

American Direct Investments in the Common Market (*)

U. S. Investments in Western Europe

In recent years, concern has been expressed about the encroachment of American capital in Western Europe. Data on the book value of long-term foreign investments do not seem to justify this concern. Thus, the U.S. Department of Commerce reported that, at the end of 1964, American private long-term investments in Western Europe were valued at \$17,484 million as against European investments in the United States of \$17,726 million (1).

The composition of American investments in Western Europe and that of European investments in the United States differ in several respects, however. To begin with, about 70 per cent of U.S. holdings take the form of direct investments while the relevant proportion is only one-third in the case of European investments in the United States (2). Moreover, within the direct investment category, American

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(1) SAMUEL PIZER and FREDERICK CUTLER, "Foreign Investments, 1964-65", *Survey of Current Business*, September 1965, p. 32. This periodical and two other publications of the U.S. Department of Commerce, *U.S. Business Investments in Foreign Countries*, Washington, D.C., 1960 and *Foreign Business Investments in the United States*, Washington, D.C. 1962 are the statistical sources used in this section of the paper.

(2) Direct foreign investments, as defined by the U.S. Department of Commerce, refer to investments in foreign business enterprises (chiefly branches and subsidiaries of domestic firms) in which a U.S. resident or organization owned a 25 per cent interest. In turn, the purchase of foreign obligations excluded from this category is classified as portfolio investments. In the following discussion we will restrict our attention to direct investments, in part because portfolio investments do not generally give rise to control over the operation of foreign firms, and in part because the motivating forces — and the economic implications — of the two kinds of investment are rather different.

capital is concentrated in manufacturing (54.5 per cent) and in petroleum (26.9 per cent) that have been in the center of the controversy about foreign ownership. By contrast, finance, insurance, and other service sectors occupy an important place in investments by European firms, with manufacturing accounting for only one-third of the total. There is also a difference in the financing of new investments: in recent years, net capital outflow accounted for about three-fourths, and undistributed earnings for one-fourth, of American investments in Western Europe, whereas reinvested earnings predominate in the financing of European direct investments in the United States.

These differences reflect the influence of historical factors. A substantial part of European investments in the United States finds its origin in the migration of capital in search of safety during the thirties and in the period of the Second World War. Safety rather than high yield being the main objective, this flow took largely the form of portfolio rather than direct investments and, within the latter category, investment in the service sectors predominated. At the same time, firms that had established branches or subsidiaries in the United States before 1941 still dominate the picture and account for four-fifths of the value of European direct investments in this country. New firms increasingly participate in American investments in Western Europe, however, and U.S. companies have a large stake in the fast-growing industries.

The rate of growth of direct investments, too, has differed greatly in the two cases. In 1950, the value of European direct investments in the United States (\$2,228 million) had exceeded that of American investments in Western Europe (\$1,733 million). The situation changed by 1957 when U.S. investments reached \$4,151 million and European investments were \$3,753 million. Since 1957, disparities in the rate of growth of direct investments have further increased. In the years 1957-1964, the value of U.S. investments in Western Europe nearly tripled as compared with an increase by one-half in the opposite direction. As a result, by the end of 1964, the value of U.S. direct investments in the European area surpassed \$12 billion while European holdings in the United States were less than \$6 billion.

Within Western Europe, the countries of the European Economic Community assumed increasing importance as a location for U.S. affiliates; the share of these countries in American direct

THE VALUE OF U.S. DIRECT INVESTMENT ABROAD
(\$ million)

TABLE I

	1950	1957	1964
Total	11,788	25,394	44,343
Canada	3,579	8,769	13,820
Western Europe	1,733	4,151	12,067
Common Market	637	1,680	5,398
Belgium-Luxembourg	69	192	452
France	217	464	1,437
Germany	204	581	2,077
Italy	63	252	845
The Netherlands	84	191	587
United Kingdom	847	1,974	4,550
Scandinavia	114	202	551
Switzerland	25	69	944
Other European Countries	110	226	624
Japan	19	185	591
Australia - New Zealand - South Africa	366	527	2,049
Latin America	4,445	7,434	8,932
Less Developed Countries other than L.A.	1,290	3,287	5,136
International	356	1,041	1,865

Source: U.S. Department of Commerce, *Survey of Current Business*, various issues.

