. In these cases no 'staged entry' had taken place. The burden of transportation costs involved in exporting from Australia was the main reason why exporting had not been pursued. In some cases the goods were so bulky that their sales were restricted to a limited radius around their British plants. In other cases the limited shelf-life of the product, or the need for its customization, had precluded exporting as a means of entering the market. Figure 8.2 outlines the different routes a firm may take in entering a foreign market and indicates the prevalence of firms in the sample which had established production entities in the UK without a history of exporting to that market.



The route to the overseas production subsidiary

	Route	Firms
A	Australian operations – OPS direct route	13
B	Australian operations – exporting – OPS	2
C	Australian operations – exporting – foreign agent – OPS	3
D	Australian operations – exporting – OSS – OPS	1
E	Australian operations – exporting – foreign agent – OSS – OPS	1
	<b>TOTAL</b>	<b>20</b>

Figure 8.2 Routes to investment in production facilities overseas

The literature reports other examples of companies skipping the export stage. An Australian study of 228 examples of FDI found no prior presence in the host market in 39 per cent of cases (Bureau of Industry Economics, 1984). Similarly, a study of forty-three UK firms in the US found that thirty-six of them had established a manufacturing facility without first forming a sales subsidiary in the country (Newbould *et al.*, 1978). Millington and Bayliss (1990) found that staged internationalization was the exception rather than the rule.

However, there was evidence that a minority of the UK subsidiaries had experienced various stages in their history. Four companies made the point that, while they had originally exported to the UK, this strategy was no longer viable. Their comments indicated that the interaction of market conditions and exporting costs required that they change modes from export to local production. The result was an incremental extension of marketing similar to that described in the Uppsala model. However, rather than being knowledge- or experience-driven, the stages were defined by cost and revenue factors, as described by Buckley and Mathew (1980), Buckley (1983) and Calof and Beamish (1995), together with strategic factors. This finding supports Anderson's (1993) contention that the existence of stages does not necessarily confirm the Uppsala model's explanation for them. It also affirms the less deterministic approach to explaining stages phenomena adopted by Dalli (1994). Rather than being driven by knowledge acquisition in a mechanistic fashion, strategic choices are available to the internationalizing firms. The best strategic decisions depend on many factors, including cost, risk, experience, opportunity and the nature of the product.

The following description summarizes the key characteristics of the staging and mode switching processes experienced by the seven firms that had progressed through stages. In the first stage these firms exported to the British market. The absence of similar products meant that they could command a premium price. At first, volumes were small and the selling prices was high. Economies of scale from expanding home production offset the costs of exporting. The second stage saw the products maturing. Sales increased in volume as the companies moved progressively beyond niche markets and towards the mainstream. Local competitors, unburdened by transportation costs, entered the market, forcing the firms to lower their selling prices and accept reduced profit margins. Customers came to demand more service, both before and after sale. Reduced margins and increased exporting costs associated with the increased volume of sales caused the companies to consider local production. The third stage commenced when the burden of transportation

costs and heightened customer demands convinced the company that it was appropriate to develop a production facility in the market.

While the international business literature pays little detailed attention to exporting costs, the survey found that these are very important in the decision to change modes, at least for Australian manufacturers in the UK. In addition to the direct costs of land transport to the port, transfers, shipping costs, insurance and foreign exchange risk, exporting costs include the opportunity cost of capital tied up in stock in transit. These costs increase with the volume of exports and with distance. A point is reached for many exporters when the fixed cost of building a local facility is less than the present value of the future cost of exporting. The smaller the cost of establishing a production facility and the greater the cost of exporting, the sooner the production facility becomes viable. In transaction cost terminology, the most efficient mode of servicing the foreign market changed over time as sales grew.

The survey showed that a similar analysis applied to the export of particular components and models. Six of the companies imported components or models despite having extensive local production facilities. They reported that the sales volume did not justify the additional investment required for local production, but this would be reviewed if the volume of imports grew.

Buckley and Mathew's (1980) study of UK direct investors in Australia also showed the importance of sales volume, establishment costs and shipping costs in determining entry mode for some firms. In one case, a firm decided to replace its export strategy with a licensing arrangement because of the high cost of shipping and stock holding. Similarly, the firms that exported and distributed goods in Australia judged that a local production facility was not justified, because production levels would not make it viable. However, their research did not give as much emphasis to exporting costs as an active reason explaining why firms had decided to switch to local production as did the current research. Given the (presumably) common shipping costs facing exporters sending goods in either direction, this suggests that differences in the nature of the goods might make exporting costs more significant for Australian firms than for their British equivalents.

Yetton *et al.*'s (1991) study sheds light on the seemingly unequal importance of exporting costs for firms at either end of Australia-UK trade, and the lesser justification for UK firms to produce in the target market from a cost minimization perspective. They found that the high level of foreign ownership in Australia's traded goods sector meant that domestically-owned but internationally-focused firms tended to be

concentrated in non-traded-goods production. For these firms, exporting, by definition, was not a viable option.

It is interesting to note that the economics of exporting may partially explain Australian firms' preference to export to closer, regional markets in Asia, but to invest and produce locally in the distant European market (ABS, 1997). If exporters follow the path described, Australian investment in Asian markets will sensibly lag investment in more distant countries. The growing volume of exports to Asia may eventually justify more FDI for production facilities there. However, goods that are standardized, cheaply transported relative to value free of import duties and call for little producer-consumer interaction are more likely to be exported, even in the long term.

With regard to the choice of ownership structure between sole venture and joint venture, the great majority of firms preferred wholly-owned subsidiaries. Figure 8.3 supplies a summary of the reasons why the firms had preferred overwhelmingly to avoid shared ownership arrangements. The central reason was the parent companies' preference to retain the independence of decision-making offered by a wholly-owned subsidiary. Hypothesis 3 was therefore affirmed by the research. The assets and capabilities that joint owners might have brought to the operations were generally considered to be insufficient to justify the associated loss of control. The two firms that were joint ventures explained this arrangement with reference to a number of factors. One combined the Australian firm's technology with the UK firm's existing market. The

**Control factors (7)**

We wanted to control our destiny.

We are a private company. The owner likes to keep control.

Ego – we wanted our name on the door

**Organizational capacity (7)**

We don't need input from others.

We had the technology – just needed to acquire distribution facilities.

A joint venture was not considered necessary in the UK – the market was familiar.

**Chance factors (3)**

It was an unintended purchase. It resulted from a take-over in Australia .

**Profit maximization (1)**

You get more profit if wholly-owned. We didn't want to share it.

**Lack of suitable partners (1)**

In the old days there were no suitable partners. We started the industry here.

*Note:* The numbers in brackets to the right of each category indicate the number of responses of that type.

**Figure 8.3** Reasons for choosing wholly-owned subsidiaries: sample quotes by category

other gave access to complementary assets in financial resources on the one hand, and markets on the other. Both parties wished to secure their interest but share the risk.

The strategy used by the firms was consistent with that described by Hill *et al.* (1990). Joint venture was chosen to rectify a resource deficiency only where the firm was willing to give the partner access to its resources, to forgo a degree of control. One such deficiency might potentially have been a lack of familiarity with the local business environment, but the firms believed that the British market was sufficiently similar to the Australian environment for them to proceed without a partner. Interestingly, many firms reported a different strategy for their continental operations. There, licensing arrangements or joint ventures were in place to help address the different language and cultural environments. This suggests that the behavioural approach adopted by Erramilli and Rao (1990), Davidson (1982) and Kogut and Singh (1988) does apply, but that the UK was judged to be sufficiently like Australia for the cultural dimension of FDI to be overlooked.

Interestingly, the scarcity of joint ventures paralleled findings by Buckley and Mathew (1980) of UK joint ventures in Australia. In that study, all sampled firms were effectively wholly controlled by the UK parent. The research showed that the companies believed a wholly-owned subsidiary would give them greater control, better feedback, higher profits, financial flexibility and would be easier to manage. Both the Buckley and Mathew (1980) research and the current work show that few companies engage in joint ventures out of choice, irrespective of their size or experience. Companies prefer to be controllers of their own destiny wherever possible.

Twelve firms had entered the UK market by establishing new businesses and eight had taken over existing firms. The reasons the firms chose their particular entry modes are summarized in Figures 8.4 and 8.5. The most important factor explaining the choice made by greenfield entrants was the lack of suitable firms to purchase, given the nature of their product or production process. Hypothesis 4 is therefore affirmed. Seeking to exploit innovative products or processes in a new market, existing firms had little to offer to justify the additional expense of a take-over (see Buckley and Mathew, 1980; Stopford, 1977; Caves, 1982). This 'life cycle' aspect was also apparent in one acquisition where the firm reported that, as its industry was an 'old' one, dependent on raw materials that were all owned by pre-existing businesses, acquisitions were the norm. The major justification for choosing the acquisition mode among the firms that had taken that path was to gain access to



**Value of business and its assets as a going concern (3)**  
 Existing markets, existing manufacturing facility, existing customer base.  
 We were buying into R&D. We wanted the technology.  
 We wanted a critical mass. We wanted to start large.

**Life cycle factors (1)**  
 Quarries are usually pre-owned in an old country like the UK.

**Chance factors (4)**  
 The purchase was an unintended result of a take-over in Australia.

*Note:* The numbers in brackets to the right of each category indicate the number of responses of that type.

**Figure 8.4** Reasons for choosing to acquire existing businesses: sample quotes by category.

**Lack of suitable businesses to purchase (6)**  
 There were no suitable businesses for sale. Our competitors had traditional processes.  
 There was no existing factory for our product. We needed an empty shell.  
 We were pioneers in the market place when we started. There wouldn't have been any companies to buy.

**Unique technology (4)**  
 All the equipment was transferred from Australia.  
 We had a new technological process. Existing plants were unsuitable

**Cost factors (1)**  
 Taking over an existing company would have generated significant overheads.

*Note:* The numbers in brackets to the right of each category indicate the number of responses of that type.

**Figure 8.5** Reasons for choosing a greenfield investment: sample quotes by category.

expertise or market share that would not otherwise be available. Wilson's (1980) view that consumer goods firms are more likely to prefer the acquisition mode was not borne out in the survey overall. However, there was a clear concentration of large firms among the acquisitions. Of the ten firms which employed more than a hundred people at the time of the survey, six were acquisitions, and respondents from these firms emphasized the importance of immediate market share and productive capacity in their decision-making.

## Conclusion

The prime motivation for establishing production facilities in the UK was the desire to access markets. A domestic population of 18 million people, comparable only to that of London or New York, offers Australian

businesses limited scope for growth. The UK market is particularly attractive in its own right, having a high average income and a compact geographic area. In addition, the UK allows access to the continental market.

The UK was the first European venture for all the companies surveyed in Britain. The factors which pulled the investment to Britain first, and not to the more centrally located European countries, were those emphasized by the 'psychic distance' model. Familiarity of language, custom, business practice and legal system minimized the risk of foreign investment. Subsequent investment by the longer established companies had gone to less familiar places on the Continent and in Asia as the 'psychic distance' of these regions has been reduced through exposure to international business.

Mode choice for Australian manufacturers in Britain was largely determined by economic factors. Heavy transportation costs meant that the great majority of the firms produced non-tradable goods, and this characteristic required them to manufacture the goods in their target market. No prior experience of exporting had been possible. A staged entry had not been viable, so they had to invest and produce in the market or forgo it. However, in a minority of cases, exporting had preceded local manufacture. Transportation costs and expanding sales volume had encouraged them to replace their export strategy progressively with local production in the UK. The bulky nature of many of the products required that they move into the UK very soon after entering the market.

This balancing of the incremental sales expected to flow from establishing a local production facility, such a facility's cost and the cost of transportation all featured in the decision to manufacture locally. This finding is consistent with that of Calof and Beamish (1995: 123): 'Executives indicated that mode choice could be attributed to their view of potential sales volume in the foreign market, belief that each mode could generate a certain sales volume and beliefs regarding the cost of each mode.' Transportation costs featured in the justification to swap from export mode to FDI by Australian firms operating in the UK. The impact of such costs has received insufficient attention in the literature on modal choice, especially in the case of remote countries, and for bulky and short-life products.

A preference for independent control of the subsidiary led Australian firms to shun joint venture as a desirable entry mode. The seemingly familiar environment that had attracted them to Britain, together with a well-developed sense of confidence in their own managerial and

technical competence, meant that firms saw no justification to establish a joint venture. Clearly, firms had a predilection to avoid joint ventures. To take a different course would require the potential partner to bring considerable resources or capacities to the new business, and these were not evident.

The final element in the choice of entry mode, whether to establish a new business or acquire an existing one, depended on the nature of the businesses and their market aspirations. In all but one case, the firms believed that their Australian developed products and processes were appropriate and adequate to support the new venture. Britain was so familiar that the home operation could simply be cloned. Only where the firms wished to minimize their risk or to commence on a large scale, with market share and the productive capacity to serve it, did they acquire an existing business.

Finally, a word of caution: the internationalizing of Australian industry is evolving rapidly. There has been little research into this process in comparison to the quantum of research conducted on European and US international firms. This chapter seeks to address the shortcoming. However, the sample was of manufacturing subsidiaries in the UK rather than Australian firms that have internationalized. The conclusions are therefore only suggestive in their applicability to the broader population.

## Notes

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# 9

## Foreign Market Servicing Strategies in the NAFTA Area\*

*with Jeremy Clegg and Nicolas Forsans*

This chapter examines the link between globalization and the growth of trade blocs using the experience of the North American Free Trade Agreement (NAFTA). Globalization is interpreted as the differential pace of integration of national markets of different types. In comparison with other forms of international business (for example, trade in intermediate and finished products, technology licensing and so on.) foreign direct investment (FDI) is seen as the agent of 'deep integration' (UNCTAD, 1993).

Therefore the key link between globalization and trade blocs is FDI. Not only does FDI raise the issue of 'who is us' (Reich, 1990), with the consequent implications of this for policy, it also represents a major strategic weapon for multinational enterprises (MNEs) in their struggle for the world's appropriable surplus (Buckley, 1996). This is an important reality of the regionalized world economy, where firms based outside trade blocs face high levels of discrimination.

The second section focuses on the globalization of markets and the localization of attempts to build competitiveness (Enright, 1998). The third section deals in greater detail with the projected impact of NAFTA on multinational firms' foreign market servicing strategies. The fourth section addresses the implications for the organizational structure of multinational firms.

### **Globalization and regionalization of the world economy**

The success of the European Union (EU) in achieving greater European integration, the deepening and extension of NAFTA and the rise of free trade areas such as MERCOSUR, point towards an accelerating trend in

world trade – the growth of trade blocs. These trade blocs are also investment and technology blocs, encouraging closer ties between member economies.

The concept of globalization has become devalued by the ascendancy of use over meaning. However, if we consider three levels of markets – financial markets, markets in goods and services, and labour markets – we can envisage each of these moving at a differential speed towards global integration. Financial markets are already integrated very closely internationally, so much so that no individual ‘national market’ can have an independent existence. Goods and services markets are integrated at the regional level. This co-ordination is largely policy-driven through institutions such as the EU, NAFTA, and ASEAN (Association of South East Asian Nations). Labour markets, however, are functionally separate at the national level, and here integration is largely resisted by national governments (for example, the UK’s opt-out of the EU Social Chapter to 1997).

Figure 9.1 shows a highly simplified picture of the world economy. It attempts to show different degrees of integration across various types of market. The suggestion is that financial markets are substantially integrated so that the world financial market can, for many purposes, be regarded as a single market. The market for goods and services is

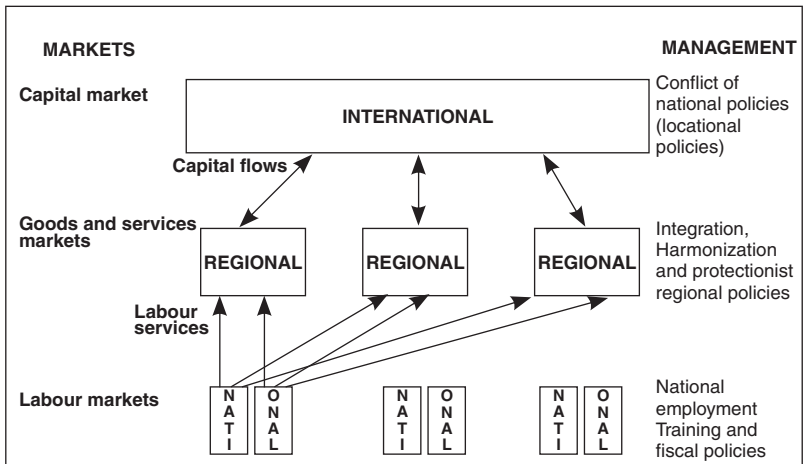


Figure 9.1 Internationalization of firms – conflict of markets

differentiated on a regional basis with 'single markets' either existing or emerging (especially in the cases of the EU and NAFTA). Such markets are increasingly uniform in regulation, standards, codes of practice (for example, anti-trust) and in business behaviour. They offer the possibility of economies of scale across the market, but are substantially differentiated by these aforementioned factors (and possibly by a common external tariff) from other regional markets. Labour markets, however, remain primarily national. Governments wish to regulate their own labour markets and to differentiate them (to protect them) from neighbouring labour markets. Many of the current difficulties in governmental regulatory policy arise from the difficulty of attempting to pursue independent labour market policies in the presence of regional goods and services markets, and an international market for capital.

In contrast, multinational enterprises are perfectly placed to exploit these differences in the international integration of markets (Buckley, 1997a). The presence of an international capital market enables capital costs to be driven to a minimum. The existence of regional goods and services markets enables firms to exploit economies of scale across several national economies. Differential labour markets enable costs to be reduced by locating the labour-intensive stages of production in cheap labour economies. A strategy of serving the regional goods and services markets of the world through horizontally-integrated FDI is complimented by vertically-integrated FDI in quality-differentiated labour markets. Vertical integration also reflects the spatial distribution of supplies of key inputs and raw materials. The multinational enterprise achieves advantages through both vertical and horizontal integration. Vertical co-ordination along the value chain is achieved by a variety of methods, from contract purchasing through alliances and joint ventures to ownership. The advantages of horizontal integration are achieved by concentrating activities at a single location to achieve maximum economies of scale. Strategic trade and foreign direct investment can be seen to take place within this overall framework (Buckley *et al.*, 1998).

However, globalization has accompanied increased volatility in the world economy. This volatility has created a new agenda for MNEs, with the search for flexibility as its priority. Flexibility may be defined as the ability to reallocate resources quickly and smoothly in response to change. So far as the MNE is concerned, the impact of change is captured by the volatility induced in its profit stream. The volatility of profit that would occur if the firm made no response to change summarizes the impact on the firm of volatility in its environment (Buckley and Casson, 1998). These developments raise profound questions about the responses



of MNEs to regionalization. The central question in this chapter concerns the implications for location strategies within the NAFTA area.

It is somewhat ironic that issues of economic geography have not been to the fore in international business theorizing. Perhaps this is because of the difficulty of modelling in this area (Krugman, 1995) or an unfortunate by-product of the academic division of labour. However, spatial issues should not be underrated in constructing more satisfactory and comprehensive approaches to international business theory. The key to progress is to elide from geography to the spatial division of labour. Geographical barriers (mountains, deserts, large land masses with no sea coast) represent difficulties of transportation. These vary with historical time because of technological innovations in transportation. Such spatial barriers inhibit trade, and therefore the emergence of specialization and co-operation in effecting a spatial division of labour. The political division of economic space into nations results in countries having an internal division of labour which differs from that prevailing externally. Primarily, this difference is mediated through trade, and so the existence of an entrepôt becomes a crucial factor in stimulating exchange and development (Buckley and Casson, 1991).

In the modern world economy, this entrepôt function is provided by the MNE. In this sense, the MNE compresses space by its organization – the mountain comes to Mahomet. The internal and external divisions of labour meet at the boundary of the multinational firm. The spatial boundaries of the state are crucial in international trade, but in a world economy dominated by MNEs, this boundary becomes much less important. The borderless world (Ohmae, 1990) results from exchange across the different divisions of labour, and becomes spatially internal to every national market of the global economy. Mediation of different divisions of labour is no longer trade through an entrepôt, but through the mediation of the different price signals generated by the managers of multinational firms. This gives rise to issues such as the 'Who is us?' issue posed by Reich (1990). Is 'us' British firms wherever they are located or all firms in Britain whoever the ultimate owners are? On this issue hangs much of modern economic policy.

Perhaps the permeable boundaries of multinational firms have relegated the importance of geography, as have technological developments in telecommunications that make the management of spatially diverse entities, such as the multinational firm, so much more efficient. If so, this puts much more emphasis on the co-ordination problem. The importance of the multinational firm arises from the fact that it is a system for integrating and co-ordinating intermediate product flows

arising from activities concentrated at different locations. It is in this sense that the multinational firm represents a real challenge to the nation state. The nation state, for its part, attempts to co-ordinate activities within a given spatial area defined by politically and historically-determined national boundaries – but these are now completely permeable to intermediate product flows of information by telegraphic communications.

Several major trends in the world economy such as the rise of East Asia, the lack of development in the poorest economies, and privatization and trade blocs, have induced specific market changes. These changes include new competitors in mass production and high technology sectors from countries such as Korea and Malaysia; the failure of import substituting investments (for example, in Africa); new competitors and competitive structures in newly privatized industries; and, combined with the driving down of transport costs (through containerization and so on), the result is the possibility of new competitive strategies such as international just-in-time production.

These specific market changes require new competences from companies facing these challenges. In general, the competences required are of a more general entrepreneurial type than the previous generation of technological skills required for efficient mass market production. In final product markets, more competition is experienced. In intermediate product markets, the transport cost revolution makes dispersed activities more feasible, and in labour markets, the adoption of policies of deregulation means that more aggressive management policies can introduce increasing flexibility to labour management. In capital markets, the rising number and greater capitalization of stock markets creates an increasing threat of hostile acquisition, which in turn puts more pressure on company managements to perform above the norm.

This issue brings us back to the idea of the 'centrality' of foreign direct investment (Buckley, 1997b). FDI has a crucial role in cementing international economic relations. It is more than just a strategic weapon in a multinational firm's armoury, or a choice among several possible foreign market-servicing strategies (Buckley and Casson, 1976; Buckley and Prescott, 1989; Buckley and Smith, 1994). FDI is a manifestation of a serious competitive commitment in the increasingly interdependent international economy. In many markets, it is not possible to gain a sizeable market share without an investment presence. Increasingly, arm's-length exports to major markets are futile. Selling through agents or distributors does not allow control of the operation or effective flow-back of information to the principal (Buckley *et al.*, 1990).

The forces outlined in Figure 9.1 can be expected to have a major impact on the current and future institutional arrangements in the international economy. This section suggests that international business theory leads to several predictions of changes in the global economy. These will include: a greater share of international business activity being focused on mergers and acquisitions; increasing volatility of foreign direct investment based on cheap-labour-seeking strategies; differential success between firms and between national ownership groups; creating value from a reputation for managing assets; leveraging of generalized skills to create powerful globally-integrated groups; and competition of national territories to create non-transferable asset bases (Buckley and Casson, 1998).

This will lead to the configuration of the world economy as depicted in Figure 9.2. Quadrant 1 represents the situation where the country of location is competing on labour costs (or labour flexibility in the external market sense), interacting with firms which have asset skills (physical assets, patents, brands). This leads to a vertically-disintegrated structure with a volatile 'home' economy where the firms' transferable skills can combine with cheap labour at home or elsewhere. Quadrant 2, similarly, shows a country of location competing on low-cost labour,

		Asset ownership by firms	
		Conventional assets	Appropriable skills
Country of location's competitive base	Labour costs	1. Vertical disintegration volatile home economy	2. Mixed outward DFI and inward labour cost seeking DFI
	Public assets	3. Inward investment – home firms as take-over targets	4. International vertically integrated structure with powerful home base

**Figure 9.2** Interactions between country of location and the ownership of assets by firm

		Asset ownership	
		Conventional assets	Appropriable skills
Country of location's competitive base	Labour costs	Less developed countries of Africa, Asia and Latin America in low tech industries	UK industry 'old European industries'
	Public assets	British car industry	Japanese export platform and <i>keiretsu</i> companies

**Figure 9.3** Examples of interaction between country of location and the ownership of assets

but this time interacting with firms which have appropriable generalized management skills. This leads to a mix of outward FDI seeking locationally-fixed public assets, together with a fluctuating flow of cost-reducing inward investment. Quadrant 3, which combines locationally-fixed public goods with firms with asset skills, will represent prime targets for inward take-overs of indigenous firms. Quadrant 4 represents the powerful home base of a vertically integrated structure, both forwards and backwards. Figure 9.3 gives examples of interaction between country of location and the ownership of assets by firms.

Figure 9.4 examines the implications of the changes identified by plotting their effect on the change of contractual arrangements made by multinational firms. East Asian and other 'new' multinationals favour non-contractual means of acquiring assets and knowledge and also have a penchant for joint ventures with foreign-owned multinationals. In their outward involvements, they favour greenfield ventures, often on a wholly-owned basis, but also using joint ventures. They are insufficiently integrated, so far, into the world capital market and are culturally unfamiliar with take-overs, so that the

	Rise of new economics		Privatization		Trade blocs
	Inward	Outward	Inward	Outward	
<b>Non-contractual modes</b>					
Imitation	✓				
Educational transfers	✓				
Piracy/counterfeiting	✓				
<b>Contractual modes</b>					
'Licensing'			✓	✓	
<b>Control modes-FDI</b>					
Joint ventures	✓	✓	✓	✓	✓
Greenfield ventures		✓			
Acquisition			✓	✓	✓

**Figure 9.4** The changing configuration of modes of international business activity

acquisition mode favoured by Western multinationals does not appeal to them. The newly privatized companies have had recourse to inward licensing and joint ventures in order to acquire skills and technology previously unavailable to them (or of which they previously had little need, such as generalized marketing skills). They have also come under the acquisition spotlight, as foreign predators see them as ripe targets because of their undervalued assets and unreleased potential. In their outward activities, they have favoured licensing and joint ventures, to access the capabilities they do not possess, while some of them have sought to complement this strategy by acquiring packages of assets. Finally, the development of trade blocs has facilitated, and been facilitated by, joint ventures and acquisitions between multinational firms.

Thus we can observe a different emerging configuration of modes of doing international business from the position of the early 1980s (Buckley, 1981). Non-contractual modes are increasing in importance as (covert) means of technology transfer, but in areas where higher levels of competitiveness and market development exist, joint ventures and

acquisitions are in the ascendant because these are key means of acquiring capabilities. These foreign market servicing strategies are examined in greater details in the next section. Since NAFTA has gone very far in the direction of discrimination, especially in sensitive sectors such as textiles and apparel, and automobiles (Fontagné, 1995), FDI can be seen as a necessary strategy to gain access to the NAFTA market, so the entrant firms can behave as insiders. We then examine what NAFTA means for the use of the various strategic weapons that multinational firms can use to serve the North American market(s).

## **NAFTA's impact on foreign market servicing strategies**

### **Foreign market servicing strategies**

There is an extensive literature on the foreign market servicing strategies of companies, which has been reviewed in Buckley and Prescott (1989). Much of the analysis took place at the level of the firm, using the twin concepts of internalization and location to differentiate the three primary forms of foreign market servicing (exports, licensing and FDI) from each other. At its simplest, exports (X) can be distinguished from the other two methods by the location effect. With exports, the bulk of value-adding activity takes place in the home country, while the other two methods transfer much of value-adding activity to the host country. Similarly, licensing (L) can be differentiated from X and FDI by the externalization effect. L represents a market sale of intermediate goods or corporate assets by the firm. In licensing, the firm sells rights and the use of assets to a licensee. In X and FDI, such activities are internalized (Buckley and Casson, 1976, 1985; Dunning, 1993, 1998). Broadly, then, the internalization and location effects separate the three generic forms of market servicing.

Exporting can take many forms: direct exporting to final customers; exporting via market-based intermediaries; or exporting via a company-owned sales and marketing office. The large geographic distance between Canada and the UK means that the cost of transporting goods across the Atlantic can act as a powerful incentive for investment or contractual arrangements, unless the high value-added nature of a product can withstand the costs of exporting. Direct exporting involves firms operating at a distance, and therefore can mean that companies lack local image, fail to display a commitment to the local market, and possibly have difficulty in persuading customers of their ability to provide after-sales cover. However, direct interaction with clients allows them

to work closely with their customers to develop mutually beneficial solutions to problems. In the early stages of market development, FDI serves as a way of testing market opportunities, establishing a customer base and developing a degree of awareness of potential clients. In the longer term, the growth of the foreign operation will dictate the location of FDI and associated personnel within the target market. To this end, firms may be aware of the long-term potential of moving from exporting to some type of foreign investment, although such a move is not considered viable until a critical mass has been achieved, and FDI can be justified. Exporting via a local market-based intermediary requires the firm to rely on an external agent for the successful sale and marketing of its products in the foreign country. Finally, the establishment of a sales office abroad permits the firm a degree of market involvement, particularly for the purpose of gathering information and tracking market developments, although, unlike a foreign subsidiary, an office does not constitute a separate firm with the potential to act and plan independently.

Licensing can also take a variety of forms ranging from simple contract manufacturing to the packaging of an array of competitive assets and services for sale to a foreign organization. Contractual arrangements are usually entered into because the manufacturer lacks the critical resources to enter the market directly (often involving their overcoming barriers to entry) or to service the market effectively. Equally, the host market firm enters into the contract in order to supplement its own resources in some way. In these cases, co-operation is the key transaction characteristic.

Finally, the generic term 'foreign direct investment' covers a variety of strategic alternatives: assembly, full manufacturing, or sales marketing investment. It also encompasses the choice of entry mode: the establishment of greenfield facilities, or the take-over of an existing firm. The choice of mode of doing business abroad and its dynamics emerge as very complex, influenced not only by industry-specific factors and location-specific factors but also by individual firm-specific factors. They are also subject to large degrees of uncertainty.

### **NAFTA's impact on inward direct investment**

Following Forsans (1995, 1996), and Forsans and Waverman (1996), Buckley *et al.* (1998), four kinds of strategy related to FDI can be pointed out following the consolidation of trade blocs in general, and NAFTA in particular: defensive import-substituting strategy; reorganization

investment; rationalization investment; and offensive import-substituting investment. We shall now examine these strategic choices below.

Defensive import-substituting investment is a response by firms to the trade-diversion effects that occur from NAFTA.<sup>1</sup> The removal of trade barriers among NAFTA members leads to an increase in the locational advantages of the members. A switch from an export-based strategy to a FDI one allows the firm to maintain its market share threatened by the trade-diversion effects. This switch is obligatory, since it is the only one that both allows an outsider to gain access to the NAFTA market(s) and to behave as an insider.

Trade-creation effects exert pressures to reorganize the production in accordance with members' comparative advantages.<sup>2</sup> This leads to 'reorganization investment'. Firms are likely to regroup their production facilities in fewer locations where more favourable production costs can be found.

Scale effects occurring from integration induce a decrease in production costs within the trading bloc, making these locations better places for international sourcing. These efficiency gains encourage 'rationalization investment', that is, FDI that responds to international differences in production costs.

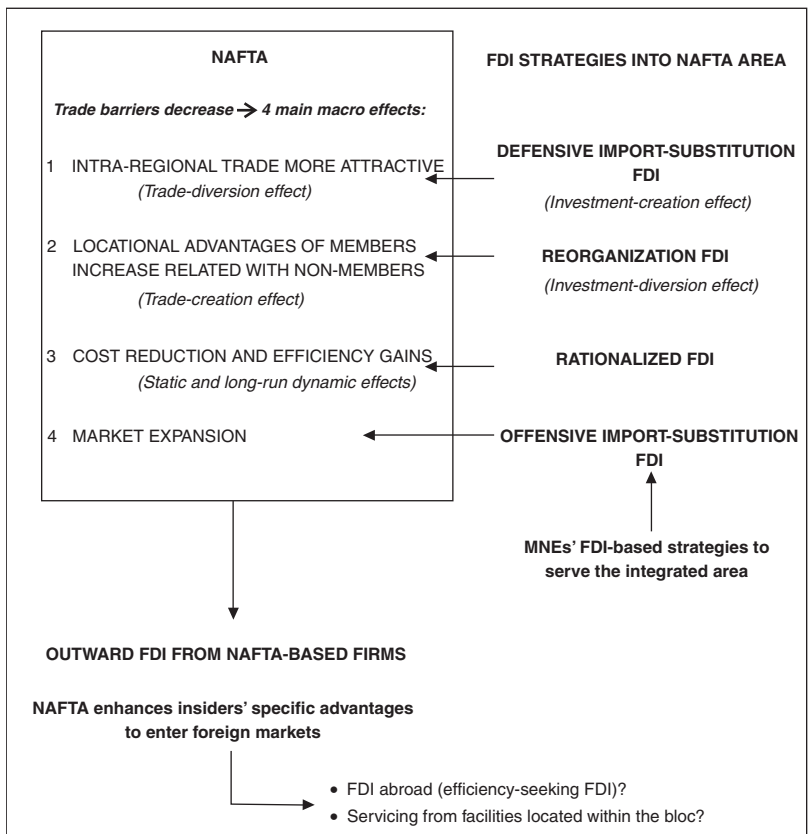
As a result of NAFTA's dynamic effects, the size of the barrier-free market within which a firm operates expands. These growth-enhancing and market-augmenting effects of NAFTA give rise to 'offensive import-substituting investment', that is, FDI whose motivation is to take advantage of growing demand and the opening up of new markets.

Figure 9.5 sums up the effects of NAFTA on FDI through its impact on intra- and extra-regional trade. The removal of trade barriers within the NAFTA area induces direct effects on the location of the production as well as indirect effects through the impact it exerts on income levels, competition, innovation and so on. The relationship between trade and investment is very complex. Defensive import-substituting investment (responding to trade-diversion effects) by its nature replaces trade. Other investment-based strategies can complement a trade-based strategy, especially in the case of rationalization investment and Reorganization investment, which can encourage inter-industry trade (rationalization FDI) and intra-industry trade (reorganization FDI).

These strategic responses also affect FDI levels within the area, as well as their geographical and sectoral distributions. Cost-reduction effects can generate reorganization or rationalization investments depending on whether the MNE served the integrated market with imports from non-member states or from production facilities located within the



trading bloc. In the first case, rationalization investments can occur from decreasing production costs within the area, and from increasing opportunities to exploit scale economies. In the second case, reorganization investments will take place within more specialized facilities, each with a smaller scope of production activities. X-efficiency gains could attract rationalization FDI as the costs of intermediate inputs become cheaper within the NAFTA area. Overall, the removal of market fragmentation and the stimulus to growth from the dynamic effects of customs unions open up new opportunities for FDI by firms with strong competitive advantages. Finally, the uncertain issue of NAFTA's future trade policy can also attract FDI motivated by the fear of future



**Figure 9.5** Effects of NAFTA FDI-based strategies of multinational firms

restrictions in market access to the enlarged market. However, this new FDI can lead to surplus capacities within the trading bloc, and do not necessarily correspond to an efficient worldwide distribution of investment resources.

### **NAFTA's impact on outward direct investment**

NAFTA will also affect outward FDI to third countries from MNEs located inside the trading bloc. Indeed, the cost-reduction effects occurring from the static and dynamic effects of free trade areas (with consequences for scale economies, X-efficiency gains, country specialization, competition and innovation) can improve the competitiveness of regionally-based MNEs and help them to exploit foreign markets better. It is likely that the attraction of servicing foreign markets from production facilities located outside the trading bloc will be reduced relative to servicing markets from locations inside. In this case, trade replaces foreign production owned outside the bloc. However, the search for efficiency to cope with increased competition within the bloc can lead firms to conduct rationalization FDI outside the trading bloc, in order to have access to cheaper inputs.

It is important here to remember that NAFTA is only one trading bloc in the world economy. Experience gained in the expanded home market (NAFTA) can be transferred both to the European Union (EU) and the more slowly integrating Asian markets. Potential investment in Southeast and East Asia may benefit from these economies of learning. Progress towards 'competitive integration' in Asia has been slow. The agreement to create the ASEAN Free Trade Area (AFTA) in 1992 represented a beginning, but membership enlargement to include other Southeast Asian countries has complicated the market integration process, as has the Asian currency crisis (Yue, 1998). The AFTA so far focuses mainly on trade liberalization, but attempts are being made to extend its provisions to investment and services. AFTA has much to learn from the progress of the EU and NAFTA, and the emergence of the Asia-Pacific Economic Cooperation (APEC) forum which includes AFTA, NAFTA and the Australia-New Zealand Closer Economic Relations (CER) schemes (Parrenas, 1998). Providing principles of 'open regionalism' are followed, and the liberalization process is undertaken on a most-favoured-nation (MFN) basis, there will be considerable scope in the future for extension of these principles to investment and services, which will provide increasing opportunities for outward investment by NAFTA member countries.<sup>3</sup> Similar arguments also apply to MERCOSUR in South America.

### **Multinational firms' strategies between trading blocs**

The emergence and the consolidation of trading blocs such as NAFTA give rise to important implications in terms of how multinational firms are doing business abroad. As stated earlier, the primary purpose of the formation of a trade bloc is to shift locational attractiveness – to encourage investment diversion (switching from outside the bloc to intra-bloc investment). Trade blocs also attempt to induce a switch in the market servicing strategies of extra-trade bloc firms, from exporting to inward investment. In addition to diverting investment into the bloc by non-bloc multinationals, trade blocs will also affect the investment location of both insider and outsider firms (as noted earlier). The creation of a single market from a series of separate markets may make a central production site more attractive. This has potential for firms to create a 'hub and spoke' system of central facilities (manufacturing), combined with a set of distribution outlets radiating from the central facility. As a location strategy, this can be combined with an ownership strategy, where joint ownership of distribution can be utilized (Buckley and Casson, 1998). It could also be argued that the formation of a trade bloc (more accurately a single market) provokes a move from a multi-domestic strategy (where firms can treat competition in each country as being separate) to a 'global' strategy, where strategy becomes inextricably intertwined across the integrated market (Porter, 1986). On a regional scale, it is evident that following regional integration, a UK firm that formerly invested in Canada to service the Canadian domestic market may now consider switching investment to the USA or Mexico. New investors face the same decision. This argument applies in parallel to, say, Canadian investors or potential investors in the UK within the context of the EU and the Single Market Programme (SMP) to achieve an integrated internal market.<sup>4</sup>

Consequently, trading blocs are likely to affect competitive advantages, the location of production of both foreign investors and insiders, and indeed their foreign market servicing strategies. Depending on the level of the external tariff and non-tariff barriers, the locational effects are likely to favour the substitution of exports for local production. It is also evident that the removal of intra-regional distortions may represent relative discrimination against foreign firms (Clegg, 1996). However, within the integrating area, the locational effects are likely to encourage more plant and process specialization, particularly in sectors where economies of scale are important. These economies, as well as those arising from geographical diversification and economies of scope are,

together with the absence of trade barriers, likely to allow firms to further exploit the economies of common governance. The impact on foreign firms very much depends on their existing locational strategies. It is possible that established Canadian investors in the UK, and UK investors in Canada, may benefit (Buckley *et al.*, 1994). Clearly, many factors, including industry- and firm-specific factors will be influential.

### **NAFTA's impact on outsiders: the examples of UK firms and NAFTA**

An earlier study by Buckley *et al.*, (1994) focused on how Canadian and UK firms regarded the development of NAFTA. UK firms, in general, saw NAFTA as a market opportunity. Many firms felt that the long-term attraction was the broader market scope and size, in the form of the greater freedom to offer goods across the whole of North America. There were a number of firms who maintained that, for strategic reasons, a presence in both markets would continue to be important in the future. These firms resisted the cessation of direct operations in either Canada or the USA, although the form of their business activities would be likely to change.

The nature of firms' adjustments in the wake of NAFTA depends on the starting position of the investor. For firms newly entering North America, location in one market may indeed be employed as a platform for expanding into the rest of NAFTA. For established investors, more harmonized legislation on standards is more likely to stimulate the replacement of subsidiaries with representative offices than to generate increased cross-border business. The rationalization of manufacturing facilities between Canada and the USA may be possible, with the caveat that local representation through sales and marketing will still be necessary. Some firms already operating through intermediaries may seek distributors through which to service the whole of North America. However, the preferred approach for this group of firms is to secure new intermediaries to develop business potential in other geographical areas.

The sheer size of the North American market, and the fact that there remain certain barriers that continue to segment Canada and the USA, mean that a single strategic approach to NAFTA is unlikely for many firms. For example, legislative differences arising out of historical developments persist.<sup>5</sup> These considerations explain why many firms will continue separate organizational developments in both markets.

The research by Buckley *et al.*, (1990) arrived at the conclusion that NAFTA has consolidated firms' trade and FDI strategies towards the North American market, rather than led to completely new strategies. The promise of greater freedoms has led to opportunities being seized

earlier, although the 'real' economic benefits from the establishment of a single market are still some way off. Certainly, the growing power of the region brought about by North American regional integration is an important magnet for investment. The sample of firms studied by Buckley *et al.* (1990) evidenced a deepening concern that to be competitive globally means developing business in all the major markets of the world, and in particular, in the triad regions of Europe, America and Asia-Pacific. The drive for regional integration should be understood in this context. In developing North American integration, the policy objective is very much to play on firms' investment strategies, and to convince them that North America will offer an enhanced rate of return on investment.

### **NAFTA's impact on insiders: Canadian firms and NAFTA**

Integration must be seen as posing new challenges for business consolidation and rationalization within 'domestic' trading blocs as well as having an impact on bilateral relations between trading blocs – that is, NAFTA and the EU. Canadian firms voiced a great deal of concern over the impact of NAFTA on the Canadian economy, and the long-term effects for Canadian competitiveness (Buckley *et al.*, 1994). The removal of US branch plants from Canada, and the potential for Canadian firms to relocate activities in Mexico added to the severe recessionary pressures besetting the economy. Rather than leading Canadian firms to become inward-looking within the North American market, however, these developments are having the reverse effect. They are encouraging firms to adopt an outward-looking view based on growth opportunities outside Canada and the USA, which are seen as offering sustainable potential.

### **NAFTA's impact on insiders: US and Mexican firms**

There is considerable evidence that US firms see the NAFTA region as a single integrated home market, and treat the investment opportunities it offers as a largely monolithic area, differentiated only by cost structures. The exception to this is, of course, varying perceptions of currency risks. Investment into Mexico is impeded by currency worries. This barrier will remain until NAFTA becomes a single currency area, which, as in the case of the euro, is an issue where political considerations predominate.

Mexican firms find themselves with opportunities in NAFTA which few of them are, as yet, able to grasp. FDI requires sustainable advantages over local firms and a management structure capable of exploiting and building on current capabilities. Few Mexican firms currently have

these abilities. We can, however, expect a few pioneering firms to begin to expand their activities outside Mexico into two kinds of market, those where language confers advantages (Latin America and Spain) and, as familiarity increases, into NAFTA's 'single market'.

### **Theoretical implications**

The emerging pattern of foreign market servicing strategies between Canada and the UK is highly complex and dynamic, with changes in the operating environment brought about by economic integration and changes in the international competitive arena reshaping strategic thinking. The simple taxonomy of exporting, licensing and strategic alliances, and foreign direct investment as being an either/or choice, is challenged here. A considerable number of firms conduct several forms of market servicing simultaneously in different areas of their business in the same market. There are also many strategies of a non-traditional, or hybrid nature, which incorporate elements of various modes.

This diversity is easier to understand in theoretical terms than might at first appear to be the case. Regional integration leads to a greater pressure on firms to diversify by product, by mode, and by geographical area. As previously separate markets become unified through regional integration, and price convergence (and thereby competition on price) proceeds, so the incentive to diversify rises. The firm's portfolio of real assets becomes over-concentrated in the integrating regional market, and an outward-looking strategy is a logical response, in order to diversify the portfolio. The implications of these developments for the organizational structure of multinational firms are taken up in the following section.

Research confirms that the internationally diversified firm typically exhibits superior performance (or lower risk) linked to the degree of multinationality, and is able to enjoy a lower cost of capital compared with non-diversified firms, because of its attractiveness to wealth holders (Clegg, 1992). A number of classic studies demonstrated that the degree of geographical diversification through FDI reduces the variance in firms' earnings (for example, Rugman (1976, 1979) for US investors), and is positively related to firms' share prices (Agmon and Lessard, 1977). These studies confirmed that investors recognize the MNE as an indirect diversification instrument. As returns in the local markets of the USA and Canada become more correlated, so cross-border FDI within NAFTA will become a less effective instrument of diversification. As argued at the beginning of this chapter, because firms must raise capital in a global financial market, inferior risk-return performance

will be a source of competitive disadvantage. It follows that, in the longer term, after the locational adjustments immediately attributable to NAFTA, firms based in the USA and Canada will increasingly seek investment opportunities outside NAFTA that contribute more effectively to reducing the risk to their portfolios. Therefore, in principle, the long-run impact of NAFTA should lead to greater inter-trade-bloc FDI, with FDI organized as efficiently as possible within each bloc.

### **Implications for the organizational structure of multinational firms**

The pressures analysed in this chapter will have a profound impact on the organizational structure of multinational firms. They are presented with two key imperatives – to create appropriable assets, especially those based on generalized management skills (and, by analogy, to prevent leakage of returns from assets where appropriability is difficult) and to derive rent by internalizing locationally specific public goods. These imperatives require radical restructuring and will alter the scope of such firms.

Leakages in appropriability can be stemmed in two ways: by moving into assets which do not leak, and by stopping leakages in conventional assets (Buckley, 1983). As Figure 9.3 showed, non-appropriability is a key issue in ‘non-contractual transfers’. Largely because of institutional difficulties, multinationals have hitherto found it difficult to control these transfers – they are occurring mainly under the auspices of governments, universities, other non-commercial entities, and through grey and black markets. Our analysis leads us to expect that multinational firms will seek increasingly to control these areas. This will involve political action to internalize some governmental activities (or at least quasi-internalize them by representation in government and in the governing bodies of non-commercial organizations), and to seek to extend patent rights, licensing arrangements, copyright, branding design and technological protection, and to clamp down on piracy and counterfeiting.

Our analysis further suggests that acquisition, in particular, and joint ventures will become more important as FDI modes. Acquisition results from companies capitalizing their general entrepreneurial skills – backing their valuation of what these skills can achieve with post-take-over assets against the market’s valuation. This will lead to a new breed of financier, whose key skills will be to value generalized entrepreneurial and management skills residing in a firm’s system of control. Company

valuation will become even more of an art, and even more well rewarded for those at the successful apex of activity. One key part of these skills will be cultural sensitivity, for foreign acquisitions require this quality in abundance in order to release the value promised to the financiers in the post-acquisition integration phase.

### **The search for flexibility**

Much of the recent literature on the theory of multinational enterprises has emphasized their search for flexibility (Buckley and Casson, 1998). Attempts to build flexibility into the organization of multinational firms have been a response to the rationalization and restructuring of international business, and to the increasing volatility of the world economy. Flexibility – the ability to reallocate resources quickly and smoothly in response to change – has been a major aim of the management strategies of multinational firms, and it suggests that firms seek real options (Trigeorgis, 1996) which can be taken up or dropped depending on the outcome of the project. Joint ventures are an important case of an information-gathering real option, which enables the firm to reassess its future stance (Buckley and Casson, 1996, 1998).

Rongan (1998), following, *inter alia*, Kogut (1983, 1985, 1989) and Kogut and Kulatilaka (1994), assesses the degree of flexibility actually utilized by multinationals in response to exchange rate changes. The implementation of flexible strategies will depend on physical immobilities (fixed assets, plant level economies of scale and so on), strategic immobilities (weak internal control systems, administrative heritage), past investments in flexibility, and technological flexibility.

All this is relevant for multinationals facing new locational requirements where trade blocs form, consolidate and extend (and break up), for a primary purpose of the formation of a trade bloc is to shift locational attractiveness – to encourage investment diversion (switching from outside the bloc to intra-bloc investment). Trade blocs also attempt to induce a switch in the market servicing strategies of extra-trade-bloc firms from exporting to inward investment. This strategy proved very successful *vis-à-vis* Japanese firms in the run-up to the formation of the EU's Single Market in 1992.

### **Conclusion**

The formation and growth of trade blocs is clearly a major factor in the decisions of multinational firms on foreign market servicing strategies.



Both market-seeking and efficiency-seeking foreign direct investment into the expanding trade bloc are likely to be encouraged as market size grows and costs fall where economies of scale can be achieved. There are also likely to be more subtle effects arising from import-substituting FDI (tariff wall-jumping) for both offensive and defensive reasons. Firms which already have FDIs within the bloc may well choose to rationalize their investments in response to changing production costs, and they may reorganize production units in fewer location. The interaction between location factors and ownership factors may result in more 'hub and spoke' operations with large-scale production hubs linked to joint ventures' distribution outlets to deal with (cultural) differences across the market. Sectoral, product and spatial influences will produce widely differentiated strategies among firms, but a common element will be a search for flexibility by firms in a globalizing world.

This issue also has important dynamic implications. It has been shown that multinationals need to plan their foreign market servicing strategies in a dynamic yet flexible fashion. One of the key advantages of a successful multinational firm is the ability to reallocate resources in a low-cost manner. Therefore, it is to be expected that future changes in NAFTA, and in other groupings of economies, will provoke changes in, and reactions to, their external environment. This dynamic interaction is accelerating, producing the phenomenon known as globalization.

## Notes

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- 1 Trade diversion is the replacement of a lower-cost world supplier by a higher-cost supplier within the integrated area.
- 2 Trade creation is the replacement of a higher-cost domestic supplier by a lower-cost supplier within the integrating area.
- 3 See the Special Issue of *The Pacific Review*, 11, no. 2, on 'Thirty Years of ASEAN'.
- 4 The EU's Single Market Programme is intended to achieve a internal market free of non-tariff barriers, with price convergence between the member states.
- 5 Examples included legislation on financial service firms, local content rules in car manufacturing, product testing and registration for pharmaceutical companies, and barriers to establishing brands facing food and drink companies.

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# 10

## Increasing the Size of the 'Country': Regional Economic Integration and Foreign Direct Investment in a Globalized World Economy

*with Jeremy Clegg, Nicolas Forsans and Kevin T. Reilly*

Two contradictory trends characterized the world economy during the approach to the twenty-first century. First, the globalization of the economy, together with the successful conclusion of the Uruguay Round and the establishment of the World Trade Organization (WTO), brought about a steady decline in barriers to international business transactions. Second, however, as countries have lost their conventional powers to protect themselves from the outside world, they have grouped together, often on a pan-continental basis, into regional trading blocs. Regional economic integration, in the form of institutions such as the North American Free Trade Agreement (NAFTA), the European Union (EU) or the Asia-Pacific Economic Co-operation (APEC), represents the main way that remains accessible to countries in their attempt to maintain and promote their levels and shares of world investment, employment, income and growth.

Regional economic integration (REI) is therefore a way of increasing the preference of multinational enterprises (MNEs) for local production within the integrating area, and of increasing relative discrimination against firms outside the area of integration. Regional integration offers insider firms incentives to invest more locally, by reducing transaction costs and thereby increasing the rate of return on capital. At the same time, it creates motives for outsider firms to become insider firms. Much regional integration represents an attempt to 'increase the size of the country', to obtain the benefits of large countries over small ones, with all the implications that this carries for the investment strategies of multinational firms. Regional integration fosters the environment for

firms themselves to grow to a large, efficient scale. The two processes are therefore intertwined.

The search for size-of-country benefits mirrors the growing importance of created, as opposed to naturally-occurring, assets in production processes. These assets account progressively for a higher proportion of value added in most manufacturing and service activities. The rise of these created assets has generated a new breed of location-specific motives for regional integration. This is evident if we contrast present-day REI with the earlier imperial groupings of geographically disparate countries. The qualitative difference so revealed reflects the ascendancy of economies of scale (at both the firm and plant level), of scope (benefiting from the joint production economies gathering together a greater range of activities), and of learning at the firm level. At the same time it reflects the relative decline of international strategies based on naturally-occurring locational advantages. Though these last mentioned strategies certainly exist, they are prevalent mainly in the international vertical disintegration of production – for example, in the location of labour-intensive stages of production processes in low-wage developing economies.

Therefore, the *prima facie* evidence suggests that country size matters, and regional economic integration is a means of obtaining the economic benefits of country size without necessarily, the complete elimination of separate sovereign countries. This chapter reviews the evidence in the context of REI in North America. Using data from the US Department of Commerce, it investigates the strategic reactions of European firms to North American regional integration in terms of their foreign direct investment into the USA.

The North American Free Trade Agreement (NAFTA), is an agreement between Canada, the USA and Mexico, which came into force on 1 January, 1994. It consists of a commitment by Mexico to implement the level of trade and investment liberalization promised between Canada and the USA, according to the Canada – United States Free Trade Agreement (CUSFTA), signed in 1988.

NAFTA provides for the phased elimination of tariff and most non-tariff barriers on regional trade within ten years, although a few import-sensitive products have a fifteen-year transition period. USA – Canada bilateral tariffs continued to be phased out according to the CUSFTA schedule (that is, by January 1998). In addition, NAFTA extends the dispute settlement procedures of the CUSFTA to Mexico. It also contains precedent-setting rights and obligations regarding services and investment, and takes an important first step in addressing environmental issues. Finally, it addresses unfinished business under the CUSFTA, in

the form of the protection of intellectual property rights, rules against distortions to investment (local-content and export performance requirements), and coverage of transportation services.

In this chapter, we focus on the strategic responses to CUSFTA and NAFTA of Europe-based MNEs. We examine the link between the size of country and the competitiveness of the firm, then introduce a framework for the study of MNEs' reactions to free trade agreements. We present and discuss the results of an econometric model aiming at differentiating the separate effects of CUSFTA and NAFTA on the direct investment-based strategies of European MNEs by their country of origin. Some of the disaggregated results we obtain seem to point away from the size-of-the-country hypothesis, while others support it. In view of the developments within the European market that have been progressing almost simultaneously with North American integration, our mixed findings simply indicate that more detailed research is needed.

### **Characterization of regional economic integration in North America**

The foremost example of regional economic integration in the post-war period has been that in Europe, though the process started with the primarily political agenda of reconciling countries. It is with the Single Market Programme (SMP) that the economic relationship between 'country size' and investment behaviour has become most apparent (Aristotelous and Fountas, 1996; Clegg and Scott-Green, 1999)<sup>1</sup>. Coupled with this deepening of economic integration, the EU has also pursued widening. Since the first enlargement in 1973, the European Union has also sought the expansion of the geographical scope of regional integration, with the addition of central and eastern European countries now in prospect.

In comparison with economic integration within Europe, REI in North America has been more driven by pressure from private-sector firms rather than by political imperatives or public policy initiatives. The two countries most similar in terms of economic development, Canada and the USA, are the most suitable candidates for REI, according to Vinerian analysis (Viner, 1950). The economic incentives to reduce trade and investment barriers within the CUSFTA and the NAFTA have primarily been those of reducing the artificial barriers that burden the considerable trade already conducted between the member countries. The USA is, of course, the home of the leading MNEs in the world, and it is in their interests to alleviate the handicaps they face in organizing efficient

patterns of production within North America. The economies of Canada, the USA and Mexico have been closely linked for a long time. This integration has developed along the lines of a 'hub and spoke' relationship for trade and direct investment, as the USA is the main destination for Mexican and Canadian exports and direct investment. However, Canada and Mexico attract only a negligible part of each other's exports and direct investment.

How, then, do we characterize CUSFTA and NAFTA in terms of the typology of REI? Unlike the EU and its precursors, the European Economic Community (EEC) and the European Community (EC), the NAFTA is not a customs union, let alone a common market. It is a free trade agreement (FTA) in which each member country retains its own tariff on imports and other regulations regarding trade with third countries. The bases of this agreement are the rules of origin. These rules prevent trade deflection, which is the import of goods from third countries into the FTA by, for example, country A (that has a relatively lower external tariff than the partner country B) in order to re-export the good to country B<sup>2</sup>. Mexico and Canada were in favour of relatively liberal rules of origin because of the positive impacts such lenient rules would have on current and future Japanese foreign direct investment (FDI) in these two countries, and therefore on potential exports of goods to the USA. The required local content of goods for liberal treatment in the NAFTA is initially set at 50 per cent but scheduled to increase to, and stay at, 62.5 per cent from 2002.

Unlike the REI pursued by the EU, the CUSFTA and NAFTA frameworks of integration leave important areas untouched. Notably the issues of subsidies, labour markets and agriculture (Jovanovic, 1998) are for the most part not addressed in these treaties. To understand why this is so, it is necessary to appreciate the political and economic contexts that have shaped these agreements. In the Canada – USA context there exists a long-standing post-war agenda for economic rationalization in goods and services. The 1965 Auto Pact is the primary pre-CUSFTA example of this implicit programme. Prior to NAFTA, the Mexico – USA relationship was one of economic barriers, where Mexico employed state intervention in the economy's operation to prevent investment and trade. As Krugman (1996: 165) has pointed out, NAFTA represents a method of trying to help the Mexican economic reform process, which is in effect a pre-condition for starting the process of economic integration between these two countries. This pre-condition was not required in the Canada – USA relationship, which was founded on the economic arguments for integration, such as the benefits of large

markets, of economies of scale, increased employment, and growth. This difference in focus between the CUSFTA and NAFTA accounts for the existence of NAFTA provisions in respect of phenomena such as the maquiladoras, which are expected to disappear<sup>3</sup> during the seven-year transition process. The striking feature of the NAFTA is that it is an arrangement that brings together countries with significant differences in per capita income. This is why Mexico was permitted a transition period of seven years for the elimination of tariffs, longer than was the case between Canada and the USA.

Within the context of North American integration, NAFTA's primary role is to enable Mexico catch up in terms of liberalization. Although the economic impact of this alone for the North American economy is not large, the NAFTA paves the way for integration of a deeper character in the future. Therefore the economic fundamentals of European and North American integration are to some extent shared. The important fact is that, although the USA is by any reckoning already large, there have been, and remain, sound economic reasons for REI. Accordingly, Canada and the USA have pursued economic integration for a considerable time during the post-war period, though the CUSFTA represents a clear acceleration. In view of this, it is reasonable that, on economic grounds, the response to CUSFTA by firms from outsider countries should have been positive. NAFTA, by including Mexico, added the long-term development and reform of Mexico to the North American agenda, but the immediate economic benefits are clearly more modest. It is in respect of Mexico that North American integration most resembles the initial motive for European integration and, to some extent, the motive for the association agreements of the eastern European states, which are intended to lead to eastern enlargement.

Before analysing how European MNEs have responded to the process of increasing the size of the North American 'country', in the following section we study in greater detail the extent to which regional economic integration might contribute to the enhancement of firms' competitiveness.

### **Competitiveness and the size of the country<sup>4</sup>**

REI allows countries to emulate the efficiency gains from increasing country size in a number of discrete ways, and to different extents. We can identify three levels of markets – financial markets, markets in goods and services, and labour markets. Each of these is moving at a different speed towards global integration. Financial markets are already



very closely integrated internationally, so much so that no individual 'national market' can have an independent existence. REI, however, is effective in integrating goods and services markets at the regional level. Labour markets, however, are functionally separate at the national level, and here integration is largely resisted by national governments (Buckley *et al.*, 1998).

While the largest multinational enterprises are already perfectly placed to exploit these differences in the international integration of markets (Buckley, 1997), however, REI offers both large and small firms the opportunity to enjoy the advantages of a large 'home' market, whether it is their native home or their adoptive one. The operation of international capital markets (which allow firms to drive their capital costs down to a minimum) have largely transcended policy on regional integration, although each region would hope to retain its own regional financial centre. It is primarily in the arena of the creation and fostering of regional goods and services markets, that enable firms to exploit economies of scale across several countries, that REI offers the most substantial size-of-country benefits. However, regional integration that encompasses countries with differential labour markets is becoming increasingly beneficial. This regional integration enables costs to be reduced by locating the labour-intensive stages of production in the cheap-labour economies, but within the integrated area. Firms that serve just one regional market, as well as those that serve several of the regional goods and services markets of the world through horizontally-integrated FDI, are able to complement this with vertically-integrated FDI in quality-differentiated labour markets. Vertical integration also reflects the spatial distribution of supplies of key inputs and raw materials. The multinational enterprise achieves advantages through both vertical and horizontal integration. Each strategy is promoted by the 'size-of-country benefits' of regional economic integration in goods and services markets, which reduce or eliminate artificial barriers to trade between the members. This maximizes the ability of firms to exploit intra-regional differences in factor abundance, including differentiated human capital.

Buckley *et al.* (1988) noted that there has been considerable debate over what competitiveness really means. Some economists argue, using the Ricardian concept of comparative advantage, that loss of manufacturing competitiveness is a natural consequence of economic maturity (Krugman, 1996). The mature economies can promote domestic structural adjustment, moving away from manufacturing towards services, and adopting expedient measures to promote labour market flexibility.

However, manufacturing is increasingly capital-intensive, whereas many service industries are inherently human-capital-intensive. To regain country competitiveness, mature countries must shift labour out of manufacturing and into services. To maximize the exploitation of the country's comparative advantage, however, it is helpful if even low-cost labour manufacturing operations are located sufficiently close that regionally integrated production strategies are viable, based on the vertical disintegration of production stages by comparative advantage. This provides an economic rationale for the integration of Mexico within NAFTA, and of the southern European countries within the EU, and of the prospect of eastern European enlargement.

It follows that REI between the advanced industrial countries can promote the competitiveness of firms that are locally-based, and regional integration with countries with lower incomes per capita can ease the costs of structural adjustment in the mature partners. There are, of course, alternative views of competitiveness that emphasize the entirely firm-specific nature of competitive advantage, quite divorced from the size-of-country effects. There may be wide differences in productivity between firms in the same industry, and theories of comparative advantage, framed in terms of a representative firm, overlook this (Thurow, 1992). The competitive advantages of leading Western firms have been eroded by internal failings, it is alleged. However, as we have argued, there are strong reasons for believing that regional integration does feed through to fostering an environment that widens the strategic options of firms, and enables them to gain, or regain, competitiveness.

Indeed, it may be argued that the distinction between firm-specific competitive advantages and nation-specific comparative advantages (such as those fostered by regional integration) is essentially a question of the period of analysis. Firm-specific competitive advantage is essentially a short-run concept. Firm-specific advantages cannot be taken as given in the long run because they continually become obsolescent, and have to be renewed regularly (Buckley and Casson, 1976; Buckley, 1983). A nation with a comparative advantage in entrepreneurship will be able to renew firm-specific advantages through sustained innovation, but a nation without such comparative advantage will not. An explanation of loss of competitiveness that emphasises loss of firm-specific advantages is equivalent, from a long-run perspective, to an argument that local comparative advantage in entrepreneurship has been lost. Countries that systematically generate firms with specific advantages are those that have a nation-specific comparative advantage in entrepreneurship. Ultimately, the link between the size-of-country effects of regional integration and

the competitiveness of firms centres on the link with the fostering of entrepreneurship; that is, risk-taking. The key is to provide market opportunities that make attractive the rewards from the taking of risks. For the mature economies it is unrealistic to expect rates of growth that compare to those of the catching-up developing economies. Instead, the rewards must be sought through alternative means, such as regional integration. As noted above, this implies the reduction or elimination of artificial barriers, as within the context of regional integration.

Specific policies of liberalization can improve some of the key conditions necessary for entrepreneurship to flourish, but they do not provide the opportunities themselves. Some governments have attempted to restore labour market flexibility through legislation. In the UK, for example, the legal privileges of trade unions (such as secondary picketing) have been reduced; and qualifications for the receipt of unemployment benefit have been tightened up. Firms have responded in a predictable way. Greater use is now made of temporary labour to accommodate peaks and troughs in demand. Full-time workers are expected to work more flexible hours. Work has been subcontracted out to avoid statutory National Insurance premiums. The rise in labour-only subcontracting has brought back the 'putting out' system which was characteristic of the eighteenth century 'commercial revolution'.

Privatization has been used to promote greater flexibility in the supply of intermediate products to industry. The UK has privatized 'strategic' heavy industries (steel), public transport (railways and airlines), and utilities (telecommunications, electricity, gas and water). Privatization allows peripheral activities to be sold off, and complementary activities to be combined, thereby facilitating significant changes in the scope of the firm. Newly-privatized enterprises can acquire other newly-privatized enterprises, or enter into joint venture agreements with them. For the first time in the post-war period, large-scale multinational enterprise is now possible in most of the utility industries.

Business education can be expanded to improve the skills of entrepreneurs, top rates of income tax can be reduced to encourage risk-taking, and successful business people can be encouraged to play a more active role in public life in order to raise the status of entrepreneurs. In recent years, politicians have increasingly promoted the values of competitive individualism, and downgraded the values of organic solidarity that characterised the Welfare State (Casson 1990, Ch. 4).

The fostering of research and development via policy does not, of itself guarantee that the benefits will be felt directly in the country concerned. Products researched in one country can be produced in

another, and even exported back to the country where they were researched to compete with local products there. The decentralization of R&D within large MNEs (Pearce and Satwinder, 1992) creates internal markets where this kind of transfer can be effected easily. Thus, for example, a German MNE could use a wholly-owned research laboratory in the USA to tap into government-funded research in order to develop a product to be made in Europe for export to North America. The profits from the product innovation will also accrue to the German parent – an effect that has been stressed by Reich (1990). The key is to not only provide the support for the creation of new knowledge, but also the conditions for the successful exploitation of the knowledge. The prototypical example of the benefits of the size-of-country effect was provided as long ago as 1966, by Raymond Vernon (1966) in the famous Product Cycle Model (PCM). This model was an elegant, stylized account of the generation of firm-specific advantages within the US economy (Buckley, 2000). These advantages were nurtured by the large domestic free market, which encouraged both entrepreneurship and high levels of research and development, through the spreading of the fixed costs of innovation. Domestic sales alone were sufficient for the profitable exploitation of firms' advantages, but exports followed, to further exploit these advantages, and then production abroad, typically via FDI. Although manufacturing industry was cast in the leading role, in principle, service industries could, with certain adaptations, also be subsumed.

The above reasoning on the linkages between the size-of-country effects of regional economic integration has been framed at the macro-economic level. However, international business theory provides an account of the strategies available to firms in the context of regional integration. An understanding of the strategies of firms under conditions of regional integration provides the bridge between the foregoing analysis and the expected impact of regional integration on the foreign direct investment behaviour of firms. The FDI behaviour of firms is an excellent acid test of the impact of regional integration on size-of-country benefits, because it reflects the investment decisions of firms located outside the integrating area to commit resources to the area. In other words, it reflects firms 'voting with their feet'.

### **A framework for the impact of regional integration on FDI-based strategic responses**

As noted earlier, while REI may be seen as a further step towards the liberalization of trade and investment, institutionalized agreements bring

with them a package of discriminatory weapons against outsiders (rule-of-origin is an example). The contrasts between the strategic reactions of insiders and outsiders in the context of regionalization are a major theme of this chapter.

This section focuses on the theoretical implications of the formation of trading blocs in North America on the strategies of multinational firms. We shall focus here on the impact of regional economic integration in North America (that is CUSFTA and NAFTA) on outsiders, especially on Europe-based MNEs.

### **North American integration's impact on bloc strategies**

The emergence and the consolidation of the CUSFTA and NAFTA give rise to important implications for how multinational firms are doing business abroad. One of the primary purposes of REI is to shift locational attractiveness – to encourage investment diversion (switching from outside the bloc to intra-bloc investment). Linked to this, regional economic integration also attempts to induce a switch in the market servicing strategies of extra-trade bloc firms from exporting to inward investment. In addition to diverting investment into the bloc by non-bloc multinationals, regional integration will also affect the investment location of both insider and outsider firms. In principle, the creation of a free trade area from a number of separate markets may make a central production site more attractive. This has potential for firms to create a 'hub and spoke' system of central facilities (manufacturing) combined with a set of distribution outlets radiating from the central facility. This location strategy can be combined with an ownership strategy where joint ownership of distribution can be utilized (Buckley and Casson, 1998).

It could also be argued that the formation of a free trade area provokes a move from a multidomestic strategy (where firms can treat competition in each country as separate) to a 'regional' strategy, where strategy becomes inextricably intertwined across the newly-integrated market (Porter, 1986). Therefore, on this new regional scale, it is evident that following regional integration, for example, a UK firm that formerly invested in Canada to service the Canadian domestic market may now switch – or consider switching – investment to the USA or Mexico. New investors face the same choice. The overall impact on foreign firms very much depends on their existing locational strategies. A study by Buckley *et al.* (1994) concluded that the competitive ability of established UK investors in Canada might benefit from regional integration. Clearly, many factors, including industry- and firm-specific factors will be influential.

The sheer size of the North American market, and the fact that there remain certain barriers that continue to segment Canada and the USA, means that a single strategic approach to North America is unlikely for many firms. For example, legislative differences arising out of historical developments persist<sup>5</sup>. These considerations explain why many firms will continue separate organizational developments in both markets.

The research by Buckley *et al.* (1994) arrived at the conclusion that NAFTA has consolidated firms' trade and FDI strategies towards the North American market, rather than led to completely new strategies. The promise of greater freedoms led to opportunities being seized earlier. That is, it primarily affected the timing of investment, even though the 'real' economic benefits from the establishment of a free trade area are still some way off. Certainly, the growing power of the region brought about by North American regional integration is an important magnet for investment. The sample of firms studied by Buckley *et al.* (1994) expressed a deepening concern that to be competitive globally means developing business in all the major markets of the world, in particular, the triad regions of Europe, America and Asia-Pacific. The drive for regional integration should be understood in this context. In developing North American integration, the policy objective (however implicit) is very much to play on outsider firms' investment strategies, and to convince them that North America will offer an enhanced rate of return on investment.

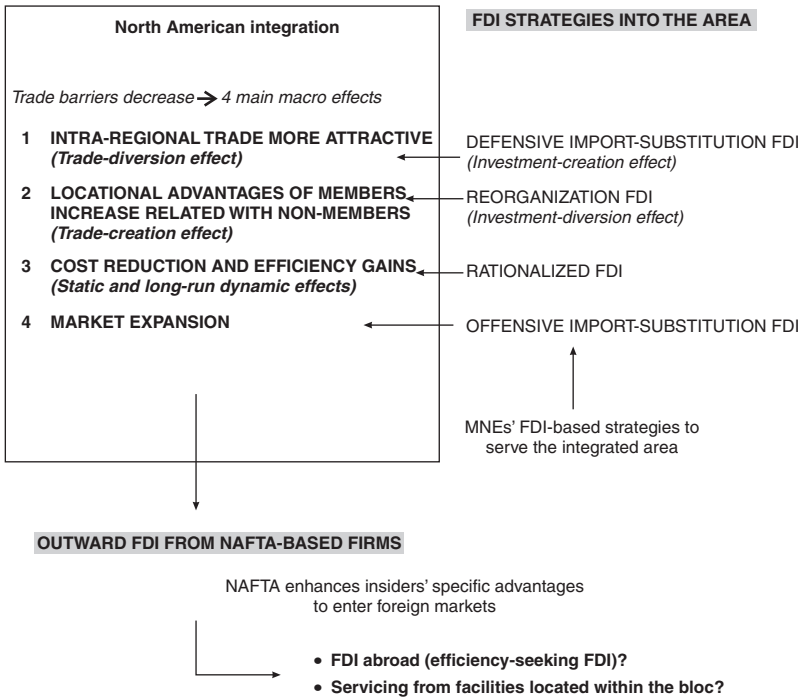
### **A framework for North American integration's impact on FDI**

Following UNCTAD (1993), Forsans (1996), and Buckley *et al.* (1998), four kinds of foreign direct investment strategies related to regional integration can be identified: defensive import-substituting strategy; reorganization investment; rationalization investment; and offensive import-substituting investment. We shall examine these strategic choices in greater detail below:

- *Defensive import-substituting investment* is a response by outsider firms to the trade-diversion<sup>6</sup> effects that occur from North American integration. The removal of trade barriers among CUSFTA and NAFTA members leads to an increase in the locational advantages of the members. A switch from an export-based strategy to a FDI one allows the firm to maintain its market share threatened by the trade-diversion effects. This switch is obligatory, since it is the only one that both allows an outsider to gain access to the integrated market(s) and to behave as an insider.