Note: Figures refer to the end of the years indicated.

investments in the European area grew from 36.8 per cent in 1950 to 44.7 per cent in 1964 (Table 1). The rise of U.S. investments in the Common Market countries has been especially pronounced since the EEC's establishment, with part of this increase taking place at the expense of the United Kingdom. While investments in the two areas grew more-or-less parallel beforehand, between 1957 and 1964 the amount of new investments increased from \$212 million to \$889 million in the EEC as against a change from \$332 to \$377 million in Britain (3). The United Kingdom has also lost ground compared with most other countries of Western Europe. Among these, Switzerland has been the main beneficiary, largely as a result of the advantageous tax treatment accorded to American corporations (Table 2).

(3) The differences are even more marked if data on the net inflow of capital are compared, since the proportion of new investments financed from undistributed earnings is nearly one-half in the United Kingdom but it does not exceed one-eighth in the Common Market.

TABLE 2

THE FLOW OF U.S. DIRECT INVESTMENT TO WESTERN EUROPE
(\$ million)

	1950			1957			1964		
	A	B	A+B	A	B	A+B	A	B	A+B
Western Europe	119	151	270	287	294	581	1,341	420	1,761
Common Market	53	70	123	96	116	212	787	102	889
United Kingdom	49	69	118	172	160	332	207	170	377
Scandinavia	4	7	11	4	4	8	66	6	72
Switzerland	2	1	3	4	3	7	215	113	328
Other European Countries .	11	4	15	11	11	22	66	29	95

Source: U.S. Department of Commerce, *Survey of Current Business*, various issues.
Explanation of symbols:
A. Net capital flow.
B. Undistributed subsidiary earnings.
A+B. Total new investment.

To explain the rapid growth of American investment in Western Europe, and its orientation within the European area, we should first consider the influences that contribute to direct foreign investment. In a recent paper, Stephen Hymer noted the relationship between oligopolistic market structures and foreign investment. It appears that 44 per cent of the principal U.S. foreign investors come from industries where four firms supply over three-fourths of sales, although these industries account for only 8 per cent of the total value of industrial output in the United States. By contrast, industries where the four largest firms provide less than one-fourth of sales had only one of the seventy-two firms classified as major foreign investors (4).

According to Hymer, the motivating force of foreign investment is that, by acquiring control over foreign enterprises, oligopolistic firms can reduce competition and increase profits. Hymer's main concern is with the determination of oligopolistic market shares; in the present paper, emphasis is given to changes in these shares. This approach is especially appropriate in the case of U.S. investments in Western Europe, since the sevenfold increase in the value of this investment between 1950 and 1964 was accompanied

(4) STEPHEN HYMER, "Direct Foreign Investment and International Oligopoly", June, 1965 (mimeo).

by increases in the share of American subsidiaries in certain industries (food products), entry into industries that had largely been the preserve of European firms (chemicals), and participation in new industries (computers).

Correspondingly, I will focus on the cost of expansion in domestic and in foreign markets for the oligopolistic firm. After having attained a more or less stable share in the home market, selling efforts aimed at increasing the firm's share in domestic sales are bound to meet with retaliation on the part of other enterprises, raising thereby the cost of expansion. On the other hand, although the cost of entry into foreign markets may be substantial, it will often be easier for the firm to carve out a new market for itself than to increase its domestic share — especially if the rate of growth of demand is greater and market structures are more fluid abroad.

These conclusions can find application to American investments in Western Europe. For one thing, in the postwar period demand for durable consumer and producer goods has been rising more rapidly in Western Europe than in the United States. For another, the fluidity of market structures has greatly increased as a result of economic integration in Europe that has upset established patterns in the individual countries. But while the high rate of increase of demand and the fluidity of market structures have provided incentives for American firms to encroach upon European markets, additional considerations have to be introduced to explain the choice between supplying foreign markets from domestic or from foreign plants (5).

The Choice between Exports and Foreign Investment

In chronological order, sales from domestic plants usually precede the establishment of plants in foreign countries. For one thing, the lack of familiarity with conditions abroad augments the risk of setting up foreign plants; for another, time may be needed to increase sales to the level where the establishment of a foreign plant is warranted. The chemical industry provides a good example of the process of expanding foreign sales and the subsequent shift

(5) Here and throughout this paper, I will neglect the problem of licensing arrangements. Neither will I consider questions relating to the importation of products manufactured by foreign subsidiaries into the United States. At any rate, these imports hardly exceed one per cent of the total sales of U.S. affiliates.

from exports to producing abroad. Given the high rate of expansion of demand for chemicals in Western Europe and the fluidity of market structures, a rising proportion of sales by American chemical firms is directed to Western Europe and the expansion in sales has been followed by investment in European manufacturing facilities.

The Dow Chemical Co., one of the largest chemical manufacturers in the United States, increased its foreign sales during the postwar period from nil to one-fifth of the total, for example, and expects a further rise to one-half within a decade. With much of these sales going to Western Europe, European production facilities are expanded at a rapid rate. *The Economist* (November 7, 1964, p. 631) reports that Dow's investments in Western Europe reached \$100 million in 1964, and are planned to rise to \$150 million in 1966 and to \$250 million in another two or three years. Du Pont and other larger American chemical companies are acting in a similar fashion. Correspondingly, the book value of U.S. investments in the European chemical industry rose from \$74 million in 1950 to \$319 million in 1957 and \$1,073 million in 1964, with further increases indicated in the years following (6).

But while we often find that the expansion of foreign sales is followed by American investments abroad, the question remains what factors motivate the decision at the time when prospective sales attain the amount that a new plant could supply. In the following I will consider the impact of cost-factors (production costs, transportation costs, and tariffs), and nonprice factors (the availability of funds, antitrust legislation, and the servicing of foreign markets) on the individual firm's decisions, and continue with an evaluation of the "market strategy" of American enterprises.

Production costs in domestic and foreign plants of American companies were compared in the course of an investigation carried out by the National Industrial Conference Board. The NICB report found production costs to be generally lower in plants located in the United Kingdom and in the Common Market than in the United States, largely because the advantages of European countries in regard to labor costs are not fully offset by the lower cost of intermediate products in the United States. For the year 1960, median cost ratios expressed in terms of the cost of domestic operations were reported to be .85 in the European Common Market and

(6) *Survey of Current Business*, September 1965, pp. 27, 29.

.82 in the United Kingdom (7). Similar conclusions were reached by John H. Dunning in regard to the United Kingdom. Dunning reports that, in the mid-fifties, three out of five American companies had lower costs in their British than in their American plants (8).

It may be objected that the comparisons are biased because American companies tend to locate abroad in cases when foreign costs are lower than domestic costs. But the same pattern is shown in the large majority of manufacturing industries and, according to the calculations of the U.S. Department of Commerce, until 1961 the rate of return on manufacturing investments by U.S. firms exceeded that obtained in domestic operations by a substantial margin (9). These results, then, confirm the findings of the two studies cited above.

Differences in average profit rates in U.S. and foreign operations well-nigh disappeared in 1962 but interindustry disparities in production costs continue to influence decisions concerning the location of manufacturing facilities. And, at any rate, the investment decision is influenced by the long-term rate of return rather than the current rate (10). Long-term profitability, in turn, is affected by the possibilities for cost reductions and the expansion of the market. I will return to a consideration of these factors at a later point.