- *Reorganization investment* is a consequence of the trade-creation<sup>7</sup> effects. These exert pressures on insider firms (be they native or foreign-owned) to reorganize production in accordance with member countries' comparative advantages. Firms are likely to regroup their production facilities in fewer locations where more favourable production costs can be found.
- *Rationalization investment* is a strategic response by insider firms to returns-to-scale effects that arise as a result of integration. These induce a decrease in production costs within the integrating area, rendering certain locations better places for the sourcing of output. Increased levels of investment will result in locations that benefit most from the reductions in production costs, and plant closures (or reductions in the extent of production) may result in other locations. This is the most likely form of FDI strategy to cause the adoption of a 'hub and spoke' system of organization as a result of regional integration.
- *Offensive import-substituting investment* is FDI whose motivation is to take advantage of growing demand and the opening up of new markets. As a result of NAFTA's growth-enhancing and market-augmenting dynamic effects, the size of the barrier-free market within which a firm operates (or has the potential to operate) expands. This motive could be shared by both outsider and insider firms.

Figure 10.1 sums up the effects of NAFTA on FDI through its impact on intra- and extra-regional trade. The removal of trade-barriers within the area induces direct effects on the location of production as well as indirect effects through the impact it exerts on factors such as income levels, competition and innovation. The relationship between trade and investment is very complex. Defensive import-substituting investment (responding to trade-diversion effects) by its nature replaces trade. Other investment-based strategies can complement a trade-based strategy, especially in the case of rationalization investment and reorganization investment, which can encourage inter-industry trade (rationalization FDI) and intra-industry trade (reorganization FDI). Therefore, the FDI literature is ambivalent with regard to the effects of regional integration on the FDI – trade relationship. Different effects could be foreseen, contingent upon the type of FDI being considered. The literature would suggest, for example, that while defensive import-substituting FDI would decline, efficiency-seeking FDI would increase. The net effect will then depend on industry, country or even firm-specific considerations, and notably whether, in supplying products from a given location,



**Figure 10.1** Effects of North American regional economic integration on FDI-based strategies of multinational firms: foreign investment as a weapon to cope with the trade effects of FTAs

foreign rather than domestic-owned firms have a competitive advantage (European Commission, 1998: 36–7). Both theories of trade and international production posit that the relationship between intra- and extra-regional trade and FDI was conditional on the kind of trade and FDI being considered, and the conditions under which each took place. However, it is reasonable to hypothesize that the more similar the industrial and geographical patterns of trade and FDI (or both), the more it is likely that they will be complementary, rather than substitute for each other.

These strategic responses will also affect geographical and sectoral distributions within the free trade area, as well as the level of FDI. Cost-reduction effects can generate reorganization or rationalization investments, depending on whether the MNE served the integrated market with imports from non-member states or from production facilities located



within the trading bloc. In the first case, rationalization investments can occur from decreasing production costs within the area, and from increasing opportunities to exploit scale economies. In the second case, reorganization investments will take place within more specialized facilities, each with a smaller scope of production activities. X-efficiency gains could combine with rationalization FDI as the costs of intermediate inputs become cheaper within the integrated area. Overall, the removal of market fragmentation and the stimulus to growth from the dynamic effects of regional economic integration open up new opportunities for FDI by firms with strong competitive advantages. Finally, the uncertain issue of NAFTA's future trade policy can also attract FDI motivated by the fear of future restrictions in market access to the enlarged market. This augments the defensive import-substituting motive noted above. However, this type of FDI can lead to surplus capacities within the regionally-integrated area, and does not necessarily correspond to an efficient worldwide distribution of investment resources.

North American integration will also affect outward FDI to third countries from MNEs located within the area. Indeed, the cost-reduction effects occurring from the static and dynamic effects of free trade areas (with consequences for scale economies, X-efficiency gains, country specialization, competition and innovation) can improve the competitiveness of regionally-based MNEs and help them to exploit foreign markets better, indeed to become globally competitive. This is the same reasoning that formed the basis of the outsider firms' views reported by Buckley *et al.* (1994), but applied more generally to all firms operating in North America. It is possible that for some (especially smaller) firms, the attraction of servicing foreign markets from production facilities located outside the regionally-integrated area will be reduced relative to servicing markets from locations inside. In this case, trade would replace foreign production owned outside the bloc. However, the search for efficiency to cope with increased competition within the bloc can lead the larger established multinational firms (with the greater internal resources) to conduct rationalization FDI outside the trading bloc. In this way, these firms benefit from regionalization while ensuring access to cheaper inputs.

### **The impact of North American economic integration on FDI-based strategic responses of multinational firms**

The FDI values are constructed using data from the US Bureau of Economic Analysis, Department of Commerce, which calculates annual

**Table 10.1** Share of foreign direct investment in the USA by Canada, Europe, Japan and the rest of the world (ROW)

	1960	1973	1980	1985	1990	1995	1996	1997
Canada	27.99	23.24	14.74	9.28	7.48	8.52	9.22	9.39
Europe	68.12	71.85	66.91	65.77	62.63	62.06	62.00	62.38
Japan	1.27	1.49	6.18	10.46	21.04	19.61	19.28	18.12
ROW	2.62	3.42	12.17	14.49	8.85	9.81	9.50	10.11
Total	100	100	100	100	100	100	100	100

Source: US Bureau of Economic Analysis.

estimates of the inward FDI stock. We draw on data<sup>8</sup> for the time period 1960 to 1997, and will concentrate on the UK, the Netherlands, Switzerland, France and Germany<sup>9</sup>. To analyse the trends in FDI we shall look first at some basic descriptive statistics and then at a simple model of growth in FDI to highlight the differential reaction of European MNEs to the policy variables CUSFTA and NAFTA.

To set the context for the European countries response to CUSFTA and NAFTA, we present the trend in the share of FDI into the USA between 1960 and 1997 in Table 10.1. Clearly, the trend is a rise for both Japan and the rest of the world (ROW) in terms of market share of FDI in the USA. Japan, in particular, increased its share by over 900 per cent in this period. The major loser in terms of market share has been Canada, dropping from 28 per cent to 9.4 per cent in this period. The other market share losers are the European countries, falling by approximately 5 per cent. However, the data indicate that it is about the time of CUSFTA and NAFTA that most of this market share was lost. A question of interest is whether the reaction of European countries was uniform in terms of this shift in the market size of 'North America' that the 'big country' hypothesis would suggest.

Table 10.2 breaks down the share of FDI in the USA by the five significant European investor countries. This table suggests strongly that there have been differential responses to the enlargement of the North American market by these countries. For the UK and Switzerland, we observe a stabilization of a declining trend, while for the Netherlands we are observing a significant abandonment of the US market in market share terms. France and Germany have, however, exhibited a slight downward trend in their market share of FDI, all of which suggest that the response of European firms was country-specific.

**Table 10.2** Share of foreign direct investment in the USA by selected European countries

	1960	1973	1980	1985	1990	1995	1996	1997
UK	32.53	32.46	17.91	23.59	24.99	21.71	20.42	19.01
Netherlands	13.70	14.45	24.74	20.07	16.38	12.16	12.51	12.45
Switzerland	11.19	10.85	7.42	5.72	4.48	5.13	5.12	5.66
France	n.a.	4.75	5.46	3.61	4.72	6.75	6.92	6.91
Germany	n.a.	5.55	11.11	8.03	7.15	8.59	10.08	10.23
Europe	68.12	71.85	66.91	65.77	62.63	62.06	62.00	62.38

Source: US Bureau of Economic Analysis.

In terms of the industry distribution, since 1985 the petroleum industry's share in European FDI into the USA has plummeted, from 21 per cent to 7 per cent. The Netherlands' drop can be explained partly by this shift in composition away from the petroleum industry. The other extractive industry for which there are some data, mining, was deleted as a separate item by 1990, from which it can be inferred that this industry had become so minor as to cease warranting its own category. The counterpart of these sectoral changes is the growth of the service sector. In the case of US inward FDI, finance and insurance are identified separately, totalling an 18 per cent share. The two European countries with the strongest bases in finance, the UK and Switzerland, have made the greatest inroads into the USA. The UK's share rose from less than 1 per cent in 1985 to 16 per cent in 1997, and the Swiss share from 6 per cent to 20 per cent.

Apart from these, the leading industries remain in the manufacturing sector. The chemicals industry, in particular, accounts for high shares, suggesting both European industrial competitive strength and the attractiveness of the US market in these industries. Apart from the general secular trends, European FDI in the USA does exhibit some source-country-specific patterns. UK foreign investment in real estate, which peaked in the mid-1980s at the time of the low exchange value of the dollar to sterling, has fallen subsequently. The negative FDI position of France in this industry in 1985 and 1990 is likely to be a reflection of French affiliates in the finance industry expanding their lending to their parent firms in France<sup>10</sup>.

So, while the growth of the service sector has accompanied, and has been part of, the intensification of transatlantic FDI, nevertheless US inward FDI from Europe in key manufacturing industries remains

relatively strong. Market-seeking FDI characterizes all European involvement in the USA; that is production is predominantly for the US or North American market. It is likely that North American market size and integration have combined to shift market servicing strategies increasingly towards direct local production. This does indeed seem to be case in certain industries (for example, in the chemicals group). The strong and growing attractiveness of the US market for FDI in this industry certainly appears to signify market-seeking FDI. As this industry group comprises pharmaceuticals, its market-seeking character may probably be allied to the need to locate pharmaceuticals production in North America. However, an overview of the statistics does not allow us to draw any conclusions regarding the significance or the strength of impact of North American REI on the inflow of FDI. Clearly, more analytical research is needed to assess the role of policy changes for the evolving pattern of transatlantic FDI.

### The model

To model the growth in the FDI we have selected a parsimonious constant growth curve. The intercept term in this equation represents base (or starting point), while the natural log FDI ( $\ln FDI$ ) and the parameter on the time trend ( $t$ ) represent the growth rate of FDI. Both parameters have an expected sign of greater than zero. To measure the policy effects in this equation we introduce two dummy variables which correspond to the time periods in which FDI behaviour is likely to be affected by the Canada – US Free Trade Agreement (CUSFTA) and North American Free Trade Agreement (NAFTA)<sup>11</sup>. The expected signs on these variables are positive, in that we propose the alternative hypothesis that North American integration has resulted in a significantly greater level of inward FDI into the USA. The interpretation of the actual coefficient is that it represents the effect on natural log of base FDI. So the equation for country  $i$  in period  $t$  is:

$$\ln FDI_{it} = \alpha_i + \beta_{1it} + \beta_{2i} CUSFTA_{it} + \beta_{3i} NAFTA_{it} + m_{it}. \quad (10.1)$$

The 'countries' of interest are 'Europe' (as a whole), 'Europe 3', defined as the UK, the Netherlands and Switzerland, for which data are available for the time period 1960–97, and 'Europe 5', defined as 'Europe 3' plus France and Germany, for which data are only available from 1973 (See Table 10.3.).

**Table 10.3** Determinants of the natural log of foreign direct investment into the USA by Europe, Europe 3 and Europe 5

	Year	CUSFTA	NAFTA	Constant	Adj.R <sup>2</sup>
Europe (1960–97)	0.080 <sup>a</sup> [24.433]	0.327 <sup>a</sup> [3.909]	0.078 [0.839]	9.535 <sup>a</sup> [191.463]	0.981
Europe 3 (1960–97)	0.072 <sup>a</sup> [18.745]	0.421 <sup>a</sup> [4.304]	0.082 [0.753]	9.371 <sup>a</sup> [160.773]	0.969
Europe 5 (1973–97)	0.114 <sup>a</sup> [20.242]	0.040 [0.567]	-0.433 <sup>a</sup> [-4.547]	8.759 <sup>a</sup> [77.868]	0.985

Notes: Europe includes all European countries, whether belonging to the EU or not.

Europe 3 includes the UK, the Netherlands and Switzerland, for which data are available from 1960.

Europe 5 includes Europe 3, France and Germany for the period 1973–97.

Numbers in [ ] are the *t*-ratios.

<sup>a</sup> Indicates the parameter is significant at the 99% level of confidence.

### Statistical findings: the selected countries of Europe

The ‘big country’ hypothesis suggests that European reactions to CUSFTA and NAFTA could be uniform. However, as we have already seen at the descriptive statistics level, the evidence is not supportive of this hypothesis. If we treat Europe as one big country (see Table 10.4), it reacts in a way

**Table 10.4** Determinants of the natural log of foreign direct investment into the USA by selected European countries

	Year	CUSFTA	NAFTA	Constant	Adj.R <sup>2</sup>
United Kingdom (1960–97)	0.061 <sup>a</sup> [11.362]	0.768 <sup>a</sup> [5.569]	0.406 <sup>a</sup> [2.654]	8.756 <sup>a</sup> [106.622]	0.943
Netherlands (1960–97)	0.093 <sup>a</sup> [28.968]	-0.25 [-0.306]	-0.439 <sup>a</sup> [-4.841]	8.115 <sup>a</sup> [166.628]	0.981
Switzerland (1960–97)	0.054 <sup>a</sup> [14.323]	0.367 <sup>a</sup> [3.829]	0.380 <sup>a</sup> [3.575]	7.646 <sup>a</sup> [134.144]	0.959
France (1973–97)	0.101 <sup>a</sup> [10.275]	0.142 [1.152]	0.209 [1.262]	6.468 <sup>a</sup> [33.111]	0.965
Germany (1973–97)	0.145 <sup>a</sup> [14.669]	-0.235 <sup>b</sup> [-1.878]	-0.678 <sup>a</sup> [-4.048]	6.068 <sup>a</sup> [30.696]	0.965

Notes: Numbers in [ ] and the *t*-ratios.

<sup>a</sup> Indicates the parameter is significant at the 99% level of confidence.

<sup>b</sup> Indicates the parameter is significant at the 90% level of confidence.

Source: Data on FDI into the USA by France and Germany have only been made available from 1973.

that would be expected given the expansion of the North American market. The CUSFTA dummy is positive and highly significant. The result for the NAFTA dummy, although contrary to expectations, is explicable, however, in the 'big country' context. As discussed above, part of the role of NAFTA was to support the economic reforms of the Mexican economy that is a necessary pre-condition to economic integration. This implies that the effect on FDI in terms of the 'big country' expansion would only be observed when these reforms are completed.

When we look over the whole time period for the three large FDI countries in Europe 3 we see a very similar result to the aggregate numbers. This suggests that Europe as a whole reacted favourably to market expansion in North America. This result is in line with Dunning's findings on the positive impact of the European Single Market programme on extra-EC FDI flows (Dunning, 1996). However, when we include France and Germany [Europe 5], our results disappear, which suggests that the aggregate results observed in Europe and Europe 3 have been driven by country-specific behaviour that is dominating in these regressions. This country-specific behaviour has also been observed by Pain and Lansbury (1996) in European countries' intra-EC FDI flows as a result of the Single Market Programme (see Dunning, 1996).

Two countries, the UK and Switzerland, perform entirely in line with expectations. However, the Netherlands, France and Germany each have responses that are either insignificant, or even negative. It is apparent that the selected European countries cleave into two distinct groups, with only the first group (the UK and Switzerland) responding as expected. As Table 10.2 demonstrated, the UK has, overall, been the leading investor in the USA, but in the early 1980s the Netherlands accounted for just under a quarter of all US inward FDI. Since then, the Netherlands' share has declined to one-eighth. This results in a negative coefficient for NAFTA.

The likely explanation for the contrast in the investment behaviour towards North American integration is that the Netherlands, France and Germany were preoccupied with investing in the European Union from the mid-1980s, typically via mergers and acquisitions (Clegg and Scott-Green, 1999). The capital requirements of investment within Europe in particular taxed firms in the Federal Republic of Germany which, in 1990, had experienced the political reunification of East and West Germany. The strength of the German retrenchment can be seen in the negative coefficients for both CUSFTA and NAFTA.

The fact that the full set of North American integration variables are positive as expected only for the UK and Switzerland, indicates that

firms from these countries had different strategic plans from those of other European origin. The response by British investors could fall into the category of reorganization, rationalized or import-substituting FDI. Because UK firms already own a considerable amount of FDI in both the USA and Canada, reorganization or rationalized FDI may have been pursued, as many UK firms were already insiders within NAFTA. On the other hand, many may have upgraded the importance of North America because of North American integration, and this may have prompted defensive or offensive import-substituting FDI. Investment by UK multinationals in Canada place the United Kingdom as the leading European investor. Europe in total accounted for 24 per cent of all Canadian inward FDI in 1995, of which the UK held just under 10 per cent (Buckley and Clegg, 1998). To tease out the precise nature of these motives, analysis of secondary data, at least at the industry level, and preferably of primary data at the firm level, will be needed in the future.

At the aggregate level, we do observe support for the 'big country' hypothesis. However, when we turn to individual countries, MNEs have been pursuing very different strategies over the period. The UK and Switzerland reacted as predicted, in that expansion in effective country size resulted in significant growth in FDI. This is in line with the earlier discussion of industrial composition. However, firms from the Netherlands, France and Germany have pursued overall strategies that were contrary. In part, this can be explained by compositional differences (that is, the Netherlands); however, a more likely explanation is that these countries' MNEs were focused strategically on another 'big country' – the Single European Market.

## **Conclusions**

Regional economic integration is attractive because it offers the opportunity to increasing the size of the 'country' and internal trade, the observance of comparative advantage, and the reaping of scale economies. It does not primarily concern the raising of trade barriers with the rest of the world so much as the unfettering of trade and international business between the integrating countries. Many of the most important gains can be realized via the creation of a free trade area rather than a customs union. The logic of regional economic integration in the 1950s and 1960s by the European Economic Community and the European Community was based on the gains from internal trade, but for political reasons the structure took the form of a customs union and common market.

In the 1960s, countries that sought capital inflows (typically developing countries) were more likely to raise tariff and non-tariff barriers on imports. This has changed with the proliferation of investment opportunities around the world, the increased competition for investment funds, and the constant reduction of trade barriers under successive rounds of the GATT and WTO negotiations. It is not possible for countries to expect to attract inflows of FDI funds based on their domestic market size alone. There are a few notable exceptions, notably China and India, where the pace of domestic liberalization is the decisive factor determining capital inflows. However, for most developed countries, the only way that their size of country can effectively be augmented, to provide increased internal efficiency in production conditions and market opportunities, is via regional economic integration.

At the time of writing, countries increasingly group together in their trade and investment relations, or plan to do so, on the basis of geographical proximity. This is not entirely driven by the concession under international trade law given to countries pursuing regional economic integration, absolving them from applying most-favoured-nation treatment to all partner countries. As we conclude in this study, this progressive regional economic integration is targeted at attaining economies commonly associated with country size. This contrasts with the diffuse geographical membership under the former empires of many European countries, based primarily on inter-industry trade and conventional factor-abundance-driven comparative advantage (often resting primarily on natural resources).

We began by arguing that, as countries have ceded their conventional powers of protection of domestic industry, they have turned to REI. In our relatively short time-series study, we cannot investigate REI in terms of its size-of-country effects on the quality of firms' competitiveness. However, we have been able to examine the reactions of firms in the form of their FDI behaviour. That is to say, to research the strategic choice to become 'insider firms', which carries with it the benefits of size-of-country effects, notably the attainment of efficient production via economies of scale. Of course, there are protectionist aspects to REI, such as rules of origin, which mean that we cannot infer that size-of-country benefits alone are responsible for the reactions of outsider firms. However, the fact that the desire for protection takes the form that it does – REI – tells us something about the underlying economic fundamentals.

In this enquiry we have seen that, with respect to the size-of-country hypothesis, there is some evidence of regional economic integration



within North America has been effective. Investment by firms from European countries has been greater than it would otherwise have been, as a result of North American integration. Multinational firms from the UK and Switzerland appear to have upgraded the importance of the USA as an investment location as a result of REI. This, however, does not apply to the Netherlands, nor to more modest investors, such as France and Germany, each of whose firms in aggregate may have been more concerned with investment opportunities within Europe. In this respect, what we might be observing is the differential comparative advantages of countries' MNEs to be insiders and outsiders. Of course, we cannot say for certain that aggregate FDI by firms from these latter three countries would not have been even lower had North American integration not taken place. Even so, the evidence points to the conclusion that, collectively, European multinational firms raised their level of FDI into the USA as a result of North American integration.

For European countries, we have not found unambiguous support for the 'big country' hypothesis. We have generated the hypothesis that Switzerland and the UK may have behaved as outsiders in their FDI locational strategy, while Germany, France and the Netherlands' behaviour has been as insiders. To analyse this properly as part of the size-of-country hypothesis is beyond the scope of this chapter. However, it represents a worthy research programme for the future.

## **Data appendix**

### **Data on FDI into the USA**

The dependent variable is constructed from US Bureau of Economic Analysis (BEA), Department of Commerce annual estimates of the inward FDI stock. These data are the result of periodic benchmark (universe) surveys, with the data for intervening years being interpolated using smaller-scale surveys. The BEA considers the benchmark survey to be the foundation of its reporting system (Graham and Krugman, 1994). Normally, this survey is conducted once every five years. The most recent benchmark surveys, however, were those for 1997, 1992, 1987, 1980.

Our leading research question is whether the level of inward FDI into the USA was greater than it would otherwise have been as a result of the CUSFTA and NAFTA. These formal agreements came into force in 1989 and 1994, respectively. Consistent with the literature on the impact of the European Single Market Programme (Clegg and Scott-Green, 1999),

we would expect changes in the level of inward FDI into the USA to take place some two years before CUSFTA and NAFTA officially started (that is, from 1987 and 1992). However, the unusually large increases in the FDI position in the USA in 1987 and 1992 are partly related to the method by which the data are collected. As noted above, these particular years are ones for which a benchmark survey was conducted. Because of the imperfect estimation method between benchmarks, the transition from non-benchmark-year to benchmark-year data can produce a break in the series. The re-benchmarking of the series can result in significant increases or decreases entirely as a result of the universe survey. Unfortunately, there is no simple way to make an adjustment for this discontinuity. To be done correctly, the adjustment should be conducted using firm-level data. In recent years, the US BEA have begun to estimate the size of the discontinuity created and, where necessary, to reestimate the data for intra-benchmark years to remove the discontinuity. This exercise has never been done for FDI into the USA, because the discontinuity has not been large in the most recent benchmark survey years (1997 and 1992). Also, resource constraints have inhibited the US BEA from re-estimating the FDI data for earlier years (1987, 1980, 1974), even though it is statistically desirable.

However, we were provided with some idea of the magnitude of the discontinuities for 1980, 1987 and 1992. In 1980, benchmark discontinuities accounted for 51 per cent of the overall 1979–80 change in the FDI position of the USA. In 1987, they accounted for 20 per cent of the overall 1986–7 change. As we would expect, the magnitude of the discontinuities varies by country and industry. We were provided with tables showing a few country and industry details on the discontinuities, which represented the only information the BEA currently holds.

We then recalculated the FDI data for non-benchmark years by inflating the data for the earlier years on the basis that, as each benchmark survey is an improvement in accuracy, then it provides some information on the growth of underrecorded affiliates in earlier years. We know that immediately after a benchmark, the data are completely accurate, so we could not up-value the years immediately after a benchmark using the later benchmark at the same rate as we do for a year immediately preceding a benchmark. In the absence of any better information, the most reasonable adjustment is a straight line from zero to 100 per cent. For example, if there are six data years in between the benchmark years (for example, 1981–6, 1980 and 1987 being benchmark years), then we assumed that the 1981 data needed to be up-valued by  $(1/7)$  times the ratio of the 1987 benchmark value for 1987 data, with the 1980 benchmark

value for the 1987 data. Each year would add (1/7) until 1987, for which it is 100 percent of the ratio of the two different benchmark basis estimates.

These money value data were then translated into constant (1985 prices) US dollars for the period 1960–97, and the deflation of the monetary variables was conducted using the GNP deflator derived from national account statistics from the IMF (various years).

### The dummy variables

Two sets of dummy variables have been constructed.

*CUSFTA* A dummy variable to capture the impact of the Canada–US Free Trade Agreement. The variable assumes a value of 1 from 1987 to 1991, and of 0 in all other years. Consistent with the EU experience, we expect that MNEs reacted to CUSFTA some two years before it officially came into force in 1989.

*NAFTA* A dummy variable to capture the impact of the North American Free Trade Agreement. The variable assumes a value of 1 from 1992 to 1997, and 0 in all previous years. Again, we expect that MNEs reacted to NAFTA two years before it officially came into force in 1994.

**Table 10.A1** Value of Foreign Direct Investment into the USA by Canada, Europe and Japan (US\$ millions)

	1960	1970	1980	1985	1990	1995	1996	1997
Canada	1 934	3 117	10 074	17 131	29 544	45 618	54 799	64 022
Europe	4 707	9 554	45 731	121 413	247 320	332 374	368 322	425 220
Japan	88	229	4 225	19 313	83 091	104 997	114 534	123 514
Total	6 910	13 270	68 351	184 615	394 911	535 553	594 088	681 651

Source: US Bureau of Economic Analysis.

### Notes

- 1 In relation to trade alone, Petith (1977) had earlier demonstrated the welfare gains to European countries from the terms-of-trade effects (based on increased world market power) arising from the formation of the European Economic Community.
- 2 None the less, production deflection is possible if the production of goods that contain imported inputs is shifted to countries that have lower tariffs. This can occur if the difference in tariff offsets the difference in production costs.

- 3 Since creating the Maquiladora Program – originally referred to as the Border Industrialization Program – in 1965, the Mexican government has added temporary importation (TI) programmes, allowing foreign-owned manufacturers to locate assembly plants in Mexico, with varying degrees of access to the local market. The TI programmes allow manufacturers to import free of duty into Mexico raw materials, parts and components for their assembly and processing operations. Approximately 6,000 firms are registered in either the Maquiladora or TI programmes (USITC, 1998). Initially, products assembled in the maquiladoras were required to be exported. Under NAFTA however, maquiladoras are allowed to sell an increasing share of their annual production (75 per cent in 1998; 100 per cent in 2001) in the Mexican domestic market. The Maquiladora Program's special tax treatment is scheduled to end on 1, January 2001. Maquiladora plants will be required to pay customs duties on imported inputs that are not of North American origin, even if the assembled products are exported.
- 4 These arguments are taken largely from Buckley and Casson (1998).
- 5 Examples included legislation on financial service firms, local content rules in car manufacturing, product testing and registration for pharmaceutical companies, and barriers to establishing brands facing food and drink companies.
- 6 Trade diversion is the replacement of a lower-cost world supplier by a higher-cost supplier within the integrated area.
- 7 Trade creation is the replacement of a higher-cost domestic supplier by a lower-cost supplier within the integrating area.
- 8 The Data Appendix provides a complete description of our use of the BEA data and other variables introduced in the econometric analysis.
- 9 Data for France and Germany are available only for the time period 1973–97.
- 10 This sort of behaviour is short-term in motivation, and is intended to avoid losses, or exploit potential gains, from expected changes in exchange rates or interest rates. Although counter-intuitive as an indicator of foreign activity, negative FDI positions signify the use of highly integrated financial practices, and testify to a high degree of internal co-ordination within the multinational firm.
- 11 Clegg and Scott-Green (1999) argue that, when considering the effect of economic integration on FDI decisions, one should allow for the fact that firms will make decisions on the assumption that the agreement will be reached prior to actual implementation, given the time lags for the returns. In this context, we turned on the CUSFTA dummy in 1987 and turned off the dummy when we assume the NAFTA agreement becomes effective in 1992. These dates are employed rather than the actual implementation dates of 1989 and 1994 for CUSFTA and NAFTA, respectively.

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## **Part III**

# **International Joint Ventures**



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# 11

## Task and Partner-related Selection Criteria in UK International Joint Ventures\*

*with Keith W. Glaister*

The formation of international joint ventures between firms in developed market economies has increased markedly since the late 1970s (Anderson, 1990; Hergert and Morris, 1988; Glaister and Buckley, 1994). Firms have increasingly adopted joint ventures as a purposeful strategic response to changing market conditions, often with their direct competitors (Harrigan, 1988a; Vonortas, 1990). In the context of European industrial restructuring, Doz (1992) has argued that alliances will become more prominent as they are more effective than organic development, avoid some of the pitfalls of acquisitions and

represent a 'softer' approach more likely to bring the same rationalization and restructuring benefits as mergers are expected to provide. (Doz, 1992: 296)

A number of theoretical perspectives have been developed for joint-venture formation, the most prominent being those based on the transaction-cost approach (Hennart, 1988; Buckley and Casson, 1988), organizational learning (Kogut, 1988a; Hamel, 1991; Mody, 1993) and resource dependency (Pfeffer and Nowak, 1976).

There are a number of definitional issues which are important to note. Several authors have felt it necessary to refer to particular subsets of interorganizational forms such as international coalitions (Porter and Fuller, 1986), strategic networks (Jarillo, 1988), hybrid organizational agreements (Borys and Jemison, 1989) and industrial systems constellations (Perlmutter and Heenan, 1986). Others, including Lorange and Roos (1992), consider joint ventures and strategic alliances on a continuum, spanning degrees and intensity of integration. Our position is

that alliances are the generic form of co-operation between firms, and that equity joint ventures are a special case of alliances, where the co-operation is cemented by ownership-sharing through equity holdings. In contrast, non-equity joint ventures are a special case of alliances where the relationship is through a formal contract. An equity joint venture involves the incorporation of a new company in which two or more partners hold an equal stake. Each partner will expect to participate in the decision-making activities of the jointly-owned entity, will anticipate a proportional share of dividend, and expect representation on the board of directors (Harrigan, 1985; Geringer, 1991). A joint venture is strategic in the sense that strategic decisions involve long-lasting commitments as distinct from tactical decisions, which are short-term responses to the prevailing environment (Shapiro, 1989). Strategic co-ordination as well as operational co-ordination is thus a feature of this form of joint venture (Teece, 1992). A joint venture is international in dimension if at least one partner has its headquarters outside the venture's country of operation, or if the joint venture has a significant level of operation in more than one country (Geringer and Hebert, 1989).

Despite the apparent proliferation of joint ventures and several attempts to provide a theoretical context for their occurrence, relatively little research effort has been devoted to the important process of partner selection in joint-venture formation, particularly between partners from developed market economies. It is readily apparent that central to the joint-venture formation process is the quest for a suitable partner (Parkhe, 1993; Blodgett, 1991; Brown et al., 1989; Burton and Saelens, 1982; Harrigan, 1988b). More significantly, performance outcomes of the joint venture will be considerably influenced by the nature of the chosen partner. Geringer (1991: 42) argues that

Prior research has suggested that the choice of a particular partner is an important variable influencing IJV [international joint venture] performance, since it influences the mix of skills and resources which will be available to the venture and thus the IJV's ability to achieve its strategic objectives.

As co-operation through joint ventures is likely to play an increasingly important role among firms' strategy options in the future (Harrigan, 1988a; Anderson, 1990), then the selection of the appropriate partner is of considerable importance to managers intent on following this organizational mode.

The main goals of this chapter are as follows: first, to consider the relative importance of a set of selection criteria for a sample of UK joint ventures in terms of a recently developed typology. Second, to provide a parsimonious set of selection criteria for the sample studied by means of factor analysis. Third, to formulate and test hypotheses on the relationship between the identified factors and individual selection criterion and the characteristics of the sample. To date there have been no empirical studies reported that examine specifically selection criteria for UK joint ventures with partners from developed countries. This chapter therefore presents new empirical findings on selection criteria in UK joint ventures. The remainder of the chapter is set out in the following way: the next section discusses partner selection criteria in joint ventures and derives the hypotheses of the study. Following that, the research methods for the study and the characteristics of the sample are reported. This is followed by the results and discussion of the empirical findings. Conclusions are in the final section.

## **A partner selection criteria**

The importance of selecting the right partner to ensure the success of the joint venture has been suggested by a number of authors (Berg et al., 1982; Killing, 1983; Harrigan, 1985; Beamish, 1987). It should be recognized that, when firms first become engaged in the negotiation of a joint venture, the organizations are likely to have different strategic objectives and asymmetric capabilities, as well as other important differences. These differences will condition firms' choices about whether to co-operate at all; which partner to select should they decide to co-operate; and which business to enter, using joint ventures as well as other dimensions of co-operative strategies (Harrigan and Newman, 1990). Harrigan (1985), for example, stresses that joint ventures are more likely to succeed when partners possess complementary missions, resources capabilities, managerial capabilities and other attributes that create a strategic fit in which the bargaining power of the venture partners is evenly matched. Despite this kind of emphasis on the importance of recognizing respective partner need, and of matching with the appropriate partner, there is in fact a paucity of literature that addresses the issue of partner selection in joint-venture formation specifically, and particularly in the instance of joint ventures established between firms from developed market economies. Apart from the work of Geringer (1988, 1991), who examined data from US-based organizations, there are no systematic

studies that investigate the nature of partner selection for joint ventures formed to operate in developed markets.<sup>1</sup>

In summarizing prior research, Geringer (1991) notes that most of the studies suffer from potentially serious methodological shortcomings – for example, respondents may not have been involved in the selection of partners (as was the case in the study by Tomlinson (1970)), or they embody a narrow or biased geographical or industrial focus, thus limiting the applicability of their results. This suggestion is subject to debate. It may be argued that, in an area with such a small theoretical underpinning, studies that control for industry and partner nationality are in fact required in order to build a base that can be tested subsequently for generalizability (Parkhe, 1993). Geringer (1991) also argues that success has been limited in identifying the relative importance of the various selection criteria used by firms, or in identifying those variables that might explain why or how the importance of criteria can be expected to vary among joint ventures. These conclusions are particularly applicable for joint ventures oriented towards developed countries. Despite the shortcomings of the prior literature, Geringer concludes that previous studies do demonstrate that partner selection is an important variable in the formation and operation of joint ventures, particularly as the mix of skills and resources, operating policies and procedures, and overall competitive viability of a venture, are partly determined by the partner chosen. Moreover, partner selection appears to be a distinct decision within the joint-venture formation process, thereby providing the possibility of identifying the selection criteria employed as well as their relative importance in this decision.

Geringer's principal contributions to this literature have been first, the suggestion that, despite the almost unlimited range of alternative criteria that might exist, it is possible to provide a simple twofold typology of categories of selection criteria. Second, using this typology, Geringer provides empirical estimates of the importance of the selection criteria for a sample of joint ventures oriented towards developed markets, and third, he identifies and estimates the correlations of the key variables which affect the relative importance of some of these criteria.

The typology suggested by Geringer is based on the distinction between task-related criteria and partner-related criteria. Task-related criteria are associated with the operational skills and resources that a venture requires for its competitive success. Thus, task-related criteria refer to those variables that are related intimately to the viability of a proposed venture's operations, irrespective of whether the chosen investment mode involves multiple partners. Geringer provides examples such as patents

or technical know-how, financial resources, experienced managerial personnel, and access to marketing and distribution systems. In contrast, partner-related criteria refer to those variables that become relevant only if the chosen investment mode involves the presence of multiple partners. Geringer cites the following examples: the national or corporate culture of a partner, compatibility or trust between the partners' management teams, the degree of favorable past association between the partners, and the size or corporate structure of a partner. Geringer's survey of the prior literature leads him to conclude that soundly based and systematic treatment of partner selection criteria has largely been absent from the study of joint ventures. Geringer breaks new ground in this respect, both in developing a coherent typology of partner selection, and in providing a methodologically defensible study of selection criteria for a US-based sample of joint ventures. A major purpose of this chapter is to examine Geringer's typology of task-related and partner-related selection criteria for a sample of UK joint ventures with partners from developed market economies.

## **Hypotheses**

The literature gives little indication a priori of what to expect in terms of the relative importance of a set of selection criteria. It may be conjectured, however, that the relative importance of the criteria would vary with the underlying key characteristics of the sample. For the purposes of this study, these characteristics have been identified as partner nationality, industry of the joint venture, joint venture purpose, geographical location of the venture, initial approach for joint venture formation and relative partner size.

### *Partner nationality*

Previous literature considers the choice of nationality of joint-venture partners only as a reflection of the notion of 'psychic distance' (Hallen and Wiedersheim-Paul, 1979), through which partners who are closer on this measure presumably have fewer cultural differences and therefore lower transactions costs to overcome in setting up and managing the venture. In general, the necessary resources and characteristics required from a partner may in certain circumstances identify a potential partner of a particular nationality. To the extent that a firm from one country believes that potential partners from another country can meet its requirements, these partners will be chosen in preference to potential partners of a different nationality. As argued by Geringer (1988, 1991) partner choice will hinge on the tasks to be accomplished by the venture,

and the particular characteristics required from a partner. It may be conjectured that UK partners place different emphases on task and partner-related criteria when considering potential partners from Western Europe, the USA and Japan. Hence it may be argued that, given relative proximity, UK partners seek different criteria in partners located in Western Europe than they do from partners located in the USA or Japan. Conversely, UK firms may believe that certain sets of characteristics are more readily available in venture partnerships with Japanese firms than with partners from, say, the USA or Western Europe. The partner selection criteria may then be expected to vary according to the nationality of the foreign partner. This gives the first hypothesis:

**Hypothesis 1** The relative importance of the selection criteria will vary with the nationality of the foreign partner.

#### *Industry of the joint venture*

There is no prior literature that provides an examination of partner-selection criteria according to the industry of the joint venture. We can suggest that the relative importance of partner-selection criteria will depend on the nature of the industry of the joint venture, and on the respective industries of the venture partners. To the extent that the joint venture represents diversification into new activities on the part of UK firms, then the type of selection criteria sought would be expected to be different from the type of criteria considered important for a venture building on an existing business. More broadly, the set of selection criteria relevant to firms in the manufacturing sector may differ from the selection criteria considered to be important in the tertiary sector. The extent to which this is the case is the basis of the second hypothesis:

**Hypothesis 2** The relative importance of the selection criteria will vary with the industry of the joint venture.

#### *Purpose of the joint venture*

The purpose is taken to mean the operating function of the joint venture, and is not an indication of the partner motives for establishing the venture (Glaister and Buckley, 1994: 40). As far as task-related variables are concerned, it would be expected that the nature of the selection criteria would vary with the underlying purpose of the joint venture. From their empirical study, Hergert and Morris (1988: 107) reported that co-operative behaviour begins to occur very early in the product-development cycle. This is explained partly by the difficulties in managing

the joint venture as the project gets closer to its eventual market. Acts of opportunism, in terms of cheating or otherwise benefiting at a partner's expense, are likely to increase as the venture approaches the marketing phase. This line of argument indicates that the qualities one partner would look for in another in terms of partner-related selection criteria would tend to vary given the extent to which the purpose of the venture is involved with close to market activities. This leads to the third hypothesis:

**Hypothesis 3 The relative importance of the selection criteria will vary with the purpose of the joint venture.**

*Geographic location of the joint venture*

The primary geographical location of the joint-venture activity may be related in some way to the nationality of the foreign partner. Thus a UK firm may establish a joint venture with a Japanese firm in order to facilitate the UK firm's entry into the Japanese market, with the primary geographical location of the venture being Japan. Conversely, a joint venture may be established between the same two firms in order to provide the Japanese firm with access to the UK market, with the primary geographical location of the venture, in that case, being the UK. Alternatively, both partners may form a joint venture in order to penetrate a third market, such as the USA, with the primary geographical location of the venture being unrelated to the nationality of the foreign partner. To the extent that some UK partner firms wish to establish joint ventures in order to expand their activities abroad or to enter new markets quickly, compared to others who wish to consolidate their competitive position in the home market, it would be expected that the underlying set of partner-selection criteria would tend to vary with the primary geographical location of the venture – either UK-based or based abroad. This leads to the fourth hypothesis:

**Hypothesis 4 The relative importance of the selection criteria will vary with the primary geographical location of the joint venture.**

*Initial approach for the joint venture*

While the partner to the joint venture must be appropriate to the motives and purpose of the venture, it is not necessarily the case that the partners will have the same set of motives for the formation of the joint venture. From a study of West European, US and Japanese MNCs that established joint ventures with local companies in Turkey, Demirbag *et al.* (1995)



found that the motives of local parent companies in which the firm itself was the initiator of the venture (that is made the initial approach for the formation of the joint venture) differed from those in which the foreign parent was the initiator. They also found contrasts between the motives of initiator and non-initiator local firms. Where motives for a joint venture differ between parent firms, the selection criteria are likely to vary between partners. To the extent that partners are either proactive or reactive with respect to the initiative for the joint venture, and thus either making the initial approach or responding to an approach, then differences in the importance of particular selection criteria are likely to be evidenced between initiating and non-initiating partner firms. This leads to the fifth hypothesis:

**Hypothesis 5** The relative importance of the selection criteria will vary, depending on whether or not the partner firm initiated the joint venture.

#### *Relative partner size*

A firm-specific variable that might condition the relative importance of selection criteria is firm size. Firm size is likely to be related to the underlying motives for the joint venture; for example, size may be important in that smaller partners might be more motivated to enter international joint ventures in order to secure scale economies. Firm size may also act as a proxy measure for the number of resources available (Caves and Mehra, 1986; Hill *et al.*, 1990). Woodcock *et al.* (1994) have noted that firm size may also produce concerns related to the bounded rationality problem in an organization. Bounded rationality could influence top managers' perceptions of core or inimitable resources, and thus influence the motives for co-operative linkages including the entry-mode selection process. As a contingency variable, therefore, relative partner size may influence the relative importance of selection criteria. This leads to the final hypothesis:

**Hypothesis 6** The relative importance of the selection criteria will vary with relative partner size.

### **Research methods and sample characteristics**

This study involves UK partners of international joint ventures with partner firms from Western Europe, the USA and Japan, formed since 1980. As there is publicly available database of UK joint-venture formation,

a list of qualifying joint ventures was obtained from press announcements in the *Financial Times*. Using press announcements as a source of joint-venture data has several precedents (Ghemawat *et al.*, 1986; Hergert and Morris, 1988; Harrigan, 1985). It was assumed that this sampling frame approximated to the population of qualifying joint ventures, and that there would be minimal selection bias. It should be noted, however, that the qualifying joint ventures do not include those organized through national or international government agencies, particularly European Community programmes such as ESPRIT. This ensures that the sample was derived from joint ventures created from the free association of firms, and not those encouraged by incentives provided by external agents.

To obtain the requisite level of detail on selection criteria, the UK partners had to be approached directly. Given time and cost constraints, a postal questionnaire was used to gather the data. The specialized nature of the desired information meant that participants had to be senior managers who were knowledgeable about the partner-selection process. A set of semi-structured interviews with a senior manager from each of eight UK partners helped to shape the form of the final questionnaire. Results from a pre-test questionnaire confirmed the appropriateness of the data-collection instrument. To enhance the quality of the data, telephone contact was made with each UK partner to ascertain the name and position of the most appropriate senior manager, to whom the questionnaire was personally addressed.<sup>2</sup>

The set of task-related and partner-related selection criteria used in the study was derived in two stages. First, from the variables used in studies by Geringer (1988, 1991) and those variables reported by Geringer as used in prior studies examining partner selection (Tomlinson, 1970; Tomlinson and Thompson, 1977; Daniels, 1971; Adler and Hlavacek, 1976; Awadzi, 1987) a substantial list of criteria was assembled. Second, through discussion and elaboration of this list in semi-structured interviews with UK partners in the development phase of the questionnaire, the most important variables were identified. A manageable list of twelve task-related selection criteria and twelve partner-related selection criteria was thus produced.

The questions relating to selection variables were *ex post* measures of managers' perceptions of the relative value of the variables at the time of joint venture formation. With respect to task-related criteria, for example, respondents were asked 'How important was the formation of the joint venture in allowing access to inputs that *your company* did not have?' Responses were assessed using three-point Likert-type scales (1 = 'of no importance', 2 = 'of some importance', 3 = 'of major importance'). Prior

research indicated that ordinal classification of perception was a more realistic task for respondents than use of interval or ratio measures (Geringer, 1991: 51). Geringer (1991) also notes that it is reasonable to expect that managers would have only a limited amount of time to devote to the questionnaire, hence an easily understood Likert scale appeared to be more feasible than a potentially more precise but more complex scaling method.<sup>3</sup>

The 520 joint ventures recorded from the *Financial Times* involved 277 separate UK firms. Several firms proved impossible to contact, either because they had been taken over and restructured or had gone out of business altogether. Other firms had moved location and could not be traced. In some of the firms contacted there was no longer anyone in employment with sufficient knowledge to provide the depth of answers the study required. This left a total of 203 UK partners to whom the questionnaire was administered in the autumn of 1992. In exchange for their participation in the study, and to provide motivation and accurate responses, the respondents were assured of anonymity and were promised a summary report of the findings. After one reminder, 94 questionnaires were returned, a response rate of 46.3 per cent. Of these, 17 had more than one foreign partner. As Geringer (1991) has pointed out, there may be difficulties associated with analysing multiple-partner joint ventures, in that two-partner ventures may demonstrate significant differences from ventures with three or more partners. Such difficulties are likely to be exacerbated when considering partner-selection criteria. Hence this study only concerns the single foreign partner ventures. Of these, 24 were non-equity joint ventures; that is, ventures that do not involve the creation of new firms, but are formal long-term agreements between partners to co-operate in some way. In order to simplify the analysis and to follow the precedent of previous recent research on joint venture selection criteria, for the purposes of this study only equity joint ventures are considered. The study therefore concerns 53 equity joint ventures. The majority were formed with partners from Western Europe (28) followed by the USA (14) and Japan (11). The characteristics of the sample are summarized in Table 11.1.

Despite the advantages that parent firms may derive from joint ventures, a notable feature of this kind of relationship is the relatively high level of instability and breakdown (Beamish, 1985; Kogut, 1989). Changes in the underlying competitive conditions that originally motivated joint-venture formation may also initiate joint-venture breakdown (Kogut, 1988b), while a range of behavioural, cultural and administrative problems may contribute to joint-venture termination

**Table 11.1** Characteristics of the sample

	n	%
Number	53	100
Number of partners		
1	53	100
>1	0	0.0
Partner nationality		
Western Europe	28	52.8
USA	14	26.4
Japan	11	20.8
Joint-venture survival		
Non-terminated joint ventures	35	66.0
Terminated joint ventures	18	34.0
Mean age of joint ventures (years)		
All sample	4.64	100
Non-terminated joint ventures	4.77	66.0
Terminated joint ventures	4.39	34.0
Equity share of UK partner at joint-venture formation (n = 53)		
<50%	12	23.5
50%–50%	31	60.8
>50%	8	15.7
At data collection (n = 35)		
<50%	8	23.5
50%–50%	19	55.9
>50%	7	20.6
Industry of joint venture		
Manufacturing	34	64.2
Tertiary	19	35.8
Purpose of joint venture		
Non-marketing related	7	13.2
Marketing related	32	60.4
Service provision	14	26.4
Primary geographical location of joint venture		
UK	27	50.9
Abroad	26	49.1
Initial approach to joint venture		
UK partner	37	71.2
Foreign partner	15	28.8
Relative partner size		
UK partner larger	19	37.3
Foreign partner larger	32	62.7

(Datta, 1988). Bleeke and Ernst (1995: 97) claim that nearly 80 percent of joint ventures ultimately end in a sale by one of the partners. Of the 53 equity joint ventures in the sample, 35 were still in existence at the time of data collection. Of the 18 that had been terminated, 3 had been acquired by the UK partner, 11 had been acquired by the foreign partner, 3 had been acquired by a third party, and 1 had gone out of business. Only 5 of the ventures had been terminated because of poor performance; 5 of the ventures had fulfilled their purpose; in 4 cases there had been a change in parent strategy towards joint ventures; and 4 ventures were terminated for other reasons. In only 6 of the 18 terminated ventures did the respondents consider that the joint venture had been a failure, which tends to support the view that termination does not necessarily imply failure (Gomes-Casseres, 1987). The mean age of the whole sample, measured from the date of formation to either the time of data collection for non-terminated joint ventures or to the time of termination for the terminated ventures, is 4.64 years (standard deviation 3.10 years). The mean age of non-terminated joint ventures is 4.77 years (3.18 years), and the mean age of terminated joint ventures is 4.39 years (3.01 years).

The average holding of equity in the ventures by UK parents at the time of joint-venture formation was 49.6% (with a standard deviation of 11.2%). At the time of joint-venture formation in 31 cases (60.8%) the equity in the venture was shared equally between the partners. Of the remainder, the UK parents had a minority stake in 12 cases (23.5%) and a majority stake in 8 cases (15.7%). Relative equity shareholding had been subject to some instability by the time of data collection, with the average holding of UK parents in non-terminated ventures rising marginally to 50.6% (with a standard deviation of 12.6%). Of the 35 non-terminated ventures, in 19 (55.9%) the partners had equal shareholdings, UK parents had a minority holding in 8 ventures (23.5%), and a majority holding in 7 ventures (20.6%). At the time of data collection, 29 of the non-terminated ventures had the same distribution of equity share as at the time of formation, with the UK-parent share falling in 3 cases and increasing in 3 cases.

The industry of the joint venture was classified into the following two groups:

- Manufacturing: food/drink manufacturing; metals and minerals; energy; construction; chemicals; pharmaceuticals; computers; telecommunications; other electrical; automobiles; other manufacturing.
- Tertiary: distribution; financial services; other services.

A total of 34 joint ventures is in the manufacturing sector and 19 in the tertiary sector.<sup>4</sup>

The purpose of the joint venture was identified by the respondents as one of eight categories which were subsequently classified into the following three groups, depending on whether or not the purpose included marketing:

- (i) Non-marketing-related; that is, the purpose categories of R&D, production, and development and production;
- (ii) Marketing-related; that is the purpose categories of marketing, development and marketing, production and marketing, and development, production and marketing;
- (iii) Service provision; that is the joint venture was formed to carry out a service activity, for example, provision of insurance services. These joint ventures may or may not include marketing activities, but from the responses it is not possible to determine which do and which do not. Given this uncertainty and the distinctly different nature of this purpose, it was left as a separate category.

A total of 7 joint ventures are classified as non-marketing; 32 are marketing-related; and 14 service provision.

The primary geographical location of the activity of the joint venture was coded as a dichotomous variable according to whether the joint venture activity was wholly or partly based in the UK, or was entirely located abroad. A total of 27 joint ventures have a UK base, and 26 have a foreign base. The majority of the 26 foreign-based joint ventures are located in Western Europe (50.0% of the total), followed by Japan (26.9%) and the USA (19.2%), with the remainder (3.8%) located elsewhere.

The initial approach to the joint venture was measured dichotomously according to whether the UK partner or the foreign partner/third party had suggested the venture. A total of 37 UK partner firms had initiated the joint venture, with 15 of the joint ventures having been initiated by the foreign partner or through third-party mediation. One respondent did not provide this information.

The absolute size of the UK or foreign partner (for example, in terms of turnover or number of employees) was not measured, but data on the relative size of each partner in the joint venture was obtained by asking respondents whether their firm or the partner firm had the higher level of turnover. The UK partner was the largest in 19 joint ventures, and the foreign partner the largest in 32. Two respondents did not provide this information.

## Data analysis

The relative importance of each of the task-related and partner-related selection criteria was considered first by ranking the mean responses. Factor analysis was employed to derive a parsimonious set of selection criteria. The hypotheses were tested by considering differences in means of the importance of the selection criteria. Given the relatively large sample size and the reasonable assumption that the sample is from a close to normal distribution, it was considered legitimate to use parametric tests of the hypotheses. Hypotheses 1–6 were therefore tested by conducting two sample t-tests or Anova, as appropriate. The nature of the data made it judicious to ‘shadow’ these parametric tests by equivalent non-parametric ones (Mann-Whitney U and the Kruskal-Wallis Test) as a check on their interpretation. The non-parametric tests (not reported here) confirm the findings of the parametric tests reported below.

## Results and discussion

### Task-related selection criteria

The task-related selection criteria are set out in rank order in Table 11.2. The median value of the three-point scale is 2. Only one task-related selection criterion exceeds this value: access to knowledge of local market. Other relatively high-ranked task-related selection criteria are access

**Table 11.2** Rank order of task-related selection criteria

	Rank	Mean	s.d.
Access to:			
Knowledge of local market	1	2.08	0.87
Distribution channels	2	1.96	0.85
Links with major buyers	3	1.93	0.90
Knowledge of local culture	4	1.83	0.89
Technology	5	1.79	0.86
The product itself	6	1.66	0.78
Knowledge of production processes	7	1.57	0.80
Capital	8	1.45	0.67
Regulatory permits	9	1.42	0.63
Labour	10	1.38	0.60
Local brand names	11	1.30	0.50
Materials/natural resources 1	12	1.17	0.47

*Notes:* The mean is the average on a scale of 1 (=‘of no importance’) to 3 (= ‘of major importance’); n=53.

to distribution channels, access to links with major buyers, and access to knowledge of local culture.

Recalling that task-related selection criteria refer to the necessary requirements of the venture irrespective of the mode of investment, it is clear from the sample that the high-ranked set of criteria reflects the UK partners' concern with understanding the nature of the proposed market for the venture, and ensuring adequate links to buyers once established in the chosen market. The understanding and penetration of the market are thus the major concerns of the task-related selection criteria. It may be conjectured that this set of task-related selection criteria is consistent with the underlying strategic motivation for joint-venture formation.

A second group of task-related selection criteria can be identified which are of intermediate rank: access to technology, access to the product itself, access to knowledge of production processes, and access to capital. This group reflects a concern with the operational requirement of the venture, including access to the product, the appropriate technology, and adequacy of the capital base. These operational concerns are clearly secondary.

Task-related selection criteria displaying relatively weak importance are: access to regulatory permits; access to labour; access to local brand names; and access to materials/natural resources. The weakest set of criteria are perhaps not surprising; adequate labour is unlikely to be a binding constraint on joint ventures formed with partners from advanced industrial nations, nor is access to materials and/or natural resources. Regulatory permits for most forms of economic activity are unlikely to be needed in developed markets, the most notable exception probably being in pharmaceuticals, while local brand names have less relevance in the context of firms operating in increasingly global markets.

### **Partner-related selection criteria**

The twelve partner-related selection criteria are set out in rank order in Table 11.3. The median value of 2 for the three-point scale is exceeded by five partner-related selection criteria. However, the three highest-ranked selection criteria display means much higher than the rest: trust between the top management teams, relatedness of partner's business, and reputation. The other high-ranked partner-selection criteria are: financial status/financial resources of the partner, and complementarity of partner's resource contribution.

The received literature on partner-related selection criteria gives no real indication of what to expect when dealing with partners from advanced market economies. However, some inferences can be made. First, the finding that trust between the top management teams is the



**Table 11.3** Rank order of partner-related selection criteria

Criteria	Rank	Mean	s.d.
Trust between the top management teams	1	2.53	0.58
Relatedness of partner's business	2	2.45	0.64
Reputation	3	2.38	0.63
Financial status/financial resources of the partner	4	2.08	0.58
Complementarity of partner's resource contribution	5	2.02	0.75
Established marketing and distribution system	6	1.98	0.87
The partner company's size	7	1.89	0.61
International experience	8	1.87	0.76
Experience in technology applications	9	1.85	0.82
Management in depth	10	1.76	0.68
Degree of favourable past association between partners	11	1.64	0.76
Partner's ability to negotiate with foreign government	12	1.40	0.66

*Note:* The mean is the average on a scale of 1 (= 'of no importance') to 3 (= 'of major importance');  $n = 53$ .

highest-ranked partner-selection criterion for equity joint ventures partly confirms the findings of Geringer (1988), where compatibility of top management of partner firms was ranked second in his sample. More significantly, this finding provides a degree of empirical support for the contention of Buckley and Casson (1988), that the basis of the relationship between the partners in an alliance must be 'mutual forbearance' – the absence of cheating between partners. Crucial here, and to the success of the venture, is the degree of trust between the management teams of the partner firms. Second, it is clear that favourable past association between partners is a relatively unimportant selection criterion for this sample of joint ventures. This supports Geringer's (1988) findings, and is again at odds with Tomlinson's (1970) emphasis on this criterion. Third, partner company's size, stressed as important by a number of authors, does not feature as a prominent selection criterion for this sample. Fourth, the finding that the relatedness of the partner's business is a relatively high-ranked selection criterion can be explained partly by the fact that the business activity of most joint ventures is closely related to that of the parent firms. The Spearman correlation coefficient between the industry of the joint venture and the industry of the UK parent firm (at the level of the individual industries classified into the manufacturing and tertiary sectors identified above) is 0.87, the Spearman correlation coefficient between the industry of the joint venture and the industry of the foreign partner is 0.79, and the Spearman correlation coefficient

between the industry of the UK parent and the industry of the foreign partner is 0.80 (all coefficient significant at  $P < 0.000$ ). Apparently, relatively few ventures in the sample are undertaken for the purpose of diversification, and it would appear that the strategic thrust of the venture compels firms to seek partners in related businesses. Finally, the low ranking given to the partner's ability to negotiate with the foreign government is not particularly surprising in the context of this sample. This particular skill is unlikely to be required for most joint ventures formed from the free choice of parent firms in developed market economies.

### **Factor analysis of selection criteria**

The twenty-four selection criteria represent a number of overlapping perspectives. This is partly confirmed by the correlation matrix of selection criteria which displays a number of low to moderate intercorrelations between the selection criteria categories. Because of the potential conceptual and statistical overlap an attempt was made to identify a smaller number of distinct, non-overlapping selection criteria for the sample data by means of exploratory factor analysis.<sup>5</sup> The factor analysis produced eight underlying factors that appear to make good conceptual sense and explained a total of 70.9% of the observed variance, as shown in Table 11.4. Four of the factors are composed of both task-and partner-related selection criteria indicating conceptual overlap between these concepts. Of the remaining four factors, two are composed of only task-related selection criteria and two are composed of only partner-related selection criteria. The remainder of this section discusses the interpretation of each of these factors.

#### *Factor 1: Technology know-how*

The first factor had high positive loadings on three selection criteria: the partner-related selection criterion of experience in technology applications, and the two task-related selection criteria of access to technology and access to knowledge of production processes. This factor also had high negative loadings on two task-related selection criteria: access to knowledge of local culture, and access to knowledge of local market. This first factor was interpreted to be a selection criterion based on the partner's ability to offer technology know-how, without access to knowledge of local markets.

#### *Factor 2: Management experience and financial assets*

The second factor had high positive loadings on three partner-related selection criteria: international experience, financial status/financial

**Table 11.4** Factors of selection criteria

Factor/selection criteria	Factor loads	Eigen-value	% of variance	Cumulative %
Factor 1: Technology know-how		4.804	20.0	20.0
(P) Experience in technology applications	0.8628			
(T) Access to technology	0.8435			
(T) Access to knowledge of production processes	0.7230			
(T) Access to knowledge of local culture	-0.6151			
(T) Access to knowledge of local market	-0.5707			
Factor 2: Management experience and financial assets		3.196	13.3	33.3
(P) International experience	0.7658			
(P) Financial status/financial resources of partner	0.7213			
(P) Management in depth	0.6781			
Factor 3: Official access		2.261	9.4	42.8
(P) Partner's ability to negotiate with foreign government	0.7387			
(P) Relatedness of partner's business	-0.6997			
(T) Access to regulatory permits	0.5519			
Factor 4: Access to labour		1.839	7.7	50.4
(T) Access to labour	0.8841			
Factor 5: Complementary resources		1.485	6.2	56.6
(P) Complementarity of partner's resource contribution	0.7962			
(P) Established marketing and distribution system	0.7602			

Factor 6: Large partner with distribution access		1.368	5.7	62.3
(P) The partner company's size	0.7627			
(T) Access to the product itself	-0.5049			
(T) Access to distribution channels	0.4644			
Factor 7: Highly regarded firm with links to major buyers		1.038	4.3	66.6
(P) Trust between the top management teams	0.7460			
(T) Access to materials/natural resources	-0.7302			
(T) Access to links with major buyers	0.5250			
(P) Degree of favourable past association between partners	0.4262			
(P) Reputation	0.3985			
Factor 8: Access to local brand names		1.015	4.2	70.9
(T) Access to local brand names	0.8815			
(T) Access to capital	-0.4413			

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Notes: (T) = Task-related selection criteria; (P) = Partner-related selection criteria.

Principal components factor analysis with varimax rotation; K-M-O measure of sampling adequacy = 0.5551; Bartlett test of sphericity = 525.203;  $p < 0.0000$ .

resources of the partner, and management in depth. This factor was interpreted as a selection criterion based on management experience and financial assets.

*Factor 3: Official access*

The third factor had high positive loadings on two selection criteria: the partner-related selection criterion of ability to negotiate with the foreign government, and the task-related criterion of access to regulatory permits. This factor also had a high negative loading on the partner-related selection criterion of relatedness of partner's business. This factor was interpreted to be a selection criterion based on the perception of the partner offering access to official government channels and official permits to engage in the venture activity.

*Factor 4: Access to labour*

The fourth factor had a single high positive loading on the task-related selection criterion of access to labour. This factor was obviously interpreted to be a selection criterion based on the necessity to access labour.

*Factor 5: Complementary resources*

The fifth factor had high positive loadings on two partner-related selection criteria: complementarity of partner's resource contribution, and established marketing and distribution system. This factor was interpreted to be based on the need to identify a partner with complementary resources, including marketing and distribution resources.

*Factor 6: Large partner company with distribution access*

The sixth factor had high positive loadings on the partner-related selection criterion of the partner company's size and the task-related selection criterion of access to distribution channels. This factor also had a high negative loading on the task-related selection criterion on access to the product itself. This factor was interpreted to mean that the partner would be chosen from a large-sized firm with access to channels of distribution, but not a partner that provided access to the product itself.

*Factor 7: Highly regarded firm with links to major buyer*

The seventh factor had high positive loadings on three partner-related selection criteria: trust between the top management teams, degree of favourable past association between partners, and partner reputation. This factor also had a high positive loading on the task-related selection criterion of access to links with major buyers, and a high negative loading

on the task-related selection criterion of access to materials/natural resources. This factor was interpreted to mean that the partner would be chosen from a well-regarded and trusted firm, where a sound relationship already existed and the firm provided access to major buyers.

*Factor 8: Access to local brand names*

This factor had a high positive loading on the task-related selection criterion of access to local brand names, and a high negative loading on the task-related selection criterion of access to capital. This factor was therefore interpreted to mean a selection criterion based on access to local brand names.

As the eight factors are not correlated with each other, each of these selection criteria may be applied independently. It is still possible, of course, for combinations of these eight factors to apply in particular circumstances.

**Selection criteria and sample characteristics**

The remainder of this section reports the results of the tests of Hypotheses 1–6, which consider the selection criteria in terms of the characteristics of the sample. For each of the relevant characteristics of the sample under consideration, Tables 11.5 to 11.10 report the means and standard deviations of the eight factors and the appropriate test statistic for comparing differences in means. These tables also report the mean and standard deviation of the individual selection criterion where the means are significantly different (at better than the 0.1 level).

**Selection criteria and partner nationality**

Table 11.5 shows that there is little support for Hypothesis 1, indicating that the relative importance of the selection criteria tend not to vary with the nationality of the foreign partner. None of the factors have means that are significantly different, and only four of the individual selection criteria have means that are significantly different – two task-related selection criteria, and two partner-related selection criteria.

The rejection of Hypothesis 1 for practically all of the task-related selection criteria indicates that the nationality of the foreign partner is not driving the quest for partner inputs to achieve the strategic objectives of the joint venture. Rather, the necessary resources and capabilities may be derived from partners across a spectrum of nationalities, and what the firms in the sample are striving for is the identification of partners with relevant inputs, irrespective of their nationality. There are though two exceptions to this. Access to knowledge of local culture is a more important selection criteria for joint ventures with Japanese partners

**Table 11.5** Selection criteria and partner nationality

Factor/selection criteria	Group	Mean	s.d.	F-ratio
Factor 1: Technology know-how	Western Europe	-0.02	0.99	0.23
	USA	0.14	0.89	
	Japan	-0.12	1.19	
(T) Access to knowledge of local culture	Western Europe	1.85	0.93	2.99 <sup>†</sup>
	USA	1.42	0.64	
	Japan	2.27	0.90	
Factor 2: Management experience and financial assets	Western Europe	0.27	0.89	2.43
	USA	-0.24	1.09	
	Japan	-0.38	0.99	
(P) International experience	Western Europe	2.07	0.72	3.78 <sup>‡</sup>
	USA	1.85	0.86	
	Japan	1.36	0.51	
Factor 3: Official access	Western Europe	-0.17	0.98	1.11
	USA	0.08	1.14	
	Japan	0.33	0.81	
(T) Access to regulatory permits	Western Europe	1.28	0.54	3.10 <sup>‡</sup>
	USA	1.35	0.63	
	Japan	1.81	0.75	
Factor 4: Access to labour	Western Europe	0.01	0.91	1.41
	USA	-0.30	1.17	
	Japan	0.36	0.94	

Factor 5: Complementary resources	Western Europe	-0.01	1.03	
	USA	0.05	0.94	
	Japan	-0.01	1.08	0.02
Factor 6: Large partner with distribution access	Western Europe	-0.07	1.01	
	USA	-0.15	1.16	
	Japan	0.38	0.65	1.06
Factor 7: Highly regarded firm with links to major buyers	Western Europe	-0.12	1.12	
	USA	0.03	1.03	
	Japan	0.28	0.55	0.66
(P) Reputation	Western Europe	2.42	0.63	
	USA	2.07	0.62	
	Japan	2.63	0.51	2.89 <sup>†</sup>
Factor 8: Access to local brands	Western Europe	0.01	1.13	
	USA	0.22	0.96	
	Japan	-0.30	0.59	0.84

*Notes:* The mean for the factors is the mean for the factor scores, the mean for the individual selection criterion is the average on a scale of 1 (= 'of no importance') to 3 (= 'of major importance').

(T) = Task-related selection criteria; (P) = Partner-related selection criteria.

<sup>†</sup> LSD Test, USA and Japan significantly different at 0.05 level.

<sup>\*</sup> LSD Test, Western Europe and Japan significantly different at 0.05 level.

Western Europe, n = 28; USA, n = 14; Japan, n = 11.



than it is for joint ventures with Japanese partners than it is for joint ventures with partners from the USA. This is relatively unsurprising, given the similarities of UK and US cultures and the differences in UK and Japanese cultures. Access to regulatory permits is shown to be a more important selection criteria in joint ventures with Japanese partners than it is with partners from Western Europe. The obvious rationale for this finding is that Japanese partners hold more of the necessary permits than other potential partners. Alternatively, it may signal the relatively more protected Japanese business domain compared to more open access in Western Europe. However, this may simply be capturing the location aspects of the joint ventures that are considered below.

The partner-related selection criterion of international experience is more important for joint ventures with Western European partners than it is for joint ventures with Japanese partners. Table 11.5 shows that the importance of selecting a partner with international experience declines as geographical distance from the UK increases. This finding may indicate that UK firms forming joint ventures with partners far from their home base will themselves have a good deal of international experience. The fact that such firms have joined with partners at a great geographical distance from the UK implies a degree of international experience and sophistication in terms of searching for foreign partners. In contrast, those UK firms forming joint ventures with partners from Western Europe may be constrained in the limits of their geographical search by their lack of international experience, and may therefore look for this attribute in joint-venture partners. The reputation of the Japanese partner is a more important selection criterion for joint ventures with Japanese partners than it is for joint ventures with partners from the USA. This finding may be underpinned by the greater ease with which UK firms may be able to assess potential US partners, and thus the ability to come to a more considered view of the potential partner, based on personal knowledge and understanding. To the extent that this is more difficult when assessing potential Japanese partners, UK firms may have more need to rely on public knowledge of a firm's reputation.

### **Selection criteria and industry of the joint venture**

Table 11.6 shows that there is limited support for Hypothesis 2, indicating that there is little tendency for the relative importance of selection criteria to vary with the industry of the joint venture. One of the factors has means that are significantly different, and six of the individual selection criteria have means that are significantly different – three task-related selection criteria and three partner-related selection criteria.

**Table 11.6** Selection criteria and industry of joint venture

Factor/selection criteria	Group	Mean	s.d.	t-value
Factor 1: Technology know-how	Manufacturing	0.31	0.92	
	Tertiary	-0.57	0.90	3.43***
(P) Experience in technology applications	Manufacturing	2.05	0.77	
	Tertiary	1.47	0.77	2.64**
(T) Access to technology	Manufacturing	2.02	0.87	
	Tertiary	1.36	0.68	3.05***
(T) Access to knowledge of production processes	Manufacturing	1.73	0.86	
	Tertiary	1.26	0.56	2.40**
(T) Access to knowledge of local culture	Manufacturing	1.61	0.82	
	Tertiary	2.21	0.92	-2.34**
Factor 2: Management experience and financial assets	Manufacturing	0.43	0.96	
	Tertiary	-0.07	1.09	0.40
(P) Financial status/financial resources of partner	Manufacturing	2.17	0.58	
	Tertiary	1.89	0.57	1.72*
Factor 3: Official access	Manufacturing	0.10	1.02	
	Tertiary	-0.19	0.97	1.06
Factor 4: Access to labour	Manufacturing	-0.00	1.07	
	Tertiary	0.01	0.89	-0.08
Factor 5: Complementary resources	Manufacturing	0.00	1.01	
	Tertiary	-0.01	1.01	0.10
Factor 6: Large partner with distribution access	Manufacturing	0.12	0.91	
	Tertiary	-0.21	1.14	1.10
Factor 7: Highly regarded firm with links to major buyers	Manufacturing	-0.12	1.10	
	Tertiary	0.21	0.77	-1.31
(P) Trust between the top management teams	Manufacturing	2.41	0.56	
	Tertiary	2.73	0.56	-2.03**
Factor 8: Access to local brand names	Manufacturing	0.00	1.05	
	Tertiary	-0.00	0.94	0.03

*Notes:* The mean for the factors is the mean for the factor scores, the mean for the individual selection criterion is the average on a scale of 1 (= 'of no importance') to 3 (= 'of major importance').

(T) = Task-related selection criteria; (P) = Partner-related selection criteria.

\* $p < 0.1$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.01$ .

Manufacturing  $n = 34$ ; Tertiary  $n = 19$ .

The statistically significant difference in means are concentrated on Factor 1 (technology know-how) and the component selection criteria of this factor. Factor 1, each of the task-related selection criteria of access to technology and access to knowledge of production processes, and the

partner-related selection criterion of experience in technology applications, are more important in manufacturing sector joint ventures than in tertiary sector joint ventures. These findings are not surprising, because each of these selection criteria are more likely to be sought by firms operating joint ventures in the manufacturing sector than in the tertiary sector. Also a component of Factor 1, the task-related selection criteria of access to knowledge of local culture is more important in tertiary joint ventures than in manufacturing joint ventures. This latter finding may be a reflection of such activities being closer to final customers than some of the manufacturing-sector activities, and hence requiring a greater need to be fully aware of the characteristics of the market. The partner-related criterion of trust between the top management teams is also more important in tertiary sector joint ventures than in manufacturing sector joint ventures. This finding may, again, be related to the tertiary sector joint ventures being closer to the final customer and hence requiring the partners to co-operate more directly in the competitive arena than is the case for manufacturing-sector joint ventures. The implication is that a greater degree of trust is required between the partners the more the joint venture operation is involved directly in the competitive arena. Finally, the partner-related selection criterion of the financial status/financial resources of the partner is more important in manufacturing joint ventures than in tertiary-sector joint ventures. Ultimately, this finding may be related to the greater capital costs that may be involved in manufacturing joint ventures compared to tertiary-sector joint ventures, and the need for assurance on the part of UK firms that potential joint-venture partners have the necessary financial standing to participate fully in the funding of the venture.

### **Selection criteria and purpose of the joint venture**

Table 11.7 shows that there is little support for Hypothesis 3, indicating the relative importance of the selection criteria tend not to vary with the purpose of the joint venture. One of the factors has means that are significantly different, and only four of the individual selection criteria have means that are significantly different – one task-related selection criteria and three partner-related selection criteria.