Among cost factors affecting the firm's choice between exporting and producing abroad, transportation costs should next be mentioned. Dunning found that, in the case of two-fifths of American manufacturing companies operating in the United Kingdom, transportation costs incurred in supplying British markets from U.S. plants amount to less than 10 per cent of the cost of production. But this ratio is between 10 and 20 per cent in one-fourth, and between 20 and 30 per cent in over one-fifth of the cases, and 13 per cent of the companies reported that transportation costs exceeded 30 per cent of the

(7) THEODORE R. GATES and FABIAN LINDEN, *Costs and Competition*, New York, The National Industrial Conference Board, 1961, pp. 14-15.

(8) JOHN H. DUNNING, *American Investment in British Manufacturing Industry*, London, Allen and Unwin, 1958, ch. V.

(9) *Survey of Current Business*, September 1965, p. 22.

(10) On this point, our theoretical expectations are confirmed by the 1965 survey of the National Industrial Conference Board among one hundred leading U.S. manufacturing firms with foreign operations. Cf., JUDD POLK et. al., *U.S. Production Abroad and the Balance of Payments*, A Survey of Corporate Investment Experience, New York, National Industrial Conference Board, 1966, p. 63.

cost of production (11). While these results are subject to an upward bias because they reflect the experience of U.S. firms that have actually located in the United Kingdom, the wide industrial distribution of U.S. subsidiaries suggests the importance of transportation costs for locational decisions.

The level of tariffs in foreign markets is a further consideration. Since, in the cost comparisons referred to above, duties on raw materials and intermediate products have been included in the cost of inputs, tariffs on the commodities traded are relevant for the present discussion (12). A rough indication of the relative importance of tariff protection for the producer's decision to establish plants abroad can be given by comparing tariff averages for European countries. In an earlier paper, I estimated the average of duties for manufactured goods, weighted by the combined imports of the industrial countries, to be 15.5 per cent in the United Kingdom, 11.9 per cent in the European Common Market, and 6.8 per cent in Sweden. The paper also provides information on tariffs for thirty-six industries of the countries in question (13).

Effects of the Common Market on American Investments

I come now to the implications that the establishment of the European Common Market has for U.S. direct investment. While the sheltering of national markets by tariffs provides an incentive for U.S. firms to locate plants in the individual countries, the formation of the EEC has had the double effect of discriminating against U.S. exports in favor of sales from plants located in the partner countries, and enlarging the market for the individual producer. To varying degrees, both of these influences have contributed to the rapid expansion of American investments in the European Economic Community — and especially in Common Market manufacturing — since the time when the Rome Treaty was signed (14).

(11) *American Investment in British Manufacturing Industry*, p. 233.

(12) Should we consider solely tariffs, however, effective rather than nominal duties would have to be compared when the former take account of tariffs on material inputs and express the extent of protection of value added. Cf. my "Tariff Protection in Industrial Countries: An Evaluation", *Journal of Political Economy*, December 1965, pp. 573-94.

(13) *Ibid.*

(14) The book value of U.S. investments in the manufacturing industries of the EEC countries nearly quadrupled between 1957 and 1964, raising thereby the Common Market's share in U.S. manufacturing investments in Western Europe from 37.9 to 47.3 per cent

The role played by tariff discrimination in inducing American firms to locate in the Common Market should not be exaggerated, however. To begin with, an inquiry conducted by the McGraw Hill Co., into the motivation of investment decisions failed to show the importance of tariff discrimination; rather, the principal inducement appeared to be the possibility of expansion in a wider market (15). Further, a statistical investigation carried out by the present author has shown no relationship between the degree of tariff discrimination and U.S. investments in individual industries.

Following the elimination of duties on intra-EEC trade, partner country producers will be able to compete with foreign producers even if their prices exceed the price charged by the latter by the amount of tariff. If we take the foreign price to be 100, the tariff-inclusive domestic price will equal 100 plus the duty. The figures derived in this manner express the rate of discrimination against foreign producers at the end of the transitional period of the Common Market's establishment. They have been used in the present study under the assumption that investment decisions are influenced by the conditions that will obtain after internal tariff reductions have been completed.