**Table 11.7** Selection criteria and purpose of the joint venture

Factor/selection criteria	Group	Mean	s.d.	F-ratio
Factor 1: Technology know-how	Non-marketing	0.53	1.00	2.66 <sup>†</sup>
	Marketing	0.08	0.94	
	Service provision	-0.45	1.00	

(P) Experience in technology applications	Non-marketing	2.57	0.78	
	Marketing	1.78	0.75	
	Service provision	1.64	0.84	3.62 <sup>‡</sup>
(T) Access to technology Non-marketing	Non-marketing	2.29	0.95	
	Marketing	1.43	0.88	
	Service provision	1.84	0.64	2.59 <sup>†</sup>
Factor 2: Management experience and financial assets	Non-marketing	0.27	0.79	
	Marketing	-0.12	1.02	
	Service provision	0.14	1.05	0.62
Factor 3: Official access	Non-marketing	0.05	0.76	
	Marketing	0.11	1.10	
	Service provision	-0.28	0.83	0.75
Factor 4: Access to labour	Non-marketing	0.41	1.12	
	Marketing	-0.12	1.03	
	Service provision	0.06	0.85	0.87
Factor 5: Complementary resources	Non-marketing	-0.22	1.08	
	Marketing	0.19	0.99	
	Service provision	-0.34	0.93	1.67
(P) Established marketing and distribution system	Non-marketing	1.71	0.76	
	Marketing	2.22	0.87	3.39 <sup>#</sup>
	Service provision	1.57	0.76	
Factor 6: Large partner with distribution access	Non-marketing	-0.03	1.42	
	Marketing	-0.04	0.94	
	Service provision	0.10	0.96	0.08
Factor 7: Highly regarded firm with links to major buyers	Non-marketing	-0.16	1.15	
	Marketing	-0.11	1.10	
	Service provision	0.32	0.58	0.99
(P) Trust between the top management teams	Non-marketing	2.57	0.53	
	Marketing	2.37	0.61	
	Service provision	2.85	0.36	3.82 <sup>#</sup>
Factor 8: Access to local brand names	Non-marketing	-0.38	0.73	
	Marketing	0.12	1.05	0.79
	Service provision	-0.08	0.99	

*Notes:* The means for the factors is the mean for the factor scores, the mean for the individual selection criterion is the average on a scale of 1 (= 'of no importance') to 3 (= 'of major importance').

(T) = Task-related selection criteria; (P) = Partner-related selection criteria.

Non-marketing n = 7; Marketing n = 32; Service provision n = 14.

<sup>†</sup>LSD test, significant difference between non-marketing and service provision at the 0.05 level.

<sup>‡</sup>LSD test, significant difference between non-marketing and service provision and non-marketing and marketing at the 0.05 level.

<sup>#</sup>LSD test, significant difference between marketing and service provision at the 0.05 level.

For the purpose of the joint venture, the significant differences in means are concentrated on Factor 1 (technology know-how) and the component selection criteria of Factor 1. Factor 1 is more important in non-marketing joint ventures than in service provision joint ventures, as is the task-related selection criterion of access to technology. The partner-related selection criterion of experience in technology applications is more important in non-marketing joint ventures than in marketing joint ventures and service provision joint ventures. These findings are relatively unsurprising as the degree of technological expertise and appropriate level of technology access are both likely to be greater in non-marketing joint ventures (categorized as they are by R&D, production, and development and production joint ventures) than in the other purpose categories. It is also not surprising to find that the partner-related selection criterion of an established marketing and distribution system attains the highest mean in marketing-related joint ventures with the difference in means being statistically significant between marketing-related and service-provision joint ventures. What is somewhat contrary to expectations is the finding that the partner-related selection criterion of trust between the top management teams is less important for marketing-related joint ventures than for service-provision joint ventures (although, as noted above, service-provision joint ventures may include marketing activity). While non-significant, it is surprising that the mean importance of trust is lower for marketing-related joint ventures than for non-marketing joint ventures, which runs counter to the arguments made in support of the construction of Hypothesis 3.

### **Selection criteria and geographical location of the joint venture**

Table 11.8 shows that there is some degree of support for Hypothesis 4, indicating that to a considerable degree the relative importance of the selection criteria varies with the primary geographical location of the joint venture. Two of the factors have means that are significantly different, and ten of the individual selection criteria have means that are significantly different – nine task-related selection criteria and one partner-related selection criterion.

**Table 11.8** Selection criteria and the location of joint venture

Factor/selection criteria	Group	Mean	s.d.	t-value
Factor 1: Technology know-how	UK	0.21	1.03	
	Abroad	-0.22	0.93	1.60
(T) Access to technology	UK	2.00	0.92	
	Abroad	1.57	0.75	1.83*

(T) Access to knowledge of production processes	UK	1.77	0.89	
	Abroad	1.34	0.62	2.04**
(T) Access to knowledge of local culture	UK	1.48	0.75	
	Abroad	2.19	0.89	-3.12***
(T) Access to knowledge of local market	UK	1.77	0.84	
	Abroad	2.38	0.80	-2.68***
Factor 2: Management experience and financial assets	UK	0.11	1.15	
	Abroad	-0.11	0.81	0.83
Factor 3: Official access	UK	-0.18	1.09	
	Abroad	0.18	0.87	-1.37
(T) Access to regulatory permits	UK	1.22	0.50	
	Abroad	1.61	0.69	-2.34**
Factor 4: Access to labour	UK	-0.27	0.93	
	Abroad	0.28	0.99	-2.14**
(T) Access to labour	UK	1.22	0.50	
	Abroad	1.53	0.64	-1.98*
Factor 5: Complementary resources	UK	0.04	1.00	
	Abroad	-0.04	1.00	0.34
Factor 6: Large partner with distribution access	UK	-0.18	1.05	
	Abroad	0.19	0.92	-1.41
(T) Access to the product itself	UK	1.85	0.86	
	Abroad	1.46	0.64	1.87*
(T) Access to distribution channels	UK	1.70	0.86	
	Abroad	2.23	0.76	-2.35**
Factor 7: Highly regarded firm with links to major buyers	UK	-0.27	1.23	
	Abroad	0.28	0.58	-2.11**
(T) Access to materials/natural resources	UK	1.29	0.61	
	Abroad	1.03	0.19	2.09**
(P) Reputation	UK	2.22	0.69	
	Abroad	2.54	0.50	-1.89*
Factor 8: Access to local brand names	UK	0.0	0.89	
	Abroad	-0.01	1.11	0.04

*Notes:* The mean for the factors is the mean for the factor scores, the mean for the individual selection criterion is the average on a scale of 1 (= 'of no importance') to 3 (= 'of major importance').

(T) = Task-related selection criteria; (P) = Partner-related selection criteria.

\* $p < 0.1$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.01$ .

UK  $n = 27$ ; Abroad  $n = 26$ .

Factor 4 (access to labour) and Factor 7 (highly regarded firm with links to major buyers) are more important selection criteria for joint ventures located outside the UK than for joint ventures with a UK location. Also more important for joint ventures based outside the UK are the

task-related selection criteria of access to knowledge of local culture, access to knowledge of local market, access to regulatory permits, access to labour and access to distribution channels, and the partner-related selection criteria of the reputation of the foreign partner. More important for joint ventures located in the UK than those located abroad are the task-related selection criteria of access to technology, access to knowledge of production processes, access to the product itself and access to materials/natural resources.

UK firms seeking partners with a knowledge of local culture and local markets for joint ventures located outside their home country is consistent with a transaction-cost perspective of joint-venture formation. The problem of uncertainty surrounding international expansion, especially in entering new markets, can be alleviated considerably by operating with a foreign partner. Pooling and sharing information allows UK firms to economize on the information requirements of foreign investments or investments in new markets. In particular, the foreign partner can provide location-specific knowledge regarding host-country markets, infrastructure and political trends. By pooling and sharing information through the mechanism of a joint venture, the partners are able to reduce uncertainty at a lower long-term average cost than through pure hierarchical approaches (for example, a wholly owned subsidiary) or through an arm's-length market transaction (Beamish and Banks, 1987).

If the location of the joint venture is the UK, access to distribution channels and regulatory permits is unlikely to be a major motivation for a UK company. This is less so in joint ventures located outside the UK, where the UK firm needs to gain such strategic assets from its partner. This finding is therefore relatively unsurprising. Less clear is the greater need for joint ventures located abroad to gain access to labour compared to joint ventures located in the UK. This criterion is obviously extremely broad, but we can presume that the UK firm's need is to gain access to labour of requisite quality in terms of skills and competencies. For joint ventures located abroad, the UK firms lack suitably qualified manpower and specific labour competencies, so these must be obtained from partner firms. The corollary of this is that the operation of joint ventures located in the UK is facilitated through inputs of labour of requisite skills from UK partners.

The finding that the task-related selection criteria of access to technology, knowledge of production processes, the product itself, and access to materials/natural resources, are more important for joint ventures located in the UK than those located abroad clearly signals the relative

weaknesses of the UK firms in carrying out the proposed venture, given the nature of these inputs, which are so basic to any economic enterprise. It may be presumed that the quid pro quo of obtaining these inputs from the foreign partner is the provision of the kinds of selection criteria that UK firms consider important when entering into joint ventures located outside the UK; that is, UK firms are able to offer foreign partners knowledge of UK culture and markets, access to distribution channels and so on. This, in turn, is an indication of the reciprocal dependencies associated with co-operation in joint ventures where complementary resources and competencies are brought to the venture by each of the partners.

The finding that the partner-related selection criterion of reputation is more important for joint ventures located outside the UK than for those located in the UK indicates that UK firms need more assurance about the quality of the potential partner when embarking on a venture overseas. The skills of operation that UK firms have may be relatively weak abroad compared to their operating competencies in the UK, where they may have more confidence in their ability to understand and cope with the competitive environment. Hence UK firms may be relatively less concerned with the reputation of the partner firm when operating in their home base than when operating outside the UK.

### Selection criteria and initial approach for the joint venture

Table 11.9 shows that there is little support for Hypothesis 5, indicating that the relative importance of the selection criteria are virtually independent of which partner firm initiated the joint venture. None of the factors or task-related selection criteria have means that are significantly different, and only three of the partner-related selection criteria have means that are significantly different.

**Table 11.9** Selection criteria and initial approach to form joint venture

Factor/selection criteria	Group	Mean	s.d.	t-value
Factor 1: Technology know-how	UK partner	0.04	1.03	
	Other	-0.01	0.94	0.16
Factor 2: Management experience and financial assets	UK partner	-0.17	0.87	
	Other	0.32	1.22	-1.43
(P) Financial status/financial resources of partner	UK partner	1.95	0.52	
	Other	2.33	0.62	-2.14**



**Table 11.9** (Continued)

Factor/selection criteria	Group	Mean	s.d.	t-value
Factor 3: Official access	UK partner	0.03	1.07	
	Other	-0.09	0.88	0.43
Factor 4: Access to labour	UK partner	0.10	1.05	
	Other	-0.24	0.90	1.20
Factor 5: Complementary resources	UK partner	-0.04	0.98	
	Other	0.04	1.08	-0.25
Factor 6: Large partner with distribution access	UK partner	-0.02	0.89	
	Other	0.04	1.27	-0.18
Factor 7: Highly regarded firm with links to major buyers	UK partner	-0.01	1.05	
	Other	-0.02	0.94	0.04
(P) Degree of favourable past association between partners	UK partner	1.81	0.72	
	Other	1.26	0.59	2.73***
(P) Reputation	UK partner	2.27	0.61	
	Other	2.60	0.63	-1.72*
Factor 8: Access to local brand names	UK partner	0.03	1.09	
	Other	-0.13	0.77	0.65

Notes: The means for the factors is the mean for the factor scores, the mean for the individual selection criterion is the average on a scale of 1 (= 'of no importance') to 3 (= 'of major importance').

(T) = Task-related selection criteria; (P) = Partner-related selection criteria.

\* $p < 0.1$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.01$ .

UK partner  $n = 37$ ; Other  $n = 15$  (missing cases  $n = 1$ ).

The partner-related selection criterion of the degree of favourable past association between partners is more important in those joint ventures initiated by the UK partner than in those initiated by the foreign partner or third-party intermediaries. This indicates that the UK firms that are proactive in seeking to establish a joint venture solicit partners from the foreign firms that are known to them. Confining the pool of potential partners to those foreign firms that are already known clearly reduces the search costs of finding a suitable partner. Where good working relationships prevail between firms, this indicates that there will be a better understanding of the resource inputs and behaviour expected from each partner, and more rapid movement along the experience curve of operating the joint venture than would be the case with relatively unknown partners. In contrast, firms which are approached with the request to form a joint venture may be less able to control partner choice, and so give less prominence to previous relationships. The financial status/financial resources of the partner, and the reputation of

the partner firm, are more important selection criteria for those UK partners that did not initiate the joint venture. This indicates that firms approached to form a joint venture will be more likely to be swayed by the proposal the better the financial position and reputation of the firm that comes courting.

### Selection criteria and relative partner size

Table 11.10 shows that there is little support for Hypothesis 6, indicating that the relative importance of the selection criteria tend not to vary with the relative partner size. None of the factors have means that are significantly different, and only four of the individual selection criteria have means that are significantly different – one task-related selection criterion and three partner-related selection criteria.

**Table 11.10** Selection criteria and relative partner size

Factor/selection criteria	Group	Mean	s.d.	t-value
Factor 1: Technology know-how	UKPL	-0.26	1.05	
	FPL	0.15	0.95	-1.45
(P) Experience in technology applications	UKPL	1.58	0.84	
	FPL	1.97	0.78	-1.65*
Factor 2: Management experience and financial assets	UKPL	-0.32	0.83	
	FPL	0.10	1.04	-1.61
(P) International experience	UKPL	1.63	0.59	
	FPL	1.97	0.82	-1.69*
(P) Management in depth	UKPL	1.52	0.69	
	FPL	1.84	0.62	-1.68*
Factor 3: Official access	UKPL	-0.30	0.74	
	FPL	0.12	1.10	-1.63
Factor 4: Access to labour	UKPL	-0.02	1.01	
	FPL	0.02	1.04	-0.18
Factor 5: Complementary resources	UKPL	-0.10	1.04	
	FPL	0.09	1.01	-0.64
Factor 6: Large partner with distribution access	UKPL	-0.21	0.92	
	FPL	0.10	1.06	-1.13
Factor 7: Highly regarded firm with links to major buyers	UKPL	-0.11	0.89	
	FPL	0.01	1.07	-0.45

**Table 11.10** (Continued)

Factor/selection criteria	Group	Mean	s.d.	t-value
Factor 8: Access to local brand names	UKPL	0.11	1.12	0.59
	FPL	-0.07	0.91	
(T) Access to capital	UKPL	1.21	0.41	-2.22**
	FPL	1.56	0.71	

*Notes:* The mean for the factors is the mean for the factor scores, the mean for the individual selection criterion is the average on a scale of 1 (= 'of no importance') to 3 (= 'of major importance').

(T) = Task-related selection criteria; (P) = Partner-related selection criteria.

\* $p < 0.1$ ; \*\* $p < 0.05$ .

UKPL = UK partner larger; FPL = foreign partner larger.

UKPL  $n = 19$ ; FPL  $n = 32$  (missing cases  $n = 2$ ).

Each of the partner-related selection criteria of experience in technology applications, international experience and management in depth are more important in joint ventures where the foreign partner is larger than the UK partner. Clearly relatively smaller UK firms, which presumably lack these attributes, are seeking them through collaboration with larger partners. Similarly, the task-related selection criterion of access to capital is more important in those joint ventures where the foreign partner is largest. This indicates that relatively smaller UK partners require capital inputs from larger partners for the venture to succeed.

A summary of the findings relating to Hypotheses 1–6 is shown in Table 11.11. It is apparent from the table that the study finds little support for any of the hypotheses apart from Hypothesis 4 relating to the location of the joint venture. It is also apparent from Table 11.11 that across the characteristics of the sample the relative importance of the selection criteria differ most in connection with Factor 1 (technology know-how) and the component parts of this factor. Also, the difference in importance of selection criteria is somewhat greater for task-related selection criteria than it is for partner-related selection criteria, with slightly more of the former differing in importance across the characteristics of the sample. This emphasizes the point that task-related selection criteria are specific to particular joint ventures while partner-related selection criteria are more general in nature. This is also reflected in Tables 11.2 and 11.3, which record the means of the selection criteria. The means for the task-related selection criteria are much lower than the means for partner-related selection criteria. This indicates that there is greater consensus among the firms in the sample on the relative

importance of partner-related selection criteria than on the importance of task-related selection criteria. This finding is to be expected. The relative importance of task-related selection criteria will be specific to the successful operation of the joint venture; that is, the criteria looked for in a potential partner in terms of resources and skills in order to accomplish the task of the venture will be predicated on the nature of the venture itself, which will vary considerably between joint ventures. In contrast, partner-related selection criteria will be more general in nature and tend to vary less with the specific features of the joint venture.

## Conclusions

The objective of this study was to consider the relative importance of a set of selection criteria in UK joint ventures with Western European, US and Japanese partners using a typology suggested by Geringer (1991), that distinguishes between task-related selection criteria and partner-related selection criteria. This typology has been useful in clarifying the necessary requirements of the joint ventures, irrespective of the mode of investment and the requirements in the light of a multipartner venture. This study has made a contribution in providing further empirical support for Geringer's (1991) contention that partner selection criteria represents an important topic in the joint venture literature, and in providing new evidence in support of Geringer's typology of selection criteria.

Building on Geringer's typology, this study offers a further contribution towards an improved understanding of the partner-selection process in international joint ventures, which may be of value to practitioners. It is clearly necessary for managers involved in the joint-venture formation process to identify the specific task-related resources and skills they may need from a partner, and also to recognize the appropriate characteristics any partner firm must possess. Significant problems may face firms which identify the key task-related criteria in a potential partner that lacks the requisite partner-related criteria, and vice versa.

There are a number of limitations in the research methods used. The generation of the sample frame from press reports in the *Financial Times* may have led to some degree of size bias in the resulting sample, weighting the sample more towards major ventures of relatively large and well-known firms. While this is a possibility, Ghemawat *et al.* (1986), who adopted a similar method, note that the fixed costs of international inter-firm agreements would seem to deter small firms from participating in joint ventures. The potential bias in the data towards larger firms should, therefore, not be exaggerated.

Table 11.11 Summary table

Factor/selection criteria	Partner nationality	Industry	Purpose	Location	Initial approach	Relative partner size
Factor 1: Technology know-how		/	/			
(P) Experience in technology applications		/	/			/
(T) Access to technology		/	/	/		
(T) Access to knowledge of production processes		/		/		
(T) Access to knowledge of local culture	/	/		/		
(T) Access to knowledge of local market				/		
Factor 2: Management experience and financial assets						
(P) International experience	/					/
(P) Financial status/financial resources of partner		/			/	/
(P) Management in depth						/
Factor 3: Official access						
(P) Partner's ability to negotiate with foreign government						
(P) Relatedness of partner's business						
(T) Access to regulatory permits	/			/		
Factor 4: Access to labour				/		
(T) Access to labour				/		
Factor 5: Complementary resources						
(P) Complementarity of partner's resource contribution						
(P) Established marketing and distribution system			/			

Factor 6: Large partner with distribution access

(P) The partner company's size

(T) Access to the product itself

(T) Access to distribution channels

/

/

/

Factor 7: Highly regarded firm with links to major buyers

(P) Trust between the top management teams

/

/

(T) Access to materials/natural resources

/

(T) Access to links with major buyers

(P) Degree of favourable past association between partners

/

(P) Reputation

/

/

/

Factor 8: Access to local brand names

(T) Access to local brand names

(T) Access to capital

/

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Notes: (T) = Task-related selection criteria; (P) = Partner-related selection criteria.

/ = Differences in means are statistically significant at better than the 0.1 level.

The fact that some respondents reported on joint ventures that were not recorded in the original sample frame introduces the potential for systematic uncontrolled bias in the sample. This should not be exaggerated, particularly as it involves relatively few joint ventures. The main reason such ventures were not in the sample frame was because they were formed recently. The trade-off for risking potential bias is that using recently formed joint ventures offsets the possibility of memory decay and provides respondents with the opportunity to report on ventures with which they are most familiar. An obvious weakness of the research method employed in this study is that it is conducted from the perspective of one partner to the joint venture – the UK parent. It is, of course, preferable to collect data from all partners.

It is clear that the majority of the research hypotheses generated for this study are not supported. In some instances this may be because of the exploratory nature of the hypotheses, particularly in the cases Hypothesis 1 (with respect to partner nationality) and Hypothesis 2 (with respect to industry of the joint venture). Although some literature bears tangentially on these hypotheses, there is a paucity of literature that is directly relevant and underpins the logic of these hypotheses. While the hypotheses are couched in terms of an expected relationship, it is probably best to regard this as a tentative position, with the converse hypotheses being potentially as valid. Further research along these dimensions is clearly called for.

The lack of support for Hypothesis 3 (with respect to joint venture purpose) and Hypothesis 6 (with respect to relative partner size) may be a consequence of the somewhat blunt nature of the data under examination. The logic of Hypothesis 3 was concerned with the extent to which the venture was involved with close-to-the-market activities. The data made a three-way distinction between ventures that were either marketing-related or were not, with some joint ventures from the former group having a mix of non-marketing and marketing-related activities, and ventures which had a service provision purpose, where the nature and extent of marketing activity was unclear. This was therefore a relatively blunt measure of the close-to-the-market concept, and is a clear limitation of the data. The data was also limited in terms of the measure of partner size, which is in relative terms with no objective measure available of the size of partners. While the largest of the two partners was identified, there is no information on the absolute size of partners, so, for example, where the UK partner was the largest, the two partners may have been very large firms, and vice versa. This issue will be better addressed in future research by obtaining information on absolute partner size.

Although there is relatively little support for Hypothesis 5 (concerning the partner that made the initial approach to form the joint venture), the areas in which there was support – the selection criteria of financial status/financial resources of the partner, the degree of favourable past association between partners, and reputation – appear to be selection criteria that are most relevant to the hypothesis, and in this sense the data does shed some light on the issue. There is, however, a dearth of evidence relating to the conditions under which firms are likely to be either proactive or reactive in joint-venture formation, and this issue clearly warrants closer examination.

A number of other further research issues are apparent. First, the potential conceptual overlap between task-related and partner-related selection criteria, demonstrated in the factor analysis, indicates that a more fundamental approach to the identification of the core differences between the two types of criteria is needed. Hence the task of deriving orthogonal selection criteria is a clear research opportunity. The sequencing of selection criteria employed by firms from task-related to partner-related is also worthy of investigation. Second, the key variables influencing the relative importance of task-related and partner-related selection criteria is a largely unexplored area. Although Geringer (1991) has provided some understanding of the determinants of the relative importance of task-related selection criteria, further research is required to confirm and build on this work. The determinants of the variables influencing the relative importance of partner-related selection criteria remain a hitherto neglected topic area, but one clearly worthy of investigation. Third, future research should consider the dynamics of partner-selection criteria. In the examination of the changing needs of the joint venture over time, changes in the importance of different task-related and partner-related selection criteria could be identified. Finally, as Geringer (1991) notes, an important development for partner-selection research would be to examine the relationship between the partner-selection process and joint-venture performance. Of paramount importance here is the issue of whether task-related or partner-related selection criteria are more important for the long-term success of the joint venture.

## **Notes**

\* The authors thank anonymous referees for helpful comments on an earlier draft of this chapter.

- 1 As background to his own work, Geringer provides a comprehensive account of the literature relating to partner selection, which covers Tomlinson (1970),



Renforth (1974), Daniels (1971), and Hlavacek (1976), Tomlinson and Thompson (1977) and Awadzi (1987).

- 2 The questionnaire cited the joint venture referred to in the *Financial Times*, of which the UK firm was a partner, but invited the respondent to complete the questionnaire with respect to another joint venture with which they were more familiar, provided the foreign partner(s) was/were from Western Europe, the USA or Japan, and that the joint venture had been formed since 1980. The request for information on the joint venture with which the respondent had the most detailed knowledge was designed to improve the quality of the data. For the 53 respondents in the sample under study, a total of 9 respondents did this, providing data on joint ventures formed in the 1990–2 period. The sample therefore contains data on joint ventures that were not in the original sample frame, and in particular includes joint ventures that were formed post-1989. The benefit of this is that respondents provided data on more recent joint ventures and obviated the danger of memory decay. Moreover, the respondents have self-selected to report on the joint ventures they know most about. Given the detailed nature of the questions asked, it is unlikely that anyone without a full knowledge of the joint venture and interest in the research topic would have returned the questionnaire.
- 3 Prior research on selection criteria (Geringer, 1991) has used a five-point scale, typically with 0 measuring 'not important' and 4 measuring 'very important', the degree of importance thus being measured over four points of the scale. As noted, a three-point scale was adopted in this study, effectively measuring the degree of importance over two points of the scale. Clearly, this methodology involves a less precise measure of the degree of importance. However, the three-point scale does capture adequately the degree of importance, and given the need to assess importance over a total of twenty-four criteria it was felt that more numerous response categories would exceed the respondents' ability to discriminate, with the likelihood that 'noise' rather than more precise data would result. It was also considered likely that a trichotomous measure would tend to facilitate greater co-operation and return rates (Jacoby and Matell, 1971).
- 4 The percentage of joint ventures in each of the individual components of the industry sectors were as follows: food/drink manufacturing, 1.9%; metals and minerals, 11.3%; energy, 5.7%; construction, 3.8%; chemicals, 3.8%; pharmaceuticals, 3.8%; computers, 1.9%; telecommunications, 1.9%; other electrical, 7.5%; automobiles, 5.7%; other manufacturing, 17.0%; distribution, 7.5%; financial services, 20.8%; other services, 7.5%.
- 5 Factor analysis is normally employed to uncover any dimensions or structure underlying the data. Its purpose is to highlight key features which might otherwise be obscured by detail and in this way to simplify and clarify analysis.

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# 12

## Performance Relationships in UK International Alliances\*

*with Keith W. Glaister*

Since the mid-1970s, the incidence of alliance formation between partners from advanced industrial economies has accelerated (Anderson, 1990; Hergert and Morris, 1988; Glaister and Buckley, 1994). A major driving force for alliance formation is the recognition by many managements that in, an intensely competitive international business environment, self-sufficiency alone will not bring success, but the ability to compete will be considerably improved with the help of partners (Inkpen, 1995: 1). Two contractual forms of alliance can be identified – equity joint ventures and non-equity joint ventures. Equity joint ventures (EJVs) involve the incorporation of a new company in which two or more partners each hold an equity stake. Each partner will expect to participate in the decision-making activities of the jointly owned entity, will anticipate a proportional share of dividend, and expect representation on the board of directors (Harrigan, 1985; Geringer, 1991). Examples include the 50–50 EJV established in 1988 between ICI of the UK and Du Pont of the USA in industrial paint products for the purposes of product development, production and marketing. From ICI's perspective, the venture was particularly important in facilitating international expansion and to cope more effectively with a common competitor. From Du Pont's perspective, the alliance was particularly important in terms of exchange of complementary technology, and enabling both product diversification and faster entry to the market. In 1989, the UK publishing group EMAP established a 50–50 EJV with Bayard Press of France, for the purposes of product development and marketing. The venture facilitated international expansion for Bayard Press, and was particularly important in enabling fast entry to the UK market. These

motives also applied to EMAP, which also used the EJV to shape competition through forming the venture with a potential competitor, and the partners together being more able to compete against other competitors.

In contrast to EJVs, non-equity joint ventures (NEJVs) do not involve the creation of new firms, but are formal, long-term agreements between partners to co-operate in some way. Employees of the partner firms tend to work together directly from their own organizations. With NEJVs, carefully defined rules and formulas may govern the allocation of tasks, costs and revenues, and there is at least a moderate degree of inter-organizational dependence (Contractor and Lorange, 1988). In the financial services sector in 1988, the Royal Bank of Scotland established a NEJV with Banco Santander of Spain, for the purposes of product development and marketing. This venture enhanced the range of products for Banco Santander and provided access to the Royal Bank of Scotland's technology. For the Royal Bank of Scotland, the venture facilitated international expansion and enabled it to gain a presence in new markets. At the end of the 1980s, the Dalgety Group (through Spillers Foods) established a marketing NEJV with Asahi Breweries of Japan. Asahi Breweries would promote and distribute Spillers' petfood products in Japan, thus gaining a new range of products, while Spillers would benefit from fast entry to a new international market. This venture was terminated within two years of formation, however, because of poor performance.

The underlying factors that promote successful outcomes in international alliances is a relatively unknown area. Saxton (1997: 444) points out that a number of recent reviews (Smith *et al.*, 1995; Varadarajan and Cunningham, 1995) reached the same conclusion: 'Scholars know little about the underlying causes of successful alliances.' Given the increased emphasis on international alliances as an organizational form, this chapter presents new findings on aspects of alliance characteristics and performance in international alliances from a sample of UK partner firms with alliance partners from developed market countries. The basic goal of the chapter is to identify relationships between measures of alliance performance and alliance characteristics.

The remainder of the chapter is set out as follows: the background literature on performance and success factors of international alliances is discussed in the second section, together with the research hypotheses. The research methods are set out in the third section. The fourth section presents results, and the fifth a discussion of the findings. Conclusions are in the final section.

## **International alliance performance and success factors**

### **Measures of performance**

The measurement of organization performance is subject to considerable debate (Goodman and Pennings, 1980; Cameron, 1986; Chakravarthy, 1986; Lewin and Minton, 1986; Venkatraman and Ramanujam, 1986; Jacobson, 1987; Varadarajan and Ramanujam 1990; Eccles, 1991). One particularly contentious issue is the appropriate yardstick(s) to be used when assessing organization performance. Essentially, this debate revolves around the appropriateness of traditional financial measures (for example, rate of return on investment, or growth) as providing a true yardstick of performance, and the extent to which other indicators are relevant (such as maximizing shareholders' wealth; and qualitative returns to non-financial stakeholders, such as customer satisfaction). A further issue arises in attempting to account for the prevailing circumstances of the organization. Performance would be expected to vary with the nature of the organization's environment and its resource capability (Anderson, 1990). More fundamentally, controversy surrounds the lack of clarity between indicators of performance and determinants of performance.

In the context of this controversy, it is unsurprising that the operationalization of international alliance performance has proved difficult, with no consensus on the appropriate definition and measure of this concept (Geringer and Hebert, 1989, 1991; Parkhe, 1993a). Anderson notes that international alliance (as distinct from other organizational forms) may be more commonly used in highly uncertain settings, with a very long-term performance horizon and no current performance baselines for comparison. In high risk/uncertain settings, short-term financial measures would tend to indicate poor performance, although the venture may be making satisfactory progress towards long-term goals, or achieving current non-financial goals. In this respect, it should be recognized that international alliances may not be intended to achieve standard financial objectives such as profit generation, but are instead formed to fulfil a range of motives – for example, to enhance parent learning (Kogut, 1988a), or to improve the strategic positioning of the parent firms (Contractor and Lorange, 1988) – so as to gain a presence in new markets (Glaister and Buckley, 1996).

The failure of financial and objective measures to reflect adequately the extent to which an international alliance has achieved its aims is stressed by Geringer and Hebert (1991), who argue that, despite poor financial results, liquidation or instability, an international alliance may have met or exceeded the parents' objectives and so be considered

successful by one or all of the parents. Conversely, an international alliance may be viewed as unsuccessful despite good financial results or continued stability. Anderson (1990) takes this point further by arguing that parents should recognize that most international alliances should be evaluated more subjectively over a longer time horizon than is typically used. Resort to formal, financial measures of performance is likely to lead to early termination before an international alliance has had enough time to realize its potential. In this respect, international alliances require a more balanced, often subjective, approach if their promise is to be realized.

Most of the prior empirical studies examining international alliance performance relate to multinational companies from developed countries forming alliances with firms from developing countries. In these studies, a large number of criteria have been used to assess performance (Chowdhury, 1992). In summarizing prior empirical research, Geringer and Hebert (1991) pointed out that early studies relied on a variety of financial indicators, such as profitability, growth and cost position (for example, Tomlinson, 1970; Lecraw 1983). Other studies have used objective measures of performance such as survival of the alliance (Franko, 1971; Stopford and Wells, 1972; Killing, 1983; Geringer, 1990), its duration (Harrigan, 1986; Kogut, 1988b), instability of its ownership (that is significant changes in the equity holdings of the parents in EJV's), (Franko, 1971; Gomes-Casseres, 1987), and renegotiation of the alliance contract (Blodgett, 1992).

Concerns about the ability of financial and objective measures to gauge effectively international alliance performance, as noted above, have led several researchers to turn to perceptual measures of a parent's satisfaction with alliance performance (Killing, 1983; Schaan, 1983; Beamish, 1985). Perceptual measures are able to provide information regarding the extent to which the alliance has achieved its overall objectives. These authors (together with Janger, 1980) have also made use of subjective performance measures for each of a limited number of individual dimensions of the alliance.

### **International alliance success factors**

A great many factors may have a potential impact on alliance performance, ranging from the nature of the industry environment within which the alliance operates to the quality of the management of the alliance. This chapter makes a broad distinction between the variables that pertain at the time of alliance formation, for convenience termed the *ex ante* factors, and those that apply during the operation of the



alliance, particularly the nature of the alliance management process and partner–alliance interdependency, termed the *ex post* factors.<sup>1</sup>

### *Ex ante factors*

**1 Cultural distance.** The prior literature has not provided an explicit discussion concerning the choice of *nationality of the foreign partner* in alliance formation. Partner choice will presumably hinge on the tasks to be accomplished by the venture, and the particular characteristics required from the partner (Geringer, 1988, 1991), which may identify for a UK firm a potential partner of a particular nationality. With regard to alliance performance, internationalization theory would tend to suggest that an alliance would be more likely to fail the greater the cultural distance between the home base of the partners. From that perspective, the USA may be closer to the UK than some southern European countries, such as Spain or Italy. This reflects one branch of the literature, which has maintained that similar cultural values can reduce misunderstanding between partners, and that culturally distant alliances experience greater difficulty in their interactions. Communications between culturally distant partners can be difficult, for example, compounding the co-ordination problems that exist in any partnership, and leaving alliances vulnerable to managerial conflicts and early dissolution (Camerer and Vesalainen, 1988; Brown *et al.*, 1989; Lane and Beamish, 1990). Other studies have reached a somewhat different conclusion. Park and Ungson (1997), for example, found that cross-border joint ventures with partners from culturally distant countries have longer durations and are less likely to end than are domestic joint ventures. More specifically, with the effects of other variables controlled for, Park and Ungson (1997) found that *larger* cultural distances were related to a lower joint venture dissolution rate. However, when taking into account the interactive effect between prior relationships and cultural distance, the effect of cultural distance on joint venture dissolution became insignificant, and the interaction term became significant. Park and Ungson (1997) maintain that this significant interaction effect implies that prior relationship between firms may provide a powerful counter-balance to cross-cultural differences, negating the conflict and misunderstanding caused by cultural distance between cross-border partners. They maintain that this is consistent with Harrigan's (1988a) findings, with Bleeke and Ernst's (1993) case study result that cross-border joint ventures can overcome early difficulties caused by cultural differences, and with Barkema *et al.*'s (1996) suggestions that learning

between partners may offset cultural differences. Whether similarities or differences in partner culture will produce better alliance performance is therefore hedged with a degree of uncertainty. For the purposes of testing the impact of partner culture (proxied by partner nationality) on this sample of alliances, we express the maintained hypothesis in terms of the standard internationalization perspective on cultural distance, as follows:

**Hypothesis 1 Cultural distance will be significantly negatively related to alliance performance.**

*2 Previous relationships.* Saxton (1997: 445–6) notes that ‘Recent empirical work examining alliance dynamics links the extent to which firms have a prior relationship to the trust between partners, the propensity to continue to engage with that firm, and the structural mechanisms used to control behavior.’ Gulati (1995), has examined trust between alliance partners and the choice of organizational form of alliance. Recognizing that firms may enter multiple alliances with each other over time leads to the possibility that the economic and social context may alter the formal structure of those alliances, and the transaction costs associated with them. An important cause and consequence of such repeated alliances among firms is the emergence of inter-firm trust. Experience can thus engender trust among partners which in turn can limit the transaction costs associated with future alliances. Trust obliges partners to behave loyally and is built up incrementally as firms interact. Thus two firms with prior alliances are likely to trust each other more than other firms with whom they have had no alliances (Gulati, 1995: 93). Parkhe (1993a) hypothesized that the performance of an alliance would be related negatively to the extent to which the partners perceive each other as behaving opportunistically, and in an empirical study found that the presence of a prior history of co-operation limited partners’ perception of expected opportunistic behaviour in new alliances.

As a benefit of prior affiliation, Saxton (1997) stresses that it allows the partner firms to know each other better, thus facilitating a greater understanding of the respective capabilities and resources they are seeking to access and the likely behaviour expected of the partner. Saxton hypothesizes that a prior relationship will be positively related to alliance outcomes, which is echoed in this study’s second hypothesis.

**Hypothesis 2 Prior relationships will be significantly positively related to alliance performance.**

**3 *Depth of analysis.*** It is considered fundamental to the success of an alliance that the partners are appropriate to the underlying motives of the venture (Berg *et al.*, 1982; Killing, 1983; Harrigan, 1985; Beamish, 1987; Geringer, 1991). When firms first become engaged in the negotiation of an alliance, they are likely to have different strategic objectives and asymmetric capabilities as well as other important differences. These differences will condition firms' choices regarding whether to co-operate at all, which partners to select should they decide to co-operate, and which business to enter using alliances as well as other dimensions of corporate strategies (Harrigan and Newman, 1990). For example, Harrigan (1985) stresses that alliances are more likely to succeed when partners possess complementary missions, resource capabilities, managerial capabilities and other attributes that create a strategic fit in which the bargaining power of the partners is evenly matched.

The selection of the right partner and the extent to which the joint venture itself is well-founded will depend partly on the extent and *depth of the analysis* conducted by the parent during the formation period. A priori, it would be expected that the more in-depth the analysis and the more thorough the investigation of the alliance and its alternatives (for example, a wholly-owned subsidiary) during the decision phase of alliance formation, the more likely will be the success of the venture.

**Hypothesis 3** **The depth of analysis undertaken prior to the formation of the alliance will be significantly positively related to alliance performance.**

**4 *Partners actively compete.*** A common feature of much of the alliance activity since the 1970s has been the propensity for competing firms to establish alliances (Harrigan, 1988b). The tensions faced by a parent firm in attempting to manage both a co-operating strategy and a competing strategy with a partner may, however, prove too difficult to reconcile. If competitive rivalry should come to dominate the co-operative relationship between the partners – for example, because of intensification of competition in a market that both partners serve – the desire of one to win in the competitive arena against the other may reach a higher level of priority than sustaining the benefits of the alliance. It may be argued, therefore, that the extent to which the *parents actively compete* in markets has the potential to destabilize the alliance relationship and ultimately worsen alliance performance. Also, where parent firms actively compete, this may also affect respondents' attitudes to the nature of the alliance and its perceived level of success.

Hence, it would be expected that where partners actively compete, the level of satisfaction with alliance performance would be lower than where the partners do not actively compete.

**Hypothesis 4 Whether partners actively compete will be significantly negatively related to alliance performance.**

*Ex post factors*

**5 Other long-term relationships.** Kogut (1989) found that the likelihood of alliance termination is decreased when partners to the venture have *other ongoing agreements*. Kogut rationalizes this finding by arguing that 'mutual forbearance' (Buckley and Casson, 1988) is enhanced when disrupting the venture may affect other transactions. This finding also supports the transaction cost explanation of hostage positions stabilizing economic relationships (Kogut, 1988b, 1989). Kogut points out that an alliance frequently is only a part of a multiplicity of contracts between the partners. In order to understand the focal alliance it is therefore necessary to analyse it from the perspective of the total relationship, if not from its position in the wider co-operative network of the partners. It would be expected that, where other long-term relationships exist between partners, alliance performance would be better than in those alliances where the partners had no other long-term relationships.

**Hypothesis 5 Other long-term relationships will be significantly positively related to alliance performance.**

**6 Partner views and attitudes to the management of the alliance.**

**7 Behaviour/performance of partner.** It is clearly difficult, *ex ante*, for one parent to know with certainty if the 'right' partner has been selected. Through the course of the operation of the venture, however, during which time the actions and the attitude of the partner can be observed, it should be possible for a parent to arrive at an opinion on this. To the extent that one partner considers the other partner is the 'right' one for the venture, the more likely it is that the alliance will be a success, and the more the first partner will be satisfied with the performance of the alliance. This point could, of course, be argued in the converse manner: to the extent that one partner is satisfied with the performance of the alliance, the more likely it is that this partner will consider the other partner is the 'right' one for the venture. Thus, while

a correlation is expected between satisfaction of performance and the choice of the 'right' partner, the causality of the relationship is ambiguous. Nevertheless, it is unlikely that performance of the venture would be considered satisfactory by one partner if the other partner were not considered to be the 'right' one for the venture.

Partly underpinning the notion of whether the appropriate partner has been chosen and the success of the venture will be the extent to which one parent believes that the *views and attitudes to the management of the venture* are compatible between the partners, and furthermore on the perception of *appropriate behaviour/performance* in the activities undertaken by the foreign partner during the course of operation of the venture.

This may be related to the degree of similarity between the partners in terms of organizational processes. Saxton (1997: 447) has noted that the literature on diversifications has concluded that organizations must have similar cultures and approaches to strategic decisions (that is, organizational fit) in order to achieve synergies. Saxton (1997: 447) also cites Hedlund (1994) and Teece (1977) to support the view 'that similarities between partners may affect alliance performance because they facilitate the appropriability of tacit and articulated knowledge', which ultimately increases the likelihood of successful alliance performance. *Ex post*, such similarities may be reflected in the extent to which the views and attitudes of the partner firms to the management of the alliance coincide, and the extent to which the behaviour/performance of the partner during the operation of the alliance was as expected. This leads to the following hypotheses:

**Hypothesis 6** Partner views and attitudes to the management of the alliance will be significantly positively related to alliance performance.

**Hypothesis 7** The perspective of appropriate partner behaviour will be significantly positively related to alliance performance.

**8 *Integration of the alliance.*** The overall success of the alliance is likely to be related to the dependency of the partners on the alliance. Another aspect of the relative importance of the alliance to the partner firms is the extent to which the alliance is integrated into the operations of the partners. The more an alliance is integrated into the operations of a partner, the more the relative importance of the alliance is likely to be to that partner (Inkpen and Birkenshaw, 1994). The fact that the alliance is more important for the parent may have no implications for its performance: the performance will be more

important for the parent, but not necessarily better or worse. However, the *perception* of the overall success of the alliance is likely to be related to the extent of the *integration* of the alliance into the operation of the partner firm. Where the alliance is more integrated in the operations of the UK parent than the operations of the foreign partner, it would be expected that the UK parent would view more favourably the performance outcome of the alliance. This leads to the final hypothesis:

**Hypothesis 8** Integration of the alliance will be significantly positively related to alliance performance.

## Research methods

This study involves UK parents of international alliances with partner firms from Western Europe, the USA and Japan, formed since 1980. A sample frame of alliances was obtained from press announcements in the *Financial Times*. The sample frame was derived from alliances created from the free association of firms, and not those encouraged by incentives provided by external agents. The qualifying alliances therefore do not include those organized through government agencies, particularly European Community programmes such as ESPRIT.

A postal questionnaire was used to gather the data. The specialized nature of the desired information meant that participants had to be senior managers who were knowledgeable about the research topic. A set of semi-structured interviews with a senior manager from each of eight UK partners helped to shape the form of the final questionnaire. Results from a pre-test questionnaire confirmed the appropriateness of the data collection instrument. To enhance the quality of the data, telephone contact was made with each UK partner to ascertain the name and position of the most appropriate senior manager to whom the questionnaire was personally addressed. The questionnaire cited the alliance referred to in the *Financial Times* of which the UK firm was a partner, but invited the respondent to complete the questionnaire with respect to another alliance with which they were more familiar, provided the foreign partner(s) was/were from either Western Europe, the USA or Japan, and that this alliance had been formed since 1980. The request for information on the alliance about which the respondent had the most detailed knowledge was designed to improve the quality of the data.<sup>2</sup>

The 520 qualifying alliances recorded from the *Financial Times* involved 277 separate UK firms. Several firms proved impossible to contact, either because they had been taken over and restructured or had gone out of business altogether. Other firms had moved location and could not be traced. In some of the firms contacted there was no longer anyone in employment with sufficient knowledge to provide the depth of answers the study required. This left a total of 203 UK partners to whom the questionnaire was administered in the autumn of 1992. In exchange for their participation in the study, and to provide motivation and accurate responses, the respondents were assured of anonymity and were promised a summary report of the findings. After one reminder, 94 usable questionnaires were returned, a response rate from 203 mail-outs of 46.3 per cent. About 18 per cent of the returned questionnaires involved alliances with more than one foreign partner. As Geringer (1991) has pointed out, there may be difficulties associated with analysing multiple partner alliances in that two-partner ventures may demonstrate significant differences from ventures with three or more partners. Hence this study only concerns the single foreign partner alliances. In recognizing that performance data for very new alliances might not be meaningful, Dussauge and Garrette (1995), for example, reported that experts had difficulty in evaluating the performance of recently established alliances in the aerospace industry, it was decided to analyse only those alliances that had been in existence for at least one year at the time the data was collected. The time-span of the study is therefore 1980 to 1991.

The sample consists of 75 alliances (51 EJVs and 24 NEJVs). The majority of alliances were formed with partners from Western Europe, followed by the USA and Japan. A total of 48 alliances are in the manufacturing sector and 27 are in the tertiary sector. For the sample of alliances as a whole, 48 ventures were still in existence (33 EJVs and 15 NEJVs), while 27 alliances had been terminated (18 EJVs and 9 NEJVs). Alliance termination is independent of contractual form (chi-square statistic = 0.04, d.f. = 1,  $p > 0.85$ ). Of the terminated alliances, 16 were not considered as failures (12 EJVs and 4 NEJVs), with 11 considered as failures (6 EJVs and 5 NEJVs). Clearly, termination of an alliance does not necessarily signify failure. This corresponds with Saxton's (1997) evidence. Whether the alliance was considered a failure is independent of contractual form (chi-square statistic = 1.22, d.f. = 1,  $p > 0.23$ ). The average duration of all alliances was 4.7 years. The average duration of surviving (non-terminated) alliances was 5.1 years, while the average duration of terminated alliances was 4.1 years.

## Performance measures

Two subjective performance measure were obtained. First, the UK parent's subjective level of satisfaction with the alliance's overall performance. Second, as a check on the UK parent's overall satisfaction rating, an alternative measure of subjective performance based on a cost–benefit measure, was derived at a non-sequential point in the questionnaire (see Table 12.1).

**Table 12.1** Measurement of variables and expected signs

		Expected sign
<b>Independent variables</b>		
Satisfaction	Ordinal scale from 1 = 'very dissatisfied' to 5 = 'very satisfied'.	
Cost–benefit	Ordinal scale from 1 = 'benefits > costs' to 3 = 'benefits < costs': Reverse coded in data analysis.	
<b>Dependent variables</b>		
<i>Ex ante</i>		
Cultural distance	A composite index derived from the computation formula of Kogut and Singh (1988); see text for details.	–
Previous relationships	Dichotomous variable (1 or 0) depending on whether the partner firms had a relationship before the formation of the alliance (n = 52) or whether they had no previous relationships (n = 21). Missing value = 2.	+
Depth of analysis	Ordinal scale from 1 = 'In depth' to 5 = 'None'. Reverse coded in data analysis.	+
Partners compete actively	Dichotomous variable (1 or 0) measured according to whether the partners compete (n = 31) or do not compete (n = 44).	–
<i>Ex post</i>		
Other long-term relationships	Measured dichotomously (1 = Yes or 0 = No) depending on whether or not such relationships existed (Yes, n = 35; No, n = 39; missing value = 1).	+
Partner views and attitudes to management of alliance	Ordinal scale from 1 = 'Very different' to 4 = 'Very similar'.	+
Behaviour performance of partner	Ordinal scale from 1 = 'Worse than expected' to 3 = 'Better than expected'.	+



**Table 12.1** (Continued)

		Expected sign
Integration of the alliance	Measured as a dichotomous variable (1 or 0), according to whether the alliance was either more integrated into the operations of the UK parent (n = 30) or was more integrated into the operations of the foreign partner, or was integrated equally into both companies' operations (n = 45).	+
<i>Control variables</i>		
Alliance form	A dummy variable (1 or 0) measured according to whether the alliance was an equity joint venture (n = 51) or a non-equity joint venture (n = 24).	?
Industry	A dummy variable (1 or 0) measured according to whether the alliance was in the manufacturing sector (n = 48) or the tertiary sector (n = 27).	?

### International alliance success factors

The variables discussed in the hypotheses section are summarized in Table 12.1, which sets out the method of variable measurement and, where appropriate, frequencies. Table 12.1 also shows the direction of the hypothesised relationships.

The measure of cultural distance is based on the computational formula of Kogut and Singh (1988). From information provided by 88,000 respondents from 66 countries, Hofstede (1980) developed indices to measure four dimensions of national culture: power distance, uncertainty avoidance, masculinity/femininity, and individualism. Kogut and Singh (1988) employed these indices to compute cultural distances between the USA and other countries as part of their investigation of cultural influences on the entry-mode choice of foreign firms entering the USA. Using their computational formula, we measure cultural distance as follows:

$$\text{Cultural distance } j = \Sigma\{(lij - Iiu)^2 / Vi\} / 4$$

where  $Iij$  stands for the index of the  $i$ th cultural dimension and  $j$ th country,  $Vi$  is the variance of the index of the  $i$ th dimension,  $u$  indicates the UK, and Cultural distance  $j$  is cultural distance of the  $j$ th country

from the UK. As well as being employed by Kogut and Singh (1988), this measure of cultural distance has been used in several other studies (for example, Erramilli, 1991; Erramilli and Rao, 1993; Contractor and Kundu, 1998). Countries with small values of cultural distance are culturally similar to the UK, with larger values signifying increasing dissimilarity. The values of cultural distance ranged from 0.08 (for the USA) to 4.86 (for Portugal).

Evidence of prior relationships was sought in terms R&D agreements, technology transfer agreements, supply contracts, licensing/patent agreements, marketing agreements, other joint ventures, and personal relationship between the top management. Apart from the latter, a similar list of arrangements was used to identify ongoing long-term relationships.

### **Control variables**

As noted previously, the sample includes different alliance types, basically categorized as equity joint ventures and non-equity joint ventures. As Saxton (1997: 450) notes, the administrative form of an agreement may indicate the motives of the partner companies and have a considerable impact on the expected performance outcomes. This is based on the assumption that EJVs, which formally embody the creation of a new firm, represent a longer-term commitment by the parents than do NEJVs, which are frequently viewed as more temporary organizational modes. It may also be the case that the amount of investment required in the establishment of an EJV is on average greater than that for the establishment of a NEJV, and that the former absorbs more managerial time and effort than the latter (Gulati, 1995: 89–90). To control for alliance type, this variable was entered as a dummy, coded 1 for EJVs and 0 for NEJVs. The industry sector of the alliance was also entered as a dummy variable, coded 1 for the manufacturing sector and 0 for the tertiary sector.

### **Test procedures**

We tested for the existence of individual relationships between each of the hypothesized variables and the two measures of performance by running Pearson correlations between the variables. Next, a multiple regression procedure was run to determine which combination of factors predicted alliance performance. Three regression models were developed: Model 1 included the *ex ante* variables, Model 2 included the *ex post* variables, and Model 3 included both sets of variables. Alliance form and industry group were treated as control variables in the regression procedure.

## Results

Table 12.2 reports the means, standard deviations and correlations for the dependent variables, the independent variables (in the order hypothesized) and the control variables. Although there is a relatively strong significant correlation between the two independent variables, the correlation coefficient is considerably less than 1.0. It is clear that these two subjective measures of overall performance are capturing different aspects of perceived performance.

In general, there are highly significant correlations between Satisfaction and depth of analysis, other long-term relationships, partner views and attitudes to the management of the alliance, and behaviour/performance of the partner. Also, in general, there are relatively strong significant correlations between the Cost–benefit measure and depth of analysis, whether partners compete actively, and behaviour/performance of partners. Each of the significant correlations has the expected sign.

Table 12.3 displays the results of the multiple regression analyses for combinations of the independent variables with alliance performance as the dependent variables. A separate analysis of the control variables alone (not shown) indicates that this combination of variables is not significant (Satisfaction dependent variable,  $F = 0.59$ ,  $R^2 = 0.01$ ; Cost–benefit dependent variable,  $F = 0.13$ ,  $R^2 = 0.00$ ). With virtually none of the variance explained by the control variables, the percent of variance reported in Table 12.3 is explained by the each of the models specified.

Model 1 captures the effects of the *ex ante* variables on alliance performance. For Satisfaction as the dependent variable this model is not significant ( $F = 1.18$ ,  $R^2 = 0.10$ ). Depth of analysis is the only variable with a significant coefficient ( $p < 0.05$ ). For Cost–benefit as the dependent variable this model is significant at the  $p < 0.01$  level ( $F = 3.26$ ,  $R^2 = 0.23$ ). Coefficients for depth of analysis ( $p < 0.01$ ) and partners actively compete ( $p < 0.05$ ) are significant. The signs on each of the significant coefficients in Model 1 are as anticipated.

Model 2 captures the effects of the *ex post* variables on alliance performance. For Satisfaction as the dependent variable this model is significant at the  $p < 0.01$  level ( $F = 7.04$ ,  $R^2 = 0.39$ ). The coefficients for other long-term relationships ( $p < 0.05$ ) and behaviour/performance of partner ( $p < 0.01$ ) are significant. For Cost–benefit as the dependent variable this model is significant at the  $p < 0.01$  level ( $F = 5.46$ ,  $R^2 = 0.33$ ). The coefficient for behaviour/performance of partner is significant ( $p < 0.01$ ). The signs on each of the significant coefficients in Model 2 are as anticipated.

**Table 12.2** Means, standard deviations and correlations

Variable	Mean	s.d.	1	2	3	4	5	6	7	8	9	10	11
1 Satisfaction	3.56	1.32											
2 Cost-benefit	2.41	0.86	0.61**										
3 Cultural distance	1.48	1.29	0.04	0.14									
4 Previous relationships	0.71	0.46	-0.02	-0.00	-0.25*								
5 Depth of analysis	3.91	1.08	0.23*	0.38**	0.05	0.13							
6 Partners compete actively	0.41	0.50	-0.09	-0.25*	-0.14	0.04	-0.06						
7 Other long-term relationships	0.47	0.50	0.25*	0.15	0.06	0.24*	-0.01	-0.01					
8 Partner views and attitudes to management of alliance	2.88	0.66	0.29**	0.14	-0.05	0.02	0.23*	-0.01	-0.10				
9 Behaviour/performance of partner	1.95	0.66	0.54**	0.55**	-0.01	0.14	0.26*	-0.18	0.07	0.33**			
10 Integration of the alliance	0.40	0.49	0.19	0.01	-0.02	0.07	0.02	0.20*	-0.07	0.27**	0.15		
11 Alliance form <sup>a</sup>	0.68	0.47	-0.10	-0.00	0.16	0.11	0.21*	-0.12	-0.04	-0.04	-0.01	0.09	
12 Industry <sup>b</sup>	0.64	0.48	-0.08	-0.06	-0.04	-0.04	0.20*	0.12	0.02	-0.01	0.10	-0.06	0.02

Notes: <sup>a</sup>Equity or nonequity; <sup>b</sup>Manufacturing or tertiary; \*p<0.05, one-tailed test; \*\*p<0.01, one-tailed test.

**Table 12.3** Results of regression analyses

Variable	Model 1		Model 2		Model 3	
	<i>Ex ante</i>		<i>Ex post</i>		<i>Full model</i>	
	Satisfaction	Cost-benefit	Satisfaction	Cost-benefit	Satisfaction	Cost-benefit
Constant	3.00***	1.59***	1.05	1.18***	1.19	0.95*
Cultural distance	0.00	0.06			-0.01	0.06
Previous relationships	-0.08	-0.01			-0.51*	-0.24
Depth of analysis	0.33**	0.31***			0.19	0.26***
Partners compete actively	-0.23	-0.43**			-0.17	-0.29
Other long-term relationships			0.59**	0.17	0.74***	0.27
Partner views and attitudes to management of alliance			0.21	-0.05	0.13	-0.15
Behaviour/performance of partner			0.95***	0.74***	0.85***	0.61***
Integration of the alliance			0.31	-0.09	0.53*	0.05
Alliance form	-0.54	-0.24	-0.27	0.01	-0.45	-0.15
Industry	-0.29	-0.17	-0.30	-0.21	-0.30	-0.25
R <sup>2</sup>	0.10	0.23	0.39	0.33	0.44	0.46
Adjusted R <sup>2</sup>	0.02	0.16	0.33	0.27	0.35	0.37
F	1.18	3.26***	7.04***	5.46***	14.77***	5.16***

Notes: N = 75; \*p < 0.10; \*\*p < 0.05; \*\*\*p < 0.01.

Model 3 is the full model with all the independent variables. This model offers a stronger, multivariate test of the hypotheses and allows examination of how *ex ante* and *ex post* variables simultaneously affect alliance performance. For Satisfaction as the dependent variable this model is significant at the  $p < 0.01$  level ( $F = 4.77$ ,  $R^2 = 0.44$ , adjusted  $R^2 = 0.35$ ). Individual coefficients for previous relationships ( $p < 0.10$ ), other long-term relationships ( $p < 0.01$ ), behaviour/performance of partner ( $p < 0.01$ ), and integration of alliance ( $p < 0.10$ ) are significant. For Cost-benefit as the dependent variable this model is significant at the  $p < 0.01$  level ( $F = 5.16$ ,  $R^2 = 0.46$ , adjusted  $R^2 = 0.37$ ). Individual coefficients for depth of analysis ( $p < 0.01$ ) and behaviour/performance of partner ( $p < 0.01$ ) are significant. The signs on each of the significant coefficients in Model 3 are as anticipated.

Considering model fit, it may be seen that a model which includes both *ex ante* and *ex post* variables can better explain performance than can a model that incorporates either set of variables alone. For Satisfaction as the dependent variable, the full model explains an additional 33 per cent of the variance in performance over the model that includes only the *ex ante* variables, and the full model explains an additional 2 per cent of the variance compared to the model which just includes *ex post* variables. For Cost-benefit as the dependent variable, the full model explains an additional 21 per cent of the variance in performance over the model which includes only the *ex ante* variables, and the full model explains an additional 10 per cent of the variance compared to the model which just includes *ex post* variables.

The test procedures offer support for *Hypothesis 3* (depth of analysis), *Hypothesis 5* (other long-term relationships) and *Hypothesis 7* (behaviour/performance of partner). There is weak support for *Hypothesis 4* (whether partners actively compete), and *Hypothesis 8* (integration of the alliance). Correspondingly, the findings do not offer support for *Hypothesis 1* (cultural distance), *Hypothesis 2* (previous relationships), and *Hypothesis 6* (partners views and attitudes to the management of the alliance).

## Discussion

The goal of this chapter was to identify the relationships between measures of alliance performance and a set of *ex ante* and *ex post* variables that have a potential effect on alliance performance. From the prior literature, four *ex ante* variables were identified as having a potential effect on alliance performance: cultural distance, previous relationships

between the alliance partners, depth of analysis preceding the formation of the alliance, and whether or not the partners actively compete. The most significant findings for this set of variables was the confirmation of the importance of depth of analysis prior to alliance formation. Four *ex post* variables were identified as having a potential effect on alliance performance: other long-term relationships between partners, the partners' views and attitudes to the management of the alliance, the behaviour/performance of the partners and the degree of integration of the alliance. The significant findings for this set of variables was the confirmation of the importance of ongoing long-term relationships, and of the behaviour/performance of the partner firm for alliance success. From the models presented, the *ex post* variables alone explain more of the variance in subjective performance than do the *ex ante* variables alone. However, the full model incorporating both sets of variables explains more of the variance in performance than either of the individual sets of variables alone. The findings of this study therefore suggest that a combination of both *ex ante* and *ex post* variables offers superior explanatory power for predicting successful performance outcomes in international alliances.

Comparing the explanatory power of the models for the two subjective performance measures, the independent variables in Model 1 explain considerably more of the variance in the Cost-benefit measure than in the Satisfaction measure, while Model 3 (the full model) explains marginally more of the variance in the Cost-benefit measure than in the Satisfaction measure. In contrast, Model 2, with the *ex post* independent variables, explains marginally more of the variance in the Satisfaction measure than in the Cost-benefit measure. The number of significant coefficients on the independent variables are greater where Cost-benefit is the dependent variable in Model 1, but are greater where Satisfaction is the dependent variable in Model 2 and Model 3.

The moderate correlation between the Satisfaction measure of performance and the Cost-benefit measure, and the finding that the list of significant independent variables differs somewhat for each model when varying the dependent variable suggests that the two performance measures are capturing different concepts of alliance performance. The Satisfaction measure is a direct subjective assessment of the performance of the alliance. Conceptually, this measure represents a proxy for the extent to which the alliance has achieved its major objectives. Salient objective performance outcomes (such as financial performance) are likely to vary between alliances, and may vary between the partner firms to an alliance. The perceptual measure of Satisfaction allows the

respondents to reflect on the key aspects of the performance level achieved and to provide a subjective view of their firm's satisfaction with the performance level attained. The Satisfaction measure therefore encourages a broad perspective of the performance of the alliance. In contrast, the Cost-benefit measure requires a more specific evaluation of the cost of the strategy of forming an alliance against the benefits of having followed such a strategy. This requires a different kind of evaluation on the part of the respondent, whereby consideration is required of the net benefit of the alliance. While the net benefit of the alliance to the parent organization can be expected to be correlated with the direct measure of Satisfaction of performance, clearly the two are conceptually not the same thing. In a sense the Cost-benefit measure is a more demanding test of the worth of the alliance. While alliance performance may be highly satisfactory, the overall strategy of pursuing the alliance may be doubtful, or vice versa. For example, the IJV may be performing particularly well, but there is a concern by one partner that proprietary technology is leaking rapidly to the other partner firm, which could then use this technology to compete against its partner.

It is perhaps not surprising, therefore, that the correlation between the Satisfaction measure and the Cost-benefit measure is only moderate, and that different independent variables evidence different degrees of significance. In Model 1, for example, whether Partners compete actively is not significant for the Satisfaction measure but it is significant for the Cost-benefit measure. In terms of the alliance, achieving its overall objectives as represented by the direct Satisfaction measure, and whether partners compete appears to have no bearing. It is possible that the respective partners can delineate boundaries successfully between competition and collaboration in order to achieve desired performance outcomes for the alliance. However, when assessing, for example, the transaction costs of organizing the lines of demarcation between competition and collaboration, the way in which the parent firm may be inhibited from competing, or the infringement of the competitive boundary by the partner firm, the net strategic benefit of the alliance becomes more problematic. Whether the Partners compete actively is consequently more likely to have a significant presence when the Cost-benefit measure is the dependent variable.

In Models 2 and 3, the independent variable Other long-term relationships is significant when the Satisfaction measure is the dependent variable, but not when Cost-benefit is the dependent variable. This indicates that the nexus of existing relationships between the partner firms has an influence on achieving the overall objectives of the alliance



as reflected in the subjective Satisfaction measure, but not when considering the overall Cost–benefit of the alliance. Indeed, in providing hostages, the other relationships between the partners could increase the costs or reduce the benefits of the focal alliance significantly, independent of the way in which such relationships foster the successful performance of the alliance. Finally, it may be noted that in Model 3, Integration of the alliance becomes significant when Satisfaction is the dependent variable. It was argued in the hypotheses section that the perception of performance may be affected by the extent of Integration of the alliance. While the extent of integration appears to affect the perception of satisfaction of performance in the manner hypothesized, it does not have a significant effect on the Cost–benefit calculation of the alliance. This may be because the Cost–benefit measure explicitly reflects the costs as well as the benefits of the degree of integration, and therefore make respondents less susceptible to perceiving performance as a function of the degree of integration.

Despite the differences in findings relating to the dependent variables, both of the subjective performance measures used in this study appear to be useful in exercises of this type, and should be viewed as complements rather than as substitute measures.

Saxton (1997: 453) notes that ‘Recent research on alliances has focused increasingly on relationship characteristics and on trust in particular as an important consideration for explaining alliance behavior and success.’ The findings of this study provide additional support for this view. In particular, the findings of this chapter lend further support to the view that the success of the alliance is, to a degree, bound up with the extended set of long-term relationships between the partners (*Hypothesis 5*). The findings of the study buttress the view that ongoing contact between partners engenders trust and so reduces the transaction costs of alliances and promotes a set of behaviours that result in good performance. The nature of trust in these relationships may be indirect and conceptually nebulous, however. It is likely that ongoing relationships will create hostage positions (Williamson, 1975; Kogut, 1989). These hostage positions may inhibit opportunism or stimulate mutual forbearance, reciprocity and trust (Buckley and Casson, 1988). As Parkhe (1993b) has noted, these are ‘messy’ concepts, and further research is required to reveal their underlying nature and the way in which they are related to the broader set of relationships between partner firms. Nevertheless, these outcomes may be allied to the findings relating to *Hypothesis 7*, and in particular the way in which the actual versus expected behaviour/performance of the partner is related to

alliance performance. Macauley (1963: 63) noted that personal relationships which emerged between individuals in organizations that contracted with each other, in turn exerted pressures to conform to expectations.

The finding that the variable measuring depth of analysis of the venture has a significant coefficient in three of the four models in which it is included as an independent variable, is worthy of note. This finding has a clear message for practising managers: in order to enhance the successful outcome of an alliance, its formation must be preceded by an in-depth and thorough analysis. The implication is that opportunistic and casual development of alliance relationships should be avoided. An explicit examination of the factors associated with the formation of the potential alliance should be undertaken in the context of the strategy of the parent firm. It is possible, of course, that there is an alternative explanation to the finding that depth of analysis is related significantly to performance. Where potential alliances have *ex ante* high expected pay-offs, then firms may spend more time planning and analysing these alliances. Conversely, where expected pay-offs are low, firms may invest less time and effort in assessing the potential alliance. In light of this uncertainty, the nature of the causal relationship between depth of analysis and alliance performance merits further study.

The finding that cultural distance is not significant is unsurprising in the context of one branch of the prior literature which has argued that differences in culture may be beneficial to alliance relationships. This finding lends support to Saxton's findings, whose results 'contradict the popular idea that "culture clash" negatively influences alliance potential' (Saxton, 1997: 456). For alliance success it may not be necessary to link with a partner with a similar culture; indeed, there may be benefits from choosing a partner with a dissimilar culture in order to learn something from the relationship. So long as partners recognize and appreciate the differences in culture, and regard this as an opportunity to learn new things and thus expand the capabilities of the organization, then this may be a source of strength to the alliance.

The finding of no support for *Hypothesis 2* (relating to prior relationships) with only one significant coefficient ( $p < 0.10$ ) and each of the coefficients displaying a sign the reverse of that expected, is somewhat surprising. The conclusion from this study is that prior relationships are not a good predictor of successful alliance performance. This finding is, however, similar to that of Saxton (1997), who reported that prior affiliation was linked to initial satisfaction but not to longer-term benefits to partners. Saxton (1997: 455) explains this by nothing that while prior

affiliation may affect the 'propensity to engage with a firm ... it does not have a commensurate impact on subsequent performance'. From the findings of this study it may be concluded that prior relationships are less important in successful alliance outcomes than are ongoing long-term relationships. While prior relationships may encourage the initial formation of the alliance, it is the broad set of ongoing long-term relationships which endure between the partners that promotes successful alliance outcomes.

A number of caveats must be issued with the findings of the study. The subjective measures of alliance performance were obtained from UK partners. There is clearly a need in future studies to obtain information from both sets of partner firms and, where appropriate, alliance managers, in order to obtain a consensus view on alliance performance. More crucially for this study is that managers' opinions of alliance performance may not be a good measure of the extent to which the alliance has in fact met its objectives, particularly if the respondent has had responsibility for initiating and managing the alliance. To the extent that this is the case, the responses may be biased in providing a favourable view of the alliance. It should also be noted that the variables identified in this study do not constitute an exhaustive list of the potential influences on the subjective measure of the satisfaction of alliance performance. An important set of variables relate to the management of the alliance, the discussion of which is beyond the scope of this chapter.

## **Conclusions**

The findings of this chapter indicate that successful alliance outcomes are predicated on a number of basic factors. The more carefully and in depth the formation of the alliance is analysed, the greater the likelihood of successful alliance performance. Also of crucial importance are the management process issues, and in particular the ways in which partner behaviour and performance reaches expectations. In this context the nexus of relationships between the partner firms, especially in terms of other ongoing long-term relationships, serves to enhance alliance performance. This may be rationalized in terms of the development of trust between the partners and a corresponding reduction in the propensity to act opportunistically given the potential hostage position of the wider set of relationships between the partners. Further research is clearly needed in this important area, as an aid to both conceptual development and to practice. The way forward to a deeper

understanding of alliance performance must be to further develop causal models of performance.

## Notes

\*The authors would like to thank the anonymous referees for their constructive comments on earlier versions of this chapter.

- 1 A number of further variables are involved in the relationship of joint venture operations and performance, particularly those relating to the management of the joint venture. While these variables have a bearing on the main topic of this chapter they are substantial enough in themselves to warrant an examination in their own right. This chapter, therefore, does not consider the joint venture management–performance relationship. However, this relationship is analysed by the authors for the sample reported here in a separate paper (Glaister and Buckley, 1998).
- 2 It is apparent that this study relies on data collected from one parent. The extent to which data collected from one element of the alliance – one parent or the alliance general manager – represents a reliable measure of alliance performance was a topic of concern in the study by Geringer and Hebert (1991). Geringer and Hebert conclude from their analysis that where it is only possible to obtain responses from one of the partners, ‘use of a single respondent per IJV [international joint venture] appears to allow researchers to obtain fairly reliable and efficient data for overall IJV performance’ (Geringer and Hebert, 1991: 259–61). The findings of Geringer and Hebert provide some justification for the research method adopted here, and confidence in the performance data so obtained.

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## **Part IV**

# **Knowledge Management in Multinational Enterprises**



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# 13

## Managing Cross-Border Complementary Knowledge: Conceptual Developments in the Business Process Approach to Knowledge Management in Multinational Firms

*with Martin J. Carter*

The current explosion of interest in 'knowledge management' within firms (Nonaka and Takeuchi, 1995; von Krogh and Roos, 1996; Grant, 1997; Stewart, 1997; Boisot, 1998; Teece, 1998)<sup>1</sup> illustrates the strong linkage between the process of managing a firm's knowledge assets and the global competitiveness of the firm. Gaining value from the intangible assets a firm possesses is a key component in achieving the strongest possible competitive stance. Techniques of knowledge management are transferable within the firm, but only at a cost. This cost will be lower the more permeable are the internal dimensions of the firm. Thus organizational and cultural barriers internal to the firm become a prime concern when the firm's management is seeking the most effective use of its intangible knowledge assets. It is an arguable proposition that the ability to manage knowledge will have a culture-specific element, and therefore, to some degree, a nation-specific aspect. Knowledge management therefore provides a key link between a firm's global competitiveness and the national attractiveness of particular locations and of the national ownership of successful global firms.

The characteristics of knowledge and the consequent problems in transferring this intangible commodity between firms have long been a key component in the theory of multinational enterprise (Buckley and Casson, 1976, 1985). More recently, ideas about information and knowledge have played an increasing part in the analysis of all firms. The firm has

been seen as a solution to fundamental problems of information processing (Alchian and Demsetz, 1972; Casson, 1997). Following Penrose (1959), the 'knowledge-based' or 'resource-based' approach treats firms as repositories of knowledge, capabilities or competences (Winter, 1988; Prahalad and Hamel, 1990; Barney, 1991; Fransman, 1994; Teece and Pisano, 1994; von Krogh and Roos, 1996; Grant, 1997). Such knowledge or competence has been evaluated as intellectual capital (Roos and Roos, 1997; Stewart, 1997), and processes for creating organizational intellectual capital have been analysed (Nonaka and Takeuchi, 1995).

The study of processes for the transfer of knowledge within firms, particularly within multinational enterprises, is at a comparatively early stage. Ghoshal and Nohria (1989), and Gupta and Govindarajan (1991, 1993), all recognized that knowledge may be located in different parts of a multinational firm, and that subsidiaries will have different degrees of interdependence with other parts of the firm according to how much of their required knowledge they hold for themselves, how much they receive from other parts of the firm, and how much they supply to other parts of the firm. Both suggested that the types of control needed over the use of knowledge will vary according to the degree of interdependence or independence of subsidiaries. Kogut and Zander (1992, 1993) proposed that multinationals economize on the costs of knowledge transfer through 'a set of higher-order organizing principles'. They suggested that these comprise an ability to codify technologies into a language that is accessible to the individuals within the firm, together with 'combinative capabilities' for creating new applications out of existing knowledge, although they do not expand on the character of these capabilities.

This chapter presents a conceptual model of knowledge transfer and combination, taking existing theoretical approaches and developing these for potential empirical application and verification. It builds on previous concepts from the literature on knowledge management, entrepreneurship, theories of the multinational firm, and business-process design, to provide a conceptual model that encompasses knowledge-process types and generic knowledge-management strategies. The framework is derived mainly from theoretical developments, but also incorporates a small-scale exploratory study of US and UK multinational firms in two contrasting industries.