The rate of tariff discrimination, as well as index numbers representing the increase in U.S. exports to, and American investments in, the European Common Market between 1957-58 and 1963-64 are shown in Table 3 for nine industrial categories. Other things being equal, one would expect the rate of discrimination and the expansion of investments to be positively correlated. But there is no indication of the existence of such a relationship irrespective of the statistical measure employed. The results do not change if — in order to abstract from the effects of interindustry differences in the rate of demand on the inflow of foreign capital — the rate of discrimination and the ratio of the increase of American investment to that of U.S. exports are compared. Neither does the introduction of U.S. investment in the base period as a variable affecting the rate of increase of this investment bring modification in the results.

It appears, then, that available evidence does not support the contention according to which tariff discrimination against U.S.

(U.S. Department of Commerce, *American Business Investments in Foreign Countries*, Washington, D.C. 1960, pp. 92-95 and *Survey of Current Business*, September 1965, p. 24).

(15) McGraw Co. Department of Economics, *Foreign Operations of U.S. Industrial Companies*, New York, 1960, p. 4.

TABLE 3
THE RATE OF TARIFF DISCRIMINATION, AND THE EXPANSION OF U.S. EXPORTS
TO, AND AMERICAN INVESTMENT, IN THE EUROPEAN COMMON MARKET

	Rate of Tariff Discrimi- nation index (a)	Invest- ment 1963-64	Exports 1963-64	Invest- ment/ Exports 1963-64	Invest- ment 1957-58 \$ million
		Index, 1957-58 = 100			
Food products	126.2	268	145	185	19
Miscellaneous manuf.	115.6	332	320	104	31
Rubber products	115.3	743	372	200	7
Transport equipment	114.8	312	142	219	98
Electrical machinery	114.3	266	375	71	32
Chemicals	112.3	470	199	206	50
Nonelectrical machinery	110.9	475	254	163	86
Paper & paper products	110.3	300	375	80	6
Metals	105.6	574	170	338	19

Note: (a) 100 plus the weighted average of the common external tariff.

Sources: Tariffs - Committee for Economic Development, *Comparative Tariffs and Trade*, Washington, 1962.
Trade - Organization for Economic Cooperation and Development, *Foreign Trade Statistics*, various issues.
Investment - U.S. Department of Commerce, *Survey of Current Business*, various issues.

exports would have been the principal influence on American investments in the Common Market. This conclusion is further strengthened if we consider that the estimated decline of \$311 million in U.S. exports due to Common Market discrimination (16) would have hardly warranted a rise in the value of U.S. investments in the manufacturing industries of the EEC countries from \$0.8 billion in 1957 to \$3.1 billion in 1964.

Instead, emphasis should be given to the inducement provided for foreign investment by the enlargement of national markets through integration in the EEC. By allowing for the construction of larger plants and for increased intraindustry specialization, a wider market creates possibilities for exploiting economies of scale that contribute to reductions in costs. Plants established in any of the member countries can now cater to the entire area, and producers

(16) Cf. BELA BALASSA and M. E. KREININ, "Trade Liberalization under the Kennedy Round: The Static Effects", *Rev. Econ. Stat.* forthcoming. Comparable estimates derived by the use of a different method are given in L. B. KRAUSE, "The European Economic Community and the U.S. Balance-of-Payments", in W. S. SALANT, et. al., *The United States Balance of Payments in 1968*, Washington, The Brookings Institution, 1963, pp. 95-118.

may specialize in different varieties of a given commodity, or in its parts, components, and accessories, in factories located in the various member countries (17). In turn, the possibilities of increasing productivity by applying U.S. production and organizational methods in the enlarged market give promise for rapid increases in consumer incomes and demand. Lastly, the uncertainty associated with the establishment of plants for supplying the markets of the partner countries is reduced by reason of the assumed irreversibility of the elimination of all trade impediments.