## **Knowledge and uncertainty**

Our basic approach in this chapter is to see knowledge as a resource that can be used to create gains out of the uncertainty facing the firm. We see

the firm, following Casson (1997), as a specialized intermediary created by an entrepreneur to synthesize information routinely about different sources of volatility. Three sources of volatility can be identified. The first source of volatility is *primary uncertainty*, which arises both from exogenous shocks, such as random acts of nature, unpredictable changes in consumer's preferences, and external technological change, and from endogenous change resulting from the firm's own research and development. Superior knowledge about these areas of uncertainty is what enables the entrepreneurial firm to create and maintain profitable reallocations of resources (Casson, 1982, 1997).

In large corporations, there is a division of entrepreneurial (knowledge-synthesizing) labour (Carter, 1995; Casson, 1985). External uncertainty is monitored and internal developments are led by a number – possibly a large number – of key managers within the firm. This division of labour gives rise to *secondary uncertainty*, which is the risk that individual managers will not combine their knowledge in an optimum fashion with their colleagues. Synthesizing this information is the key task of the entrepreneur – expanded in large corporations into a supra-personal (or multi personal) force that may be embodied in the board of directors, in cross-functional or cross-national teams, in committees, or in strategic-planning groups.

The *tertiary* type of uncertainty arises from opportunism – 'self-interest seeking with guile' (Williamson, 1996: 56) – if managers choose not to reveal the knowledge they hold, or if they divulge incorrect or misleading information.

It is secondary uncertainty that most concerns knowledge management. As Koopmans put it:

In a rough and intuitive judgment the secondary uncertainty arising from a lack of communication, that is from one decision maker having no way of finding out the concurrent decisions and plans made by others (or merely of knowing suitable aggregate measures of such decisions or plans), is quantitatively at least as important as the primary uncertainty arising from random acts of nature and unpredictable changes in consumers' preferences. (1957: 162–3).

This definition of secondary uncertainty encapsulates the 'knowledge-management' problem. We concentrate on this issue because, like Koopmans, we believe it is 'quantitatively more important' than primary or tertiary uncertainty. It requires us to abstract, for the moment, from

the issue of primary uncertainty. The sources of volatility (exogenous shocks and internal change) are issues for the specialist (entrepreneurial) members of the firm, whose judgement is necessary to identify or plan the primary source of such shocks. Tertiary uncertainty – the issue of trust in key managers – is dealt with in a later section. The model is shown in a heuristic fashion in Figure 13.1.

The firm’s response to the three types of uncertainty corresponds to what we have elsewhere called the three organizational problems of acquiring *information*, appropriate *co-ordination*, and achieving effective *motivation* of company members (Buckley and Carter, 1996). Knowledge management concerns the internal mechanisms for *co-ordination*, that is, for pooling the key information garnered by managers whose task it

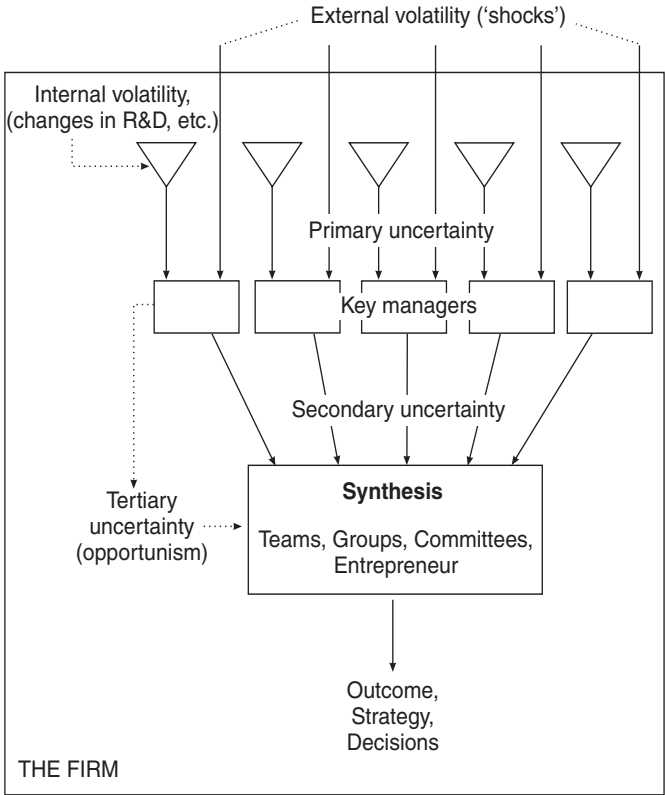


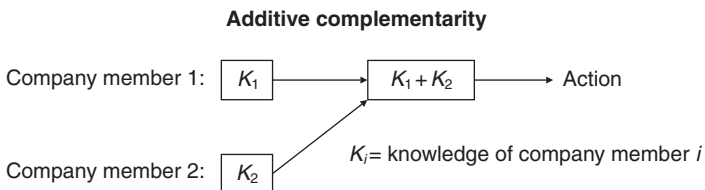
Figure 13.1 Knowledge management and secondary uncertainty

is to monitor external volatility and discover new opportunities. Our subject is thus the intermediate knowledge flows within the organization. Our focus is on multinational firms, and so the process will take place across national boundaries. In order to reduce this source of volatility, the study concentrates on US-owned firms with UK subsidiaries, and on UK-owned firms with subsidiaries in the USA. Language barriers are also reduced by our selection of firms.

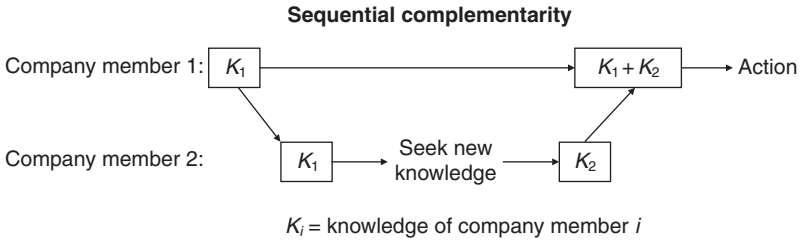
## Complementary knowledge

When the processes for gathering knowledge are decentralized, as described above, firms face secondary uncertainty. This uncertainty can be reduced by identifying which items of knowledge should be brought together, by developing efficient and effective methods of combination, and by deciding where and with whom the combined knowledge should be held. Items of knowledge that increase the potential gains for the firm when combined are 'complementary', while dealing with the organizational problem of secondary uncertainty is a question of managing complementary knowledge.

It is possible to conceive several distinct scenarios in which the firm will benefit by combining knowledge from different sources. The simplest is where knowledge in one part of the firm is of direct relevance to an action that must be taken in another part of the firm. For example, knowledge of production technology (say, costs) held by the engineering or production department is relevant to the planned-output decision to be made by sales or marketing, based on their own knowledge of market demand. This scenario is represented in Figure 13.2, indicating the transfer of Company member 2's knowledge to Company member 1, who acts on the basis of the combined knowledge. We shall call this *additive* complementarity.



**Figure 13.2** Additive complementarity

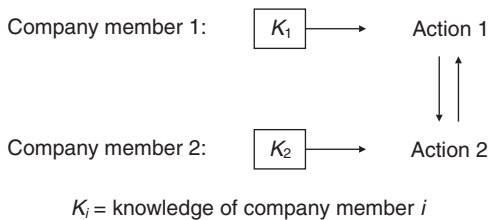


**Figure 13.3** Sequential complementarity

A second possibility is that knowledge from one firm member acts as an input prior to the acquisition of knowledge in the second part of the firm (see Figure 13.3). For example, knowledge about consumer tastes or market competition might be important for choosing the areas of product research and development to undertake. We shall call this *sequential complementarity*.

A third case concerns knowledge of the firm’s own actions when there are interactions, or between separately determined actions (spillover effects or ‘externalities’). These interactions may be positive (complementary) or negative in their impact on the outcome for the firm. Examples might include decisions on advertising and product quality, which can be the responsibility of different parts of the firm, each having specialist knowledge affecting its actions, but the actions of both affect consumers’ perceptions of its products. In such cases, it may be important to co-ordinate the actions to ensure the best combined outcome (see Figure 13.4). We shall call this *complex complementarity*.

Within these simplified scenarios, there is scope for a good deal of variety in the structures and processes companies can adopt for knowledge combination. Consider additive complementarity, continuing with the example of combining knowledge of market demand and production



**Figure 13.4** Complex complementarity

technology. These areas of knowledge might be combined in different ways. Production might convey information about production possibilities and costs to managers in marketing, so that marketing chooses the quantity it would like production to supply. Or marketing could give demand information to the managers in production to enable them to decide the firm's output. These two possibilities are represented in Figure 13.2 by switching the identities of Company member 1 and Company member 2. Furthermore, the form in which knowledge is transferred is itself variable between, say, a full transfer, in which member 2 learns all that member 1 knows, and a summarized version of member 2's knowledge is judged to be adequate for the decision to be made by member 1. The form of transfer will depend on characteristics of the knowledge being transferred – how readily it may be codified – and of the individuals concerned – for example, what codes of understanding they share. A more detailed analysis of the case of combining two items of knowledge for a single decision is found in Carter (1995).

Variations of structure and implementation are also possible for the sequential and complex scenarios. In the first of these, in which knowledge is an input for the creation of further knowledge, it may be that the transfer of the input  $K_1$  can be a distinct stage that precedes the search for  $K_2$ . Alternatively, Company member 2 may need to draw on  $K_1$  *during* the search for  $K_2$ . In the third scenario, there are several ways in which knowledge of other actions in the firm might be integrated. Company members could co-ordinate their actions by informing one another of their intended action – or they could act independently but share the knowledge on which their actions are based; they could each share their knowledge with a separate 'co-ordinator', who would choose the actions jointly; they could join together as a team to choose both of their actions jointly; or they could act in sequence, so that one of the agents knows the decision of the other and then decides its own action in the light of the prior decision. A two-decision scenario is analysed in Buckley and Carter (1996).

### **Complementary knowledge in multinational enterprise**

The internalization of complementary knowledge transfer is one of the principal reasons for the existence of multinational enterprises (Buckley and Casson, 1976, 1985). Internalization is a response to several possible kinds of market failure. These include (among others):

- The 'public good' – like character of knowledge, for which replication (transfer) costs are significantly less than its initial production costs. Internalization is required for efficient production and exploitation.



- Buyer uncertainty resulting from Arrow's 'paradox of knowledge' (Arrow, 1971), namely, that a prospective market purchaser of knowledge cannot assess its value until it is revealed, but the seller will not reveal it before a price is agreed.
- Bilateral monopoly, as when potential users of knowledge in overseas markets may themselves control key resources, including, of course, the acquisition of complementary knowledge.

These characteristics of knowledge influence more than internalization. We would also expect such characteristics to influence the detailed organizational arrangements adopted within the firm for bringing about knowledge transfer. In particular, we foresee differences for the three types of complementary knowledge defined above.

Additive complementarity (Figure 13.2) is the simplest case, and applies to an important class of multinational enterprises. The parent (Company Member 2 in Figure 13.2) has some knowledge or expertise ( $K_2$ ), developed in its home market, and with potential for creating gains for the firm in other national markets.  $K_2$  may be an invention, product or process design, more intangible technological know-how (or expertise), or particular marketing assets and capabilities or distribution and selling skills. In overseas markets, the potential gains are at risk without specialized knowledge of each particular market, indicating the need for complementary knowledge ( $K_1$ ) concerning local requirements and conditions, to be acquired by the affiliate (Company Member 1 in Figure 13.1). The characteristics that concern us here are:

- $K_2$  has public-good characteristics in the sense that its use by the affiliate does not affect its availability or value to the parent, either in its home market or in other national markets that the parent may choose to enter.
- The costs to the firm are confined to the resource costs of knowledge transfer and the costs of acquiring local knowledge by the affiliate. These costs will depend on both the characteristics of the knowledge concerned (for example, the ease with which it is codified), and the characteristics of the parent and the affiliate (see, for example, Teece, 1977; Kogut and Zander, 1992).

Sequential complementarity reflects an increase in complexity and leads to a change in the cost and benefit characteristics of the knowledge-creation process. A typical example is where knowledge acquired by an affiliate of a particular country's market requirements ( $K_1$ ) leads to active

research or development of new products or expertise ( $K_2$ ) for that market, using the capabilities of the parent. In this case, we note that:

- The parent's knowledge does not have the same public-good character as in the additive case.  $K_2$  has been created in response to the particular requirements of the affiliate's market, and may have significantly lower value to the parent in its home market or in other national markets. However, it is also possible that the affiliate's input knowledge stimulates developments with a wider application, so that  $K_2$  has a high value to the firm.
- The resource costs are likely to be significantly higher than for the additive form, since the costs of knowledge creation are higher than those of transfer.

Complex complementarity is distinctive. The associated market failure is not because of the characteristics of knowledge itself, but to externalities between sellers of related products in different markets. Examples in multinationals include: interactions between pricing in different country markets; ensuring that developing products for one market does not compromise their subsequent application elsewhere through imitation by other firms or by disqualifying them from patent protection in other markets; providing consistent and co-ordinated service to customers who buy in more than one national market; accommodating the effect of differences in taxation and tariffs and the impact of currency movements. Internalizing externalities of this kind can be regarded as a particular application of Coase's (1960) analysis, in which the transaction costs are the costs of co-ordinating the interdependent activities.

## **Governance of internal knowledge markets**

Combining complementary knowledge can overcome secondary uncertainty, but what of tertiary uncertainty – that is, the risk that firm members do not reveal the knowledge they have, or that they choose to make use of it for their own ends? For Williamson, such opportunism – 'self-interest seeking with guile' – is a necessary pre-condition for the market failures that explain the internalization of international markets; the others are bounded rationality and uncertainty. But can we be more precise in explaining how internalization deals with the problem of opportunism?

The connection between parent and affiliates in a multinational enterprise can be viewed as an exchange relationship. This exchange

constitutes an internal market in knowledge and in capital, even though these particular commodities are not traded by price.<sup>2</sup> The interests of the parties in the exchange are not symmetrical and, in consequence, nor are their respective opportunistic risks. The parent supplies knowledge and financial capital to the affiliate in return for an expectation of either profit (if the affiliate is a profit centre) or of intermediate product (if the affiliate is a cost centre). The opportunistic risks faced by the parent are:

- Expropriation of knowledge by the affiliate; and
- ‘Shirking’ or ‘cheating’ by the affiliate – say, through underinvestment in specialist local knowledge, extraction of excessive perks or payments, low effort and so on.

The affiliate accepts the parent’s knowledge and capital and the undertakings that go with them, while at the same time making its own commitment in the form of local specialist knowledge. What it expects in return goes beyond current salaries and incentives. The return on the subsidiary’s own investment in knowledge depends on the expectation of a continuing relation with the parent, involving future provision of financial capital, but also an ongoing supply of new, value-creating knowledge. The affiliates’ opportunistic risks are:

- ‘Shirking’ by the parent – underspending on the resource costs of (additive) knowledge transfer or on the acquisition of (sequential) knowledge for the affiliate; and
- Withdrawal by the parent from the affiliate’s market.

The main characteristic of this relationship that deters affiliate opportunism is the expectation of a continuing supply of new knowledge from the parent. Frequently, this is combined with monitoring by the parent of the affiliate’s financial performance through profit targets (or cost targets in the case of cost centres). This corresponds closely to the M-form multidivisional structure discussed by Williamson (1985, ch. 11), with the associated internal financial market efficiencies. Parent opportunism is deterred through the same financial mechanism, since the parent’s interest is in maximizing the future financial return from its affiliates on its financial commitment and transfer of knowledge. As Williamson pointed out (1985: 294), foreign direct investment by the parent makes most sense when a succession of technology transfers is contemplated; that is, when there will be a continuing form of relationship

of benefit to affiliates. Thus the structure of the internal-market incentives discourages opportunism by both parties to the exchange, provided that the firm's governance structure is close enough to the true M-form rather than the various hybrid structures that can be adopted by divisionalized firms (Williamson, 1975: 150–4; 1985: 283–4).

## Evaluating knowledge-coordination processes

The organizational problems of information, co-ordination, and motivation – corresponding to the primary, secondary and tertiary types of uncertainty – each have associated transaction costs and benefits. Evaluating alternative organizational arrangements depends, in principle, on comparative analysis, asking questions such as: How does the value achieved through a particular approach to combining complementary knowledge compare with the value that would have been achieved with an alternative approach? and, What are the variable costs associated with the current approach and what would they have been under the alternative?

For theoretical purposes, we have elsewhere compared the costs and benefits of a given organizational structure with a notional ideal of 'perfect information', 'perfect co-ordination', and 'perfect motivation' (Buckley and Carter, 1996). We treated the goal of organization design as minimizing the sum of information, co-ordination, and motivational *losses* (through departures from the ideal) and information, co-ordination, and motivation *costs* (that is, the resource costs of acquiring information and of co-ordinating and motivating within the organization).

This approach requires modification in the current empirical context because of the issues raised by the counterfactual problem – that is, what would be the feasible alternative arrangement? If an alternative organizational form were available, the value and cost quantities that might be used for comparing one organization with another are not susceptible to easy observation. The practice of firms is to choose organizational structures on the basis of advantages and disadvantages perceived and articulated verbally, expressing judgement and intuition rather than numerical measurements or forecasts. Firms do not generally evaluate the costs and the benefits of alternatives in quantitative terms (Buckley and Chapman, 1997a). Furthermore, empirical work on transaction costs by independent investigators has universally *inferred* the existence of transaction costs from a firm's observed organizational choices rather than by developing a method of direct measurement or estimation.

While the above problems place limits on the form of evaluation that can be carried out for an individual process, it may still be possible to draw conclusions about approaches to knowledge management by comparing several processes, either within a firm or between firms. In order to realize such comparisons, the descriptions of individual processes need to be analysed for characteristics that are significant for the effectiveness and efficiency of the process.

### **Characteristics of knowledge-coordination processes**

We adopt six criteria for analysing the characteristics of knowledge processes and for comparing processes.

**1 Knowledge characteristics.** The first characteristics to note are those concerning the firm's knowledge itself. Of these, perhaps the most important is what the knowledge is *about*, that is, what sources of volatility face the firm. These can be external (such as fluctuations in levels of demand, changes in customers' requirements, and changes in competitor activity) or internal (such as the outcomes of the firm's own research and development). Knowledge of these areas will vary in the ease with which it can be transferred according to how *tacit* or *articulable* it may be. The way in which the knowledge is held will influence whether it may be at risk of being lost, say, if individuals leave the firm. A further characteristic that may be important is the risk of other firms discovering the same knowledge through simultaneous monitoring or even through imitation (Winter, 1987).

**2 Value added from the knowledge-combination process.** In our concern with processes for combining complementary knowledge, it is necessary to be explicit about the ways in which these add value for the firm, and what capabilities depend on the combination process.

**3 Process participants.** Knowledge is held by individuals, and any knowledge transfer process is dependent on the individuals within the firm who acquire knowledge, transfer it, and receive it. The location of these individuals, geographically and organizationally (that is, whether they are part of an organizational unit that is defined by product area, or by function, or by geography) may also matter.

**4 Knowledge-transfer methods.** The variety of means by which knowledge can be transferred might be classified in three broad forms: personal communication (for example, talking, meeting, e-mail), codified communication (for example, reports, drawings), and embodied transfer

(for example, as product or equipment). Firms are likely to use multiple methods simultaneously, depending on many factors including how codifiable the knowledge may be, how much detailed information is required, the shared knowledge of the participants and so on. The costs and effectiveness of the process of knowledge combination will be very dependent on the methods the firm can use.

**5 Governance.** The measures taken by the firm to monitor and limit tertiary uncertainty because of opportunism will influence the success of knowledge combination. These include the accountability of the participants, the level of supervision by higher management, and the likelihood of participants having conflicting goals.

**6 Performance.** While it is not possible to quantify the performance of observed knowledge-combination processes, for the reasons discussed above, it is nevertheless possible to comment on the effectiveness, speed and costliness of alternative approaches.

### **Exploratory empirical study**

In order to test these conceptual developments, a small-scale interview study was conducted with managers in a sample of six companies, three from each of two contrasting industries. The aim of this study was to identify examples of complementary knowledge, and how and where it originates; to examine the organization and methods used by firms to combine complementary knowledge; and to consider what factors influence the firm's choice of organization and methods, using the conceptual framework described above.

The industries were chemicals/pharmaceuticals and engineering. All firms in the sample comprised a parent and wholly owned subsidiaries based in the UK and the USA. The parent/industry distribution is shown in Table 13.1.

A number of managers were interviewed in each firm at the middle and senior level, according to access. The intention of the interviews was to gather information about a representative sample of the firms' operations, and not necessarily to cover every activity. The aim of the research project was explained to the interviewees as:

A study of the transfer of knowledge across national boundaries in multinational corporations, with particular reference to transfer between the UK and the USA, and vice versa.

**Table 13.1** Exploratory study: companies in the sample

	Parent based in	
	USA	UK
Chemicals/ pharmaceuticals	Company 1 Company 2	Company 3
Engineering	Company 4	Company 5 Company 6

Interviewees were asked to interpret the term ‘knowledge’ in whatever ways they thought relevant to their business. The concept of ‘complementary knowledge’ was not introduced explicitly. The subject was explored by means of open questions of the following kind:

- What kinds of international knowledge transfer take place in your organization?
- Where is this knowledge generated?
- Who makes use of the knowledge, and for what purposes?
- Which knowledge is most important, and in what ways?
- How does knowledge transfer take place?
- Are any formal organizational structures used, such as matrix organizations, business process teams, etc.?
- What difficulties arise?
- What means have been tried to overcome these difficulties?
- What methods work well in your organization, and what methods work less well?
- Do different objectives of different parts of the organization affect the transfer of knowledge?

This open-ended approach was adopted in order to allow the managers to speak in their own terms – to use ‘native categories’ (Buckley and Chapman, 1997b). The interviewers were careful not to force answers or to impose their nascent conceptual framework on the managers. The terms ‘additive complementarity’, ‘sequential complementarity’, and ‘complex complementarity’ were not used; neither was the sixfold classification of process characteristics introduced to the managers. The interviews were not worked through to any kind of closure, but were extended as far as the patience of the interviewees would allow. Up to six managers were interviewed in each firm, to enable triangulation of

perspectives. The exploratory study now enables more rigorous empirical investigation.

## Findings

The diversity and complexity of the information obtained necessitate a degree of simplification and stylization in reporting our findings. The classification of process types introduced earlier enables us to highlight the significance of different knowledge-combination processes in the six companies, and the processes within each company can be described using the characteristics discussed earlier. Illustrative details for two of the companies in our sample are presented in Table 13.2.

The significance of the types of knowledge-combination process differs among the firms in the sample. We will first discuss these differences and compare the characteristics of each type of process across the firms in the sample.

### *Additive knowledge combination*

Purely additive knowledge combinations were not found in any of the firms—there is always a degree of ‘sequential’ activity in which the parent undertakes a level of activity specific to each affiliate. But the degree of such affiliate-specific knowledge creation by the parent varies, and is noticeably lower in three of the six firms in our sample. That is, the ‘additive’ character of knowledge combination is higher in these three. They are manufacturers of, respectively, sterile disposable products for hospital use; filters for air conditioning equipment; and chains for power transmission. These are market sectors where volatility is relatively low, compared with the other firms in the sample (see below). All involve comparatively mature technologies, and the rate of innovation and product change is lower than for the other firms studied.

There are nevertheless differences in the characteristics of the knowledge-combination processes in these three firms, particularly in the degree of parental monitoring of the transfer process, and the overall performance of the process. These differences may originate partly in differences in the individual historical developments of these firms, but there may also be factors in their market and technological contexts that have influenced these variations. For example, subsidiaries in the filter manufacturer were subject to the lowest level of monitoring by the parent, and there were noticeable obstacles to the flow of tacit knowledge. In this firm, the most important product knowledge is the product specification, which can largely be codified in the form of engineering drawings. Furthermore, much of the firm’s manufacturing know-how is transmitted



**Table 13.2** Examples of knowledge-combination processes

Process characteristics	Process type		
	Additive	Sequential	Complex
<b>Company 2:</b> Ethical pharmaceuticals incorporating R&D, manufacture and marketing. Worldwide customers and manufacturing; US parent			
Knowledge characteristics	The firm is research-led. R&D is a sequential multinational process (see right). In selling and marketing, the parent supplies a structured programme for new affiliates to develop marketing expertise and local market knowledge. There is a strong flow of internal product information, targets and news from parent to subsidiaries. Manufacturing facilities specialize by product type and particular capabilities (e.g., tailoring product to requirements of different markets) and supply global markets.	The product development process is multinational in character. For example, basic research is conducted in both the UK and the USA, product development in the USA, product registration in target markets, and manufacturing in the UK. A specific example is in clinical research, where acquisition of product knowledge depends on external clinicians, with associated agency problems and problems of agents' appropriate knowledge.	There is centralized planning of product sourcing and manufacturing capacity. The corporation has a highly developed matrix-form structure with three matrix dimensions (geographic area, therapeutic area, functional area). 'Global business units' are developing within each therapeutic area.
Value added from combined knowledge	Affiliates dependent on the parent for product knowledge. New affiliates are dependent on corporate marketing expertise.	All participants must know of progress of each stage in order to plan own contribution.	Planning needs of specialized manufacturing facilities supply multiple markets. Decisions also depend on taxation rules, etc.

There is complex interdependence in the research-to-market process. Historically, markets have been separate, but there is increasing interdependence between markets—buyers looking internationally for the best price, prompting ‘global business unit’ development.

Participants in the process	Functional specialists within affiliates and parent. Specialist managers oversee knowledge transfer to and knowledge acquisition by new affiliates.	Functional specialists. Project managers in parent HQ coordinate specialist teams within each location.	Central planning group for sourcing and capacity, who must know plant capabilities, etc. Also central production planning.
Knowledge-transfer methods	Methods for transfer of expertise include placing expatriates in the affiliate market, exchange programmes for training local personnel, direct training, oversight from regional HQ, strategy planning meetings, etc. Transfer of product and other company information: highly developed company intranet, internal publications, meetings: considered good for ‘pushing’ information, but not so good for ‘pulling’ information.	All methods: intranet, e-mail, video conferencing, phone, visits.	Production planning is conducted via a computerized ‘global demand management’ system with an 18-month time frame. Business planning covers the 3-year planning of major expenditure, capacity, headcount, etc.

Table 13.2 (Continued)

Process characteristics	Process type		
	Additive	Sequential	Complex
Governance	Regional HQ monitors new markets closely. There are four successive stages, with increasing autonomy. Established affiliates are profit centres responsible to HQ.	Control of development process by HQ-based project management. There is a strong culture of co-operation and teamwork.	Capacity and production planning: responsible to HQ. Global business units are developing parallel profit responsibility for their product areas.
Performance	Retaining knowledge in developing markets (new affiliates): once early growth slows, local personnel may leave in search of other growth opportunities. Countered by (i) incentive designs; (ii) care in recruitment: seeking people sharing firm's values.	No adverse features emerged in interviews. Company values development of 'world-class' performance standards.	As sequential
<b>Company 6:</b> Contract design in automotive and aerospace industries: UK parent			
Knowledge characteristics	Technical, market and competitor knowledge is acquired and disseminated actively by company's information service centre (library) to businesses in contract design and in 'technical support' to manufacturers. The	Knowledge acquired from the market is collated by the technical library and prompts the firm's own R&D. Affiliate-based projects can get support from the parent if the affiliate does not have sufficient resources. The firm has acquired	Dissemination of technical and market news via the technical library ensures that all affiliates have the latest intelligence. US subsidiaries have combined under a single name to consolidate identity of related businesses in this market.

	<p>firm is active in initiating and carrying out its own R&amp;D. Affiliates are located overseas to be close to customers and to be aware of different capabilities in affiliate markets to respond to the different demands made by customers in those markets.</p>	<p>businesses overseas with knowledge complementary to the parent's in-house knowledge.</p>	
Value added from combined knowledge	<p>Ensures that all affiliates are operating at the leading edge of technology and market developments while being close to customers.</p>	<p>Always being able to provide solutions to customers' problems. ('We sell solutions.')</p>	<p>Maintaining reputation of the group of companies as a whole.</p>
Participants in the process	<p>Seven full-time librarians ('probably the best technical library in the world'). Highly trained engineers in operating businesses. They and managers in parent and subsidiaries both receive knowledge and submit newsworthy developments to centre. Key market news sent into library by anyone, collated and sent to selected senior managers.</p>	<p>Maintaining its position as technological leader in industry with a high rate of technological change.</p>	<p>All managers collect market intelligence ('gossip and snippets of information') for the library to collate. Task forces (temporary teams) are established from where knowledge and skills exist, to deal with particular problems.</p>

Table 13.2 (Continued)

Process characteristics	Process type		
	Additive	Sequential	Complex
Knowledge-transfer methods	Reports and synopses are produced routinely on important topics, e.g., on competitors, on all new engine designs, on market news. Training and experience of engineers. May transfer some individuals from parent to subsidiary to supply particular expertise.	Market information is transferred as detailed on the left. For technical expertise, personnel are transferred to task forces if needed.	As on the left.
Governance	Affiliates are separate profit centres.	As on the left. There is monitoring of task forces, etc., by parent.	Active monitoring by the parent of activities and progress of operating companies.
Performance	Attempts to replicate parent practices too closely in affiliate markets often failed through not understanding different needs of customers.	–	The group has achieved 20% compound growth over 5 years, in face of relative recession in customer industries.

in embodied form, as specialized manufacturing equipment. The firm has therefore not developed the practice of transferring other knowledge in ways that are particularly responsive to the affiliate's needs, such as knowledge about individual customers' requirements.

There were no reported knowledge-transfer problems in the sterile hospital product manufacturer, although the company is characterized by a high level of individual autonomy for subsidiaries, within a framework of corporate systems and standards. It operates in an industry in which 'good pharmaceutical manufacturing practice' is essential for regulatory approval of its production facilities and its products. The methods for transferring this tacit knowledge have been integral to its process of internationalization. Therefore an effective knowledge-transfer capability has become ingrained in the organization. Finally, the chain manufacturer has a particularly active monitoring system of cross-border committees that were established for international co-ordination of the 'complex-complementarity' type, discussed below. Once in place, this provides a means of monitoring all aspects of knowledge transfer within the firm, and this company, too, had effective knowledge-transfer capability.

Our observations indicate that an important requirement for effective transfer is for the parent knowledge-provider to recognize the knowledge requirements of the recipient in order to provide what is appropriate, in a form that is appropriate, and with appropriate timing. In the case of additive-knowledge combination, by definition, the parent's knowledge has public-good characteristics and there are limited resource costs of knowledge transfer. But transfer performance can be deficient if the parent and recipient do not have a co-operative, team-like approach; that is, if they do not recognize their common interests in effective knowledge combination. A team approach, focused on the gains of the particular knowledge-transfer process, was clearly a characteristic of the examples of successful combinations we observed.

### **Sequential knowledge combination**

Having suggested that 'additive' combination is more significant for the three firms in less volatile environments, we must follow with the assertion that sequential combination is more important for the remaining three. These are a large ethical pharmaceutical manufacturer, wholly dependent on the continual discovery and development of new therapeutic compounds; a chemical manufacturer, using the specialist chemical technology in which it is a leader to develop and manufacture chemicals with applications in a wide range of industries; and a firm engaged in

contract design to leading automotive and aeronautical manufacturers. All three are at the leading edge of dynamically developing technologies.

Sequential combination calls for specific resource expenditures by the parent on behalf of the affiliate; for this to be effective, a degree of hierarchical overview is required for resource allocation and prioritizing decisions. Once again, the knowledge-transfer processes differ among firms. The pharmaceutical company uses project-management specialists who are based in the parent but who co-ordinate the activities of corporation-wide project teams. The contract automotive design company works through the establishment of task forces drawn from both the parent and the subsidiary. In the chemical company, communication with subsidiaries has been predominantly bilateral between an affiliate and specialists in the parent company, and the control of affiliate-specific resources takes place within this established functional hierarchy.

While these three are the firms for which sequential combination is most important, it is present in all six companies, and its effectiveness in the other three parallels that of additive combination discussed above. It is least effective in the air filter company, which, as noted above, has relatively weak knowledge-transfer capabilities. The sterile-product manufacturer encourages a team approach to sequential knowledge transfer, although the initiative for establishing the process often lies with the operating subsidiary wishing to develop the combination. The chain manufacturer uses its international committee system to evaluate, choose and monitor product-development proposals from the affiliates.

Sequential combination requiring affiliate-specific investments by the parent necessitates an overview from within the parent company. However, this is increasingly insufficient to deal with the more complex interdependencies of the global firm.

### *Complex knowledge combination*

This final form of knowledge combination is of growing importance. Two firms in our sample already have mature means of co-ordinating activities and knowledge among their operating companies. Two more have recently established organizational means for doing so, are in the process of allowing these to develop, and are likely to extend the approach throughout their businesses.

The two mature approaches are in the chain manufacturer and the automotive design company. The chain producer's system of international committees has already been mentioned. These exist at group level, as well as within individual product divisions. Their role is partly to allocate manufacturing and to set transfer prices in the face of currency fluctuations,

but they also collect operational knowledge from individual firms on purchasing, and agree on priorities for capital expenditure, product development, and so on. The automotive designer has rather different requirements. It is important for the firm's operating companies to be leaders in technological and market developments, and the firm has a highly active information centre (library) that both writes and disseminates technical reports on leading topics, but also collates and disseminates key market intelligence gathered from the subsidiaries.

Two firms – the pharmaceutical company and the chemical company – are developing strikingly similar approaches to international co-ordination in the form of 'global business teams' and 'global business units', respectively. Both are marketing-based developments in which manufacturing is co-ordinated separately. While developing similar knowledge-co-ordination processes, the firms are otherwise at different stages of development. The first has been an established multinational company for many years, whereas attempts to co-ordinate the international activities of the second are more recent. In the second firm (chemicals), there has been a deliberate decision to avoid establishing a separate 'staff' group for international co-ordination. The teams are made up of line managers, not necessarily from the parent, whose role is to co-ordinate the activities of the marketing affiliates in each country to avoid cross-border conflicts and externalities; to agree on development priorities; and to develop common marketing approaches for customers who also have a global presence. The aim of both firms is to achieve the best combination of local knowledge, central knowledge, and the delocalized knowledge of the corporation as a whole. In so doing, both are shifting control away from regionally based structures towards product-based structures. In both firms, the regional and product-based structures coexist, so that there is a dual responsibility for profit. It remains to be seen whether this tension is creative.

## **Interpretation and evaluation of results**

It is clear from these results that volatility arises both from the external circumstances of the firm in the sample and from their internal dynamics (the impact of research and development and other internal perturbations). The analysis and combination of these elements is at the core of our understanding of knowledge management.

Our approach identified three types of combined knowledge: additive; sequential; and complex. These three types of process have six key characteristics: knowledge characteristics; value added from combining



the knowledge; participants in the process; knowledge-transfer methods; governance; and performance. The wide differences observed in the six characteristics account for the disparate nature of the knowledge-management processes even in a small sample of six companies. However, as the preceding discussion indicates, our classificatory system allows us to identify reasons for the extreme variability of solutions adopted to deal with the problems of knowledge management. This should not be surprising, since firms (even within the same broad industrial group) do develop from very different historical bases, do have vastly different administrative heritages, do face varying local (and national) conditions, and are differently placed in the competitive hierarchy and in the global technostructure. It would be ridiculous indeed to expect uniform systems of knowledge management to prevail where the driving forces of such systems – the volatility faced by the firm – are so radically different.

We can thus assess the efficacy of a company's knowledge-management system by the degree to which it is capable of identifying the key sources of volatility that face it, the degree to which a system of monitoring and synthesizing this information is in place, and the way that pooling of knowledge internalizes the greatest potential externalities for the firm's long-term benefit.

The evaluative question is whether any of these companies might gain by making changes to their established knowledge-transfer processes – for example, whether any of them would gain by adopting aspects of the processes used by other firms. In several interviews, managers expressed great interest in other companies' efforts in knowledge management. There are examples where changes might be made that would improve performance. For example, with the air filter manufacturer, communications were rather rigidly hierarchical and questions were channelled upwards rather than put directly to the individuals who held the relevant knowledge. And it is possible that the performance of the comparatively autonomous affiliates of the sterile product producer might benefit from a higher degree of international co-ordination and comparison of the kind actively pursued by the chain maker.

It is also clear that processes that are successful in one company may not transplant readily into another. For example, managers in the chemical company expressed some surprise that the central information system of the automotive designer was successful, relying on managers reporting developments concerning customers and competitors to the centre (see Table 13.2). They suggested that, in their own firm, there were insufficient incentives for managers around the business to share information in this way. Also, as described briefly in Table 13.2, the pharmaceutical

company had an active process for transferring the parent company's expertise and values to new affiliates. In contrast, the automotive designer found that the least successful approach to knowledge transfer was to 'take the company operating manual'. It had more success from transferring a few selected individuals from the parent to the subsidiary, and allowing them to develop the appropriate combination to meet local requirements.

The firms in our sample themselves recognize that their management of complementary knowledge is imperfect. In every case, they are moving towards a system that they believe will tackle more effectively the problem of co-ordinating knowledge from different sources – hence the creation of 'global business teams', project management teams, 'global business units', centralized knowledge pools, and group-management committees.

Is there, then, or can there be, an optimal solution to the design of knowledge management systems? Our answer is yes, but it is likely to change as key sources of volatility change, and it is likely to differ from firm to firm precisely because companies face differing sources of volatility. However, this is not a recipe for nihilism or despair. A careful analysis of the knowledge-process types and knowledge-process characteristics enables the design of a system of knowledge management that will differ among firms, but will contain several generic types.

### **Generic strategies**

We can begin by focusing on the key process types. Additive knowledge processes require a 'local team' (local in the sense of focus rather than of place); sequential knowledge processes require a more hierarchical overview; while complex knowledge processes require an overall co-ordinating mechanism. All firms face all three types of volatility, so we should expect to see all three types of solution in the companies, and we did. We should thus expect a combination of focused team, hierarchical overview, and a co-ordinating mechanism in place in each firm. Are there any rules as to which form should dominate?

Each of our six knowledge-process characteristics provides part of the answer to the issue of dominance:

1. *Knowledge characteristics.* Of fundamental importance are the key sources of volatility that knowledge management is used to counteract. This may be internal or external, it may be more or less tacit, it may vary in degree of transferability or imitability, and the required scale of response may vary. In research-intensive industries, the R&D output may be a key source of volatility – 'driving' the knowledge-management

process. In other cases, the key driver is the volatility arising from the changing consumer demand.

2. *Value added from the knowledge-combination process.* The motivation for 'knowledge management' strategy arises from the gains (profit) from combining pieces or sources of knowledge, minus the costs necessary to achieve this. Combining knowledge is, in a sense, a synonym for the benefits of internalization (Buckley and Casson, 1976).
3. *Participants in process.* These are the acquirers and recipients of knowledge, who are constrained by the technology of:
4. *Knowledge-transfer methods.* The outcome of this constrained process is:
5. *Governance,* resulting in:
6. *Performance.*

Our framework has two *drivers*: knowledge characteristics and value added from combined knowledge; two *constraints*: the participants and the technology of knowledge transfer, both of which represent costs to the firm; and two *outcomes*: the governance structure of the firm and performance characteristics of the process.

Several observations on this schema can be made. First, we can identify clearly from our small sample the key drivers arising from crucial elements of volatility. Two in particular stand out – R&D-driven volatility (the inventive process) and changes in consumer demand. Second, we can identify clear long-term trends in our framework. In particular, there is clear evidence that the value added from combining different sources of knowledge is increasing and that the constraints on the process of combination arising from the technology of knowledge transfer are declining – hence, perhaps, the amount of interest in 'knowledge management' *per se*. The implications of this for governance and performance are such that the wholesale reorganization of companies (and of the participants in the process) is currently the norm, and not the exception.

## Conclusion

Knowledge management is perforce complex. Because there are three distinct types of process, we expect three coexisting solutions. We can identify additive, sequential and complex knowledge processes, and suggest that focused teams, hierarchical overview and overall co-ordination are the appropriate coexisting solutions.

These solutions will exist in all companies, but the particular combinations will be determined by the key drivers of the system, arising from the key sources of variability facing the firm and its (potential)

gains from synthesizing the knowledge necessary to exploit that volatility. The technological constraints on achieving such a synthesis are decreasing, so that the gains from an improvement in a firm's knowledge-management process in terms of improved governance and a better performance outcome are being sought by many companies around the world.

The success of a firm's knowledge-management process will be a major determinant of its global competitiveness. Our study was restricted to two home and two host locations, but even this limited number of cases strongly suggests that knowledge-management processes are associated strongly with national attractiveness of both home and host countries as viable locations for global competitors.

## Notes

- 1 A number of new specialist journals concerned with knowledge management have appeared; for example, *Knowledge and Process Management* (1994); *Advances in Knowledge Management* (1996); *Journal of Knowledge Management* (1997).
- 2 The internal market in knowledge and capital is distinct in this respect from internal movements of intermediate and finished products, which are often mediated by transfer prices. Whether these prices are used primarily for efficient exchange is a matter of some debate (for example, Buckley and Frecknall Hughes, 1997).

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# 14

## Knowledge Management in Global Technology Markets: Applying Theory to Practice\*

*with Martin J. Carter*

It has been known for centuries that the appropriate use of knowledge is a critical determinant of effective organization. During the 1990s however, discussion of knowledge in the management and economics literatures changed. Ideas concerning knowledge were once the concern of scholars seeking theoretical explanations of organizational structures and practices. We now see that practice is making use of theory in new and interesting ways. Ideas which explain strategic success are being used to design strategies to improve the firm's ability to capture more of the potential value from the knowledge they and their members have, or can acquire.

This chapter provides an overview of the theory of knowledge in business, and describes and analyses two matched but contrasting examples of knowledge management activities to illustrate the impact of theory on practice. These activities take place within two leading firms, both engaged in global production and marketing. Both recognize that their strategic success depends on extracting the maximum value from the knowledge which either exists, can be created, or can be acquired.

### **Practical knowledge**

The kind of knowledge that is important for business is what Machlup (1980) has called 'practical knowledge'. This is knowledge used in making decisions and taking action. All purposeful action is aided by practical knowledge, serving to reduce at least three kinds of uncertainty. First, there is uncertainty about what is attainable. We might aspire to

do impractical things; furthermore, we may fail to conceive of some achievable outcomes. Second, we might not know what actions will lead to the outcomes we wish to achieve. And, finally, we may not know enough about the contextual circumstances in which the actions are taken, and how these might influence the results. Knowledge clarifies the feasibility of desired outcomes and increases the confidence that a particular set of chosen actions will achieve the desired ends in the prevailing conditions.

Such knowledge needs to carry with it some degree of reliability or truth. Truth may be hard to tie down for some purposes; *meaning* may, however, be more important than truth. But, Machlup (1980) points out that ‘practical knowledge had better be true’. There can, of course, be ‘degrees of verisimilitude’ and different states of knowledge can be ‘a better or worse approximation to the truth’. A shorthand definition of knowledge widely used in the business literature is ‘justified true belief’ (Nonaka and Takeuchi, 1995).

## Production and use of knowledge

Knowledge is a catalyst for action, making people aware of possibilities and how to achieve them. It is often described as an economic resource, like a physical intermediate or asset, but this potentially is misleading. Just as uncertainty is a mental phenomenon, so knowledge cannot be used unless it resides in someone’s mind. Knowledge is better conceived as a quality possessed by people, acquired through a process of learning. And learning is either the transfer of existing knowledge from one individual to others – *replication* in the minds of recipients – or the discovery of new knowledge; that is, knowledge *creation*. Learning must be an active process if individuals are to absorb and internalize knowledge for use:

- *Knowledge transfer*:  
Information transfer;  
Thinking (reflection, reasoning, evaluation);  
Experience to test understanding.
- *Knowledge creation*:  
Searching for new information;  
Selection of information; and  
Creation of concepts, frameworks and capabilities.



The principal costs of knowledge production are the time costs of the individuals who create, transmit or receive the knowledge. But distinctive features of knowledge production have strategic implications for firms:

- Many discoveries are made through the alertness and creativity of particular individuals. These human capacities are relatively scarce, so that uniqueness can endow such knowledge with a high value. But this value can be lost if it is superseded by a superior discovery, so that there is reason to realize value quickly and to innovate continually.
- Transferring knowledge from one person to another does not reduce its availability to the first person. Firms can therefore appropriate greater value by employing knowledge in a variety of markets and applications.
- For the same reason, it may be difficult to prevent the transfer of knowledge to others, for example by imitation or by transfer of people. This can greatly diminish the appropriated value.
- There can be strong *increasing returns* to knowledge creation through the accumulation of past knowledge and experience. This can result in *first-mover advantages* for knowledge-intensive firms. But there is also the risk of firms being 'locked in' to technologies that could be superseded (Francis, 1989).
- The costs of transferring knowledge between individuals depend on a number of factors. A frequently cited difficulty is 'tacit knowledge' (Polanyi, 1966), an ability learned by experience and hard to explain to others, because those who have it do not articulate it even to themselves. But an important facilitator is the effect of *common knowledge*. Exchange between individuals is greatly enhanced by shared terminology, concepts and frames of reference. This can apply to knowledge which might otherwise be labelled tacit.

## **Knowledge and information**

Information is often differentiated from knowledge, although not always in the same way. One view is that information is a *flow* corresponding to the process of informing, and knowledge as a *stock*, which accumulates and is added to by information (for example, see Machlup, 1980). Another view is that data, information and knowledge form a hierarchy of increasing meaning, depth and relevance to action. Information is 'interpreted data', with meaning not possessed by simple data, and knowledge is 'structured information', revealing linkages,

insights and generalizations, which do not characterize the simpler 'information'.

These ideas complement each other. Information and knowledge have a similar practical significance in reducing uncertainty about the world, and guiding action. Information is a simple form of knowledge, a building block of understanding. It is useful to call 'information' that which can be represented and expressed verbally or in writing, and stored and retrieved from written, electronic or other records. Information may come from observations of the world, or from knowledgeable people, or from records. It serves the purpose of informing, but for application as knowledge it must be 'in the mind'.

### **Knowledge and the firm**

Business firms depend on many kinds of knowledge, much of which can be classified as *technological* knowledge (regarding production) or *market* knowledge (concerning exchange). Some knowledge, partly overlapping these categories but distinct from them, is concerned with how people work together to achieve collective goals. This is *organisational* knowledge. We shall see examples in due course.

Firms specialize in particular product or service types. There are no generalist firms offering to produce or to trade in all products and services. Organizing the production or exchange of any particular products or services requires specialised knowledge, limiting the scope of activities that may be undertaken efficiently by a particular firm. There is a trade-off between the depth and breadth of the knowledge held by individuals and by groups, though it is not a simple one, because of complementarities in the creation and application of knowledge mentioned earlier, which increase the variety of activities that can profitably be undertaken by a company. However, the scope of a company reaches its limit once the advantages it gains from specialization are reduced by increasing the variety of its activities (see Demsetz, 1988). We shall see later how depth-breadth trade-offs and complementarities influence knowledge management strategy.

Still more important in knowledge management is specialization *within* firms. The division of labour, whose importance was described by Adam Smith (1976), both results in and derives from knowledge specialization. Workers who undertake a particular task gain expertise from the specialized experience that is not gained by other members of the same firm. This provides both them and the firm with advantages that may be lost if they move to other tasks. The conventional 'functions' of

business, such as engineering, purchasing, production, marketing, sales, distribution, accounting and so on, are methods of dividing labour on the basis of knowledge. Each business function specializes in knowledge of a broadly similar content, so that workers within each function have flexibility between tasks, and so that functional managers are able to monitor and guide the activities of their subordinates.

The dual specialization between firms and within firms prompts two fundamental questions concerning knowledge and the firm:

- (i) Which specialized knowledge – what *strategic knowledge resources* – is it desirable to combine within a particular firm at any time, and which should be acquired from separate specialized firms through trade?
- (ii) How can these knowledge resources – the specialized groups or individuals who hold the firm's knowledge *separately* – be organized so that *collectively* they realize the best possible value to the firm?

### **Strategic knowledge resources**

If businesses seek profits and growth, then groups with different specialized knowledge should come together when doing so is more profitable and enhances growth. We can describe such specializations as *complementary*, or *co-specific*. For example, in most firms much of the technical and marketing knowledge is mutually specific to the requirements of the firm's particular customers. But this does not really explain why different specialists should be employed within the same firm rather than be independent, trading by contract with one another. We can identify three broad reasons:

- *Appropriation*: maintaining control over the application of resources protects the firm's market share and its discretion over prices. Independent management of some knowledge might aid competitive reproduction of a firm's outputs. In order to be effective, the appropriation must be protected by some mechanism preventing imitation or replication – what Richard Rumelt has termed 'isolating mechanisms' (Rumelt, 1984; Lippman and Rumelt, 1982).
- *Market failure*: there are risks from investing in resources whose value is dependent on other parties (so-called 'asset specificity'). These are circumstances in which agreements between separate parties might be unstable over time. Unified ownership and control improves the provision of complementary resources (Williamson, 1975, 1985a; Grossman and Hart, 1986).

- *Organizing capabilities*: firms can do things – developing and applying organizational knowledge – which markets cannot do. What these may be was raised in the second of our questions about knowledge and the firm, and is discussed below. We see the two questions as interdependent. The activities which should be maintained inside a firm include those it can organize most effectively. This motive may be of more immediate interest than the previous two, since firms have particular discretion over their internal organization. Furthermore, as technical and market knowledge become more widely accessible, organizing capability itself might become the most important source of profit and growth.

### The knowledge-organizing capability of firms

Knowledge organization presents a puzzle. When knowledge and expertise are dispersed amongst groups and individuals, through economies of specialization, no particular individual or group holds, or could hold, all the firm's strategic knowledge. Who, then, can direct the firm's activities? In order to address this question we can note that the division of labour creates a requirement to bring about four outcomes to organize knowledge:

- *Allocation*: to determine the appropriate division of labour by assigning knowledge-seeking and knowledge-using tasks to individuals and groups. Any task may, of course, benefit from knowledge or expertise held by several company members.
- *Co-ordination*: to keep each group's actions consistent with what the other groups do in contributing to the firm's goals, to avoid mistaken assumptions of each other's activities and so on.
- *Communication*: to make available to each group any relevant knowledge or specialist opinion held by others.
- *Co-operation*: to motivate members to be mutually supportive of their common interests (or the firm's interests), rather than to pursue their individual or parochial goals.

There is no single key to effectiveness for any of these organizational functions. Several alternative approaches are presented in Table 14.1, which also indicates that there is interdependence between the organizational method used and the degree of internal knowledge specialization. Specialization leads to *internal boundaries* between groups within the firm. Within such a boundary, a group with shared knowledge, or

**Table 14.1** How companies organize knowledge

<b>Organizational objective</b>	<b>Across internal boundaries</b>	<b>Within internal boundaries</b>
Allocation/ co-ordination	Hierarchy; knowledge intermediator	Mutual adjustment or specialist planner
Communication	Reports and opinions; outputs and products	Full exchange, using common knowledge, identity, social context
Co-operation	Formal monitoring; incentives, rewards	Self-enforcing or informal monitoring

sharing the application of their knowledge, may be able to allocate tasks among themselves and co-ordinate their activities through mutually agreed planning. If the group is large, a specialist planner may be more efficient. However, co-ordination across the boundaries of several groups with separate knowledge or specializing in different applications may be better done by the hierarchical direction of specialist organizing individuals. Their authority is based on their own organizational knowledge of how the knowledge of others is best applied. This is a form of *knowledge intermediation* (Casson, 1996).<sup>1</sup>

Internal boundaries influence and are influenced by costs of communication. The common understanding within a group reduces the cost of exchanging detailed knowledge. Furthermore, it has been suggested that a general source of organizational effectiveness is the *social context* or *identity* provided to individuals by an organization, necessary for co-ordinating activities and developing shared understandings, discourse and learning (Kogut and Zander, 1996). Groups *within* large firms may play a similar role. On the other hand, common knowledge is itself costly and may preclude economies of specialization. Communication across boundaries can economize in other ways. Communication between groups may be primarily in the form of summarized reports, judgements or recommendations, or may be the delivery of an output or intermediate product.<sup>2</sup>

The co-operative effectiveness of organisation depends on longer-term incentives than a pure market exchange, encouraging more complete disclosure and sharing of knowledge (Grant, 1966; Williamson, 1985b). But such co-operation may depend on monitoring, long-recognized as a key function of organization (Alchian and Demsetz, 1972). Table 14.1 indicates that the level and formality of the monitoring and incentives can depend on the degree of collaboration or separation of those concerned.

In practice, we can rarely observe just how organizations achieve these tasks. The observable features of organizations are structures and boundaries, and some of the processes that are carried out within and between them. There is currently a particular interest in certain 'knowledge management' activities, some using computer applications (communications networks, groupware, 'data warehouses' and so on), and others of a more managerial character (for example, 'knowledge maps' and 'knowledge officers'). The question, then, is how these 'architectural features' contribute to the four main functions of organization. Our discussion of the following case studies starts from these observable features and interprets them in the light of the picture of knowledge and organizing capability that has been set out.

The cases described here are based on a series of interviews with managers carried out during 1998 and 1999. By agreement with the firms concerned, their identities are not disclosed and the company names used are fictitious. Both companies are public limited companies quoted on the London Stock Exchange, with headquarters in the UK.

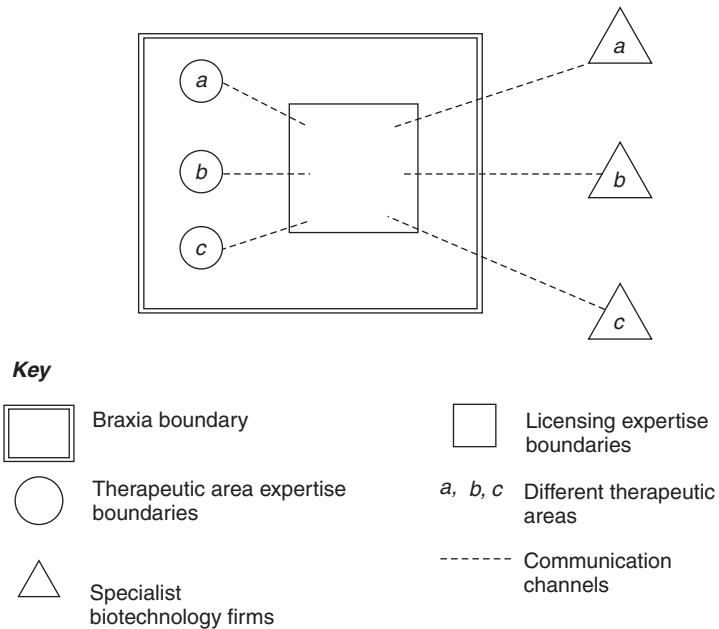
### **Braxia plc: buying technology in a global market**

The Braxia case is an example of how a firm developed a new capability to buy technology by embodying valuable organizational knowledge in a new process architecture. This not only facilitated the company-wide dissemination of a nascent organizational capability, but also incorporated a degree of continual learning. We shall see how the factors discussed above help to explain the character of the adopted solution.

Braxia is a firm with a long history of developing ethical pharmaceuticals in the traditional whole-cycle method – from basic research and development through trials, registration, production and marketing. Scientific knowledge deepens continuously, and there is an increase both in the number of technologies that can be applied in a particular therapeutic area and a widening of potential therapeutic applications of particular technologies. A single firm can no longer internalize all the knowledge relevant to even a selected group of strategically chosen therapeutic areas. One result is that the basic research for novel therapies is carried out increasingly by independent biotechnology firms, who then offer their discoveries to be licensed and marketed by the large pharmaceutical companies. Independent firms provide a greater variety of approaches, with each specializing in its own particular technology, and they can rely on the large pharmaceuticals to provide production, marketing and distribution capabilities.

This trend creates a requirement for a new organizational capability, for buying technology, in large pharmaceutical firms. Such a capability needs to combine alertness to potential developments with technological and commercial assessments of prospective ‘purchases’ and with legal and commercial expertise in drawing up agreements. Its application must be integrated with the strategic goals of the firm as a whole, with its continuing research plans, its market strategy and so on. Expertise in buying (licensing) is complementary to detailed technological knowledge and marketing knowledge of relevant therapeutic areas. The firm must in some way strike a balance between benefits of increased specialization, through a division of expertise between specialists, and the difficulties that such division of expertise creates in then combining one area of expertise with other complementary one.

One possibility is to locate all the firm’s licensing expertise in a separate specialist group which would provide a service for the corporation (see Figure 14.1). This arrangement would facilitate the development of expertise and the deepening of knowledge in this area. Such a group would have the advantages referred to earlier for functional groups: advantages of managing and monitoring performance, as managers



**Figure 14.1** Pure specialization

have expertise in common with their team; mutual support through the flexibility of individuals to move between tasks; exchange of ideas and experience; consistency of practice; and co-ordination of activities. In this structure, appropriate communication channels would be needed between the licensing group and the therapeutic groups in order to combine licensing expertise with specialist technical and marketing knowledge. Such communications take time and often use summarized information, which can result in delays and misunderstandings. It may be difficult for members of the licensing group to internalise all the knowledge that would be desirable of the different therapeutic areas and the different national markets in which products would be sold. Furthermore, even though this group is formally providing a service to the other groups, there is a risk of competing strategic goals between therapeutic area groups and the group with licensing responsibility.

An alternative is for responsibility for licensing to be allocated to specialists within each therapeutic or marketing unit. That is, for expertise to be combined within each therapeutic area (see Figure 14.2). This would help to overcome difficulties of combining knowledge of licensing with that of therapeutic strategy and marketing, because licensing experts in each group concentrate on the needs of the group.

But different experience in different groups may lead to different practices and different capabilities being dispersed through the organization. Furthermore, there is now a problem of co-ordination. Both Braxia and the independent suppliers of new technologies are geographically dispersed as well as representing a wide range of scientific and therapeutic applications. One part of the organization may be unaware of actions taken by another operating unit. For example, a biotechnology company may approach more than one group, be rejected by one part of the organization and yet be accepted by another.

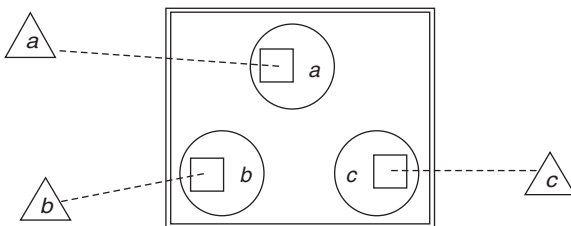


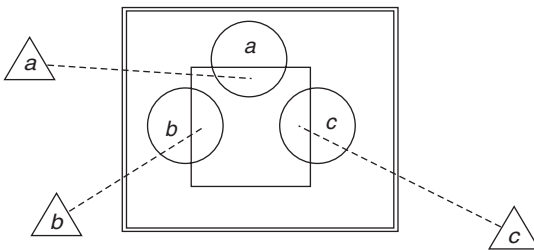
Figure 14.2 Pure combination



Braxia's chosen solution resulted in the establishment of what is informally called a 'virtual department', which provides the benefits of both specialization of expertise and of combination of expertise. Expertise in buying is developed collectively by individuals who are located in each therapeutic area, but who are also able to share their knowledge as though they were in a distinct unit specializing in licensing. This is made possible by adopting a common process for evaluating prospective offers, and a management and information system that is embodied in customized computer software. This is accessible to all firm members who have responsibilities for licensing. The 'virtual department' is made up of a group of specialists who support and manage the system, together with members of operating groups who have responsibility for licensing. The expertise of licensing specialists is available to all operating groups as needed, and the decision-makers in each client group comprise a 'virtual' licensing group while continuing to be fully integrated members of their own operating units. This arrangement is represented schematically in Figure 14.3. Thus the arrangement provides benefits of both the pure specialization forms and the pure combination forms of organization.

This form of organization successfully overcomes trade-offs in knowledge specialization. This might otherwise require a greater division of labour among more specialized individuals, but is overcome through the application of a piece of organizational knowledge. This knowledge is the recognition that all acquisitions of products and technologies (including companies) could be achieved through the same process in all therapeutic areas and all countries. Furthermore, this process could be embodied in computer software which would automate many of the administrative requirements, and facilitate the required information flows, record-keeping and documentation.

For example, if a manager in one therapeutic area is approached by a biotechnology company offering a new compound with 'XYZ inhibitor'



**Figure 14.3** Hybrid structure: Braxia's 'virtual department'

properties, he or she can immediately get a list of all documents in the company containing this term, and all projects (internal R&D and potential licensing activities, past and present) concerned with this technology. Project details include the names of all project team members, and so there is immediate access to Braxia's existing expertise in the field. If a manager decides to pursue the proposal, then it is possible to include experienced staff automatically in the new project team. All documentation for a project exists wholly and only within the software system so that it is instantly available in its latest form to all who need access. Information is provided in a variety of forms apart from text typed into standard documents. For example, data may be accessed by attaching files, by scanning printed documents into the software records, by setting hot links to other documents, databases or websites, or by attaching relevant searches. In this way, any information contributed by any member of the team is flagged and is accessible to other team members or to other firm members who need details of the project. All projects pass through five standardized decision points. The decision record at each point provides not only the details of the decision itself, but also a summary of what information was used in making the decision ('what they read') and the team's reasons for the decision made ('what they said'). In this way, the key learning in each project team is available for others to observe and absorb.

This organizational understanding, which the system embodies, was itself the result of a process of deliberate knowledge development. A collective view of the key operating parameters was hammered out in a series of international workshops, including:

- The scope of the 'virtual department' responsibilities (the acquisition of products, technologies and companies, but not materials and services);
- The stages of the process that would be covered (search, evaluation, decision and contract, but not setting strategic targets for areas or post-contract management);
- The 'ownership' of each strategic area by therapeutic teams and operating units; and
- The standardized 'decision events' and documentation requirements.

Once these and other details were agreed and understood they formed the basis for the customized development of software. For incorporating organizational knowledge into information technology, the technology needs to be adapted to the organizational requirements, and not the other way around.

The embodiment of organizational knowledge, together with some licensing knowledge, in an information technology system provides an alternative to the internalization of such knowledge in the minds of separate specialists. This improves the firm's ability to exploit the complementarities between its therapeutic and marketing knowledge, and its developing licensing expertise. There are benefits in each of the four principal knowledge organizing tasks mentioned earlier.

*Allocation of tasks.* The main responsibilities ('ownerships') were agreed in establishing the 'virtual department' system. At a detailed level, the search facilities of the system database allow instant identification of individuals with particular knowledge of circumstances and cases. There is therefore little difficulty in assigning work to the best-qualified people. One of the principal advantages of the system is that a new capability has been added while maintaining the established principal areas of responsibility and expertise within the firm, rather than adding new divisions of responsibility.

*Co-ordination of tasks.* All active work is conducted through the networked database, so that progress and actions are immediately visible to other members of the 'virtual department'. They are able to view the activities of colleagues as they are carried out, and do not have to wait for reports or briefings in order to be made aware of the actions of others whose activities affect their own.

*Communication.* The search facilities of the system allow users to locate expertise that may be relevant to their own needs. In particular, the accumulation of expertise can be disseminated, since records of all work carried out are accessible, so that users can benefit from precedents and practices developed by their colleagues. The process itself and the software system which serves it are kept under continual review by a 'community manager' who collates experiences and ideas, disseminates 'hints and tips' and facilitates review meetings (by video conference, if appropriate) of users.

*Co-operation.* Acceptance of the system by its users depends primarily on their own perceptions of benefits to themselves through the streamlining and acceleration of their own work. The time and waiting costs of information acquisition are practically eliminated, the ability to benefit from a wider range of experience is enhanced, and the risks of conflicting

interests are removed. Corporate benefits align with those experienced by individuals, and include speedier, more reliable and more confident decisions.

### **Devonian plc: selling technology in a global market<sup>3</sup>**

The knowledge characteristics of Devonian's 'major bids' process provide a useful contrast with those of Braxia's licensing activities. The differences between the technologies of the two firms, and between the knowledge requirements for buying (licensing) and for selling (bidding) help to demonstrate the influence of knowledge characteristics on organizational structures.

Devonian is a global telecommunications company which owns and operates cable systems, fibre-optic networks and satellite earth stations. It is a leading supplier of global communications services to international firms such as banks, information technology companies, oil and gas companies, and shipping companies. Two aspects of this business which strongly affect the nature of the knowledge creation requirements are, first, the rapid rate of innovation in telecommunications technology, and, second, the wide variations in the needs of individual customers. Designs must be tailored to customer requirements, and bidding is intensely competitive. Acceptance by the customer depends on a number of factors in addition to price, including:

- The design and performance characteristics of the system;
- 'Added value' capabilities, such as 'end to end' managed services;
- The flexibility and speed of response shown in meeting the client's requirements; and
- The client's expectations of the resilience and reliability of the system supplied, bearing in mind that it is customized rather than standard, and that its benefits may depend on novel technology.

Bids often comprise several rounds. The client may use the first round to select two or three competitors, who will then submit more detailed bids. Bidders can be asked to carry out partial or pilot projects in competition with one another.

The preparation of bids is a complex process drawing on many specializations within Devonian, including general and specialized network design; costing and pricing; commercial and financial appraisal; legal services; sales and service contacts with clients; liaison with third-party suppliers; and project management for the implementation of successful

bids. Through economies of specialization, these skills are located in different groups. Furthermore, Devonian is a global corporation, serving international customers with headquarters in many different parts of the world and with international service requirements. Therefore, customer contacts and Devonian's own sales and customer service personnel may be widely dispersed geographically as well as being members of different regional business units. Like Braxia, Devonian must balance the advantages of specialization (division) with the combination of complementary expertise.

This is a more complex organizational choice than in the Braxia example. Our discussion of Braxia considered how the firm developed one additional capability in line with the established needs of each of its therapeutic area 'clients'. Devonian needs to direct many diverse knowledge resources towards each potential client, where the needs vary between clients. Clients have different technical problems and the locations of their head offices and operating divisions are idiosyncratic. Devonian has to call on whatever specialized resources are required, and to align the sales and service communication channels with those of the client. The number of possible organization structures is very large, with some areas of expertise specialized separately (compare Figure 14.1) and others combined (compare Figure 14.2). The ideal structure is likely to be different for different clients, particularly for high-value projects for large international clients.

Devonian's solution is a flexible form of organization, which matches the organization to the requirements of individual bids. This is achieved by assembling 'bid teams' under the control of a specialist section called 'Major bids'. A 'virtual team' (the bid team) is appointed, with membership from each of the key areas of expertise required for the bid. The Major bids section supplies the lead design engineer, called the 'bid consultant', and the most appropriate regional business unit provides the sales account manager, who forms the primary channel of communication with the client (see Figure 14.4).

Other contacts with clients can, of course, be made at various levels, as required. The aim is for the client to experience its contact with Devonian as though it is dealing with a 'one-stop shop' in which all team members are working towards the same goal – that of meeting the requirements of the client. Devonian's view is that the Major bids approach is appropriate for high-value projects where international co-ordination is required and where there is a need for specialist design expertise.

Devonian's 'virtual team' approach to organization is an alternative way to strike the balance between the division and combination of

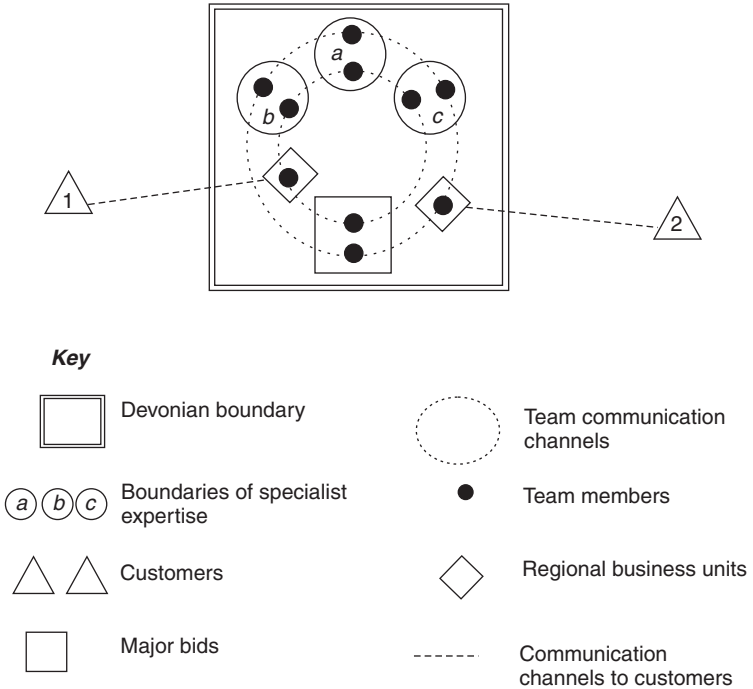


Figure 14.4 Devonian's 'virtual teams'

expertise. Braxia used computer software to allow each specialist team to internalize additional expertise as needed. Devonian uses 'variable organizational geometry' to create customized combinations of specialists to meet the needs of its clients. Complementary expertise is brought together in a more deliberate, centrally directed way than in the Braxia case. The knowledge-organizing tasks of allocation, co-ordination, communication and co-operation are directed by the Major bids section. This group acts as a reservoir of developing expertise in the preparation of bids. For example, they carry out post-bid reviews in order to learn which factors contribute to winning or losing contracts, and which might increase the chance of success in future bids.

### Lessons from the case studies

These two cases reveal alternative approaches to the balance between increased division of specialized labour, reflected by internal boundaries,

and the combination of expertise within internal boundaries. Braxia uses information technology to extend the boundary of licensing expertise to overlap with other areas of specialization. Devonian creates access across boundaries by defining cross-boundary teams with common goals.

The different forms of organization are influenced by differences in the characteristics of the knowledge deployed. The degree of *mutual specificity* between the areas of knowledge being created differs in the two cases. Braxia discovered that licensing procedures could be *generic*. Experience acquired in one therapeutic area has value to specialists in other areas, and the adoption of a software-based approach allows experience to be exchanged between specialists at minimal cost. In contrast, the knowledge created in Devonian in preparing its bids is highly *co-specific*. Each client has idiosyncratic requirements, and the contribution from each expert in the team is highly specific to the individual needs of the bid. The knowledge created is less likely to be of direct use to other teams. Therefore, teams working separately suffer no serious loss of value.

Although the two companies are different in many respects, and the types of knowledge they are managing are dissimilar, the key commonality in the cases is the critical role of organization structure. The characteristics of knowledge and the processes through which knowledge is transformed into value have important implications for the design of the two organizations.

Traditional 'command and control' methods used in companies have established structures that are effective in controlling organizational members, but they are shown here to be unsuitable for the allocation, co-ordination, communication and co-operation of knowledge specialists. The Devonian case shows that optimizing knowledge allocation, co-ordination and co-operation requires the bringing of people together in different ways for different purposes. The company has chosen to use 'virtual teams', a versatile solution to the issues of the firm, requiring different combinations and recombinations of knowledge specialists. The Braxia case shows that for knowledge that can be encoded and can provide value across boundaries, knowledge combination requires flexible arrangements which differ from the large-scale co-ordination problem. The network model involving the creation of a 'virtual department' is a means of combining the benefits of pure specialization (combining all the licensing experience of the firm in one group) with those of pure combination (where the experts are diffused into the product-specific sections of the firm).

New ideas in management present a challenge to firms. Should the ideas be adopted on trust, perhaps to avoid being left behind by more

innovative competitors? Or should they be treated with caution in order to avoid the mistakes of making changes for change's sake? We hope that the ideas set out here will help to provide a useful basis for the careful evaluation of knowledge management ideas. Firms have always 'managed knowledge', so they need not assume that change is essential. The new focus on this topic reflects both developments in technology, which offer new practical possibilities if aligned properly with organizational needs, and developments in the theoretical understanding of business. In particular, the cases we have discussed illustrate that the different forms of organization are appropriate for capitalizing on different kinds of knowledge. A single 'one model fits all' approach is unlikely to be legitimate. Some of the concepts used here may help firms to select an approach to managing their knowledge that works for them.

## Notes

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- 1 Compare with the intermediary for goods: 'His comparative advantage lies not in his knowledge of the use to which the good will be put, but his knowledge of who is the best person to put it to that use' (Casson, 1996).
- 2 Compare with Demsetz's suggestion that the boundaries between firms are a way of economizing on knowledge costs. All that firms need to exchange are the product itself and appropriate instructions for use. Detailed knowledge of its production does not need to be communicated (see Demsetz, 1988).
- 3 The authors are grateful to Mr Rahul G. Joshi for valuable assistance in conducting the Devonian case study.

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