These factors largely account for the observed differences in the behavior of American investors in the European Economic Community, the United Kingdom, and the Continental EFTA countries. Prior to 1958, the United Kingdom appeared to be the most desirable location for setting up foreign manufacturing facilities in Western Europe, since Commonwealth markets could be supplied from Britain. The establishment of the EEC has changed the situation, and the creation of a unified market equal to nearly one-half of the U.S. market has provided a powerful incentive for locating in one of the member countries. By contrast, the addition to markets supplied from British plants through the establishment of the European Free Trade Association has been relatively small. On the one hand, the combined gross domestic product of the Continental EFTA countries hardly exceeds one-fifth of that of the Common Market; on the other, tariffs in these countries were low to begin with.

Nevertheless, American firms benefit from setting up plants in the Continental EFTA countries because they will have duty free entry into the United Kingdom whose domestic market is roughly ten times as large as that of the average partner country. Prospective gains are augmented by reason of the fact that tariffs on commodities imported from other industrial countries are relatively high in Britain. Thus, despite the restraining effect of the uncertainties related to the maintenance of EFTA, U.S. investments in the Scandinavian countries have expanded at a rapid rate. But increases have been the most pronounced in Switzerland, where American corporations enjoy important tax advantages.

(17) IBM has decided, for example, to produce hybrid integrated circuits in France, and cards to mount them on in Germany. Also, computer assembly has been restricted to one variety in France and another two in Germany. (*The Economist*, March 19, 1966, p. 1150).

Nonprice Factors

Among nonprice factors, the availability of funds, antitrust legislation, and servicing should next be considered. American firms possess advantages over their European counterparts with respect to both internal and external sources of funds. Trends in the availability of internal financing are indicated by changes in profit margins over time. Judging from labor cost and wholesale price indices, these margins have been widening in the United States and narrowing in Western Europe in recent years, permitting thereby increases in U.S. investments abroad. In fact, the share of foreign investments in total expenditures on plant and equipment by U.S. corporations has risen to a considerable extent, and in industries producing rubber goods, transportation equipment, electrical machinery, nonelectrical machinery, and chemicals this share averaged 21 to 32 per cent in 1964 for companies reporting to the U.S. Department of Commerce (18). Also, most firms participating in the NICB survey reported that their domestic capital requirements did not limit their foreign investments, and companies frequently stated that "if a project is good, we find means to finance it" (19).

Aside from internal funds, financing can take the form of borrowing in the New York market while the access to borrowed funds is more limited, and rates are higher, in Europe. Moreover, the 15 per cent increase in the cost of borrowing to foreigners resulting from the introduction of the Interest Equalization Tax in July 1962 has entailed the virtual elimination of borrowing by European firms in the United States, and has disrupted the pattern characterized by the intermediation of the New York financial market between European lenders and borrowers. In the past, Europeans issued and purchased bonds in New York because of the relatively small margin between borrowing and lending rates due to the advantages of large size — stability, low brokerage fees and the ability to absorb large issues — of this market (20).

(18) *Survey of Current Business*, September 1965, p. 30.

(19) *U.S. Production Abroad and the Balance of Payments*, p. 63.

(20) Cf. CHARLES P. KINDLEBERGER, "European Economic Integration and the Development of a Single Financial Center for Long-Term Capital", *Weltwirtschaftliches Archiv*, Band 90, Heft 2 (1963), pp. 189-208, and PETER B. KENEN, "Towards an Atlantic Capital Market", *Lloyds Bank Review*, July 1963, pp. 15-30. On developments due to the introduction of the "voluntary restraint" program on U.S. foreign investments, see below.

The antitrust legislation in the United States, too, provides an incentive for investing abroad. Firms that wish to expand through the purchase of some of their competitors, and have the financial means to do so, are hindered by federal legislation that aims at precluding the establishment of dominant positions in domestic industries. These rules do not apply to appropriating foreign firms, however, and the purchase of foreign companies becomes an important avenue of expansion.

Under the general heading of servicing foreign markets, I include the adaptation of the product to requirements abroad, servicing proper, marketing, and informative advertising. The first-mentioned factor has been emphasized by Dunning, who notes that "by manufacturing in this country (the United Kingdom), an American subsidiary is both able and willing to give closer attention to its prospective market and adapt its products to meet any special requirements more successfully than it could if it were producing 4,000 miles away" (21). These considerations have especial importance for the automobile industry where the cars in demand in Europe differ in size and horsepower from those in the United States. Correspondingly, the three large American car manufacturers supply the U.S. market from their domestic plants and cater to foreign markets from plants located abroad.

The servicing of the product assumes importance in the case of consumer and producer durables. To take again the case of automobiles, it stands to reason that the consumer's choice among competing products will be influenced by the availability of servicing and repair facilities in his home country. But while the servicing function can be delegated to repair establishments in foreign countries in the case of cars, the advantages of the proximity of the manufacturing plant generally increase with the technical complexity of the product. Finally, the importance of a home base for marketing, too, increases with the product's technical complexity while this advantage pertains to a wider range of products in regard to informative advertising.

I have examined here the various influences affecting the firm's choice between supplying foreign markets from plants established at home or abroad. Clearly, their relative importance in individual industries will depend on the structure of the industry,

(21) *American Investment in British Manufacturing Industry*, p. 232.

its rate of growth, the characteristics of its products, and a host of other factors. Nevertheless, some general conclusions can be derived in terms of market strategy.

I have noted that in expanding their sales, oligopolistic firms tend to focus on locations where market structures are less rigid and/or the rate of growth of demand is higher. I have further suggested that, as a result of integration in Western Europe, these conditions are fulfilled in the EEC and — to a lesser extent — in EFTA. This process, then, can be expected to continue until market shares more or less stabilize.

But why locate abroad rather than expand exports to foreign markets? In the previous discussion, I have examined this choice for a single firm without taking account of the reaction of other enterprises and the interrelations of the decision-making process in competing enterprises. Introducing the latter considerations, it will appear that investments may be "offensive" and "defensive" at the same time. The entry of an American firm in a particular industry may bring forth a reaction on the part of other U.S. companies, for example, as evidenced by the case of the computer, chemical, and automobile industries. Also, as the sale of a given item in a foreign market reaches the level where the establishment of a plant is warranted, the question may not be whether the exporter should set up a plant or not but whether this firm or a competitor will establish the plant. Accordingly, the firm's choice may be restricted to setting up a plant or losing a smaller or greater proportion of sales to a competitor that enjoys the advantages of locating near to the market.

This dilemma was clearly expressed in reference to enterprises in the host country by an official of Du Pont: "Should we choose not to set up a plant ourselves, the void would be filled by a domestic competitor. Hence, we have the alternatives of losing business either to a domestic producer or to ourselves. We prefer the latter" (22).

More generally, foreign investment should be regarded as a part of the market strategy of the firm that aims at improving or,

(22) KLAUS-HEINRICH STANDKE, *Amerikanische Investitionspolitik in der EWG*, Berlin: Benth-Vertrieb, 1965, p. 88. Also, in a discussion of the motivation of investment abroad, the NICB report concludes: "In developed areas, notably in Europe, the emphasis is on local and foreign competitors who, having plants on the spot, are in a position to take advantage of changes in terms of volume and typical product demanded, and can supply customers faster and better than a company that depends on lower and costlier long distance supply lines". *U.S. Production Abroad and the Balance of Payments*, p. 44.

at least, defending its position in domestic and in foreign markets. As I noted above, oligopolistic firms are long-term maximizers, and current profitability plays a secondary role in the decision-making process. At the same time, the expansion of sales and that of profits are intertwined, especially since long run average costs in individual plants can often be taken as constant and hence an incentive is provided to spread fixed costs — including that of research and product development — over a larger output. This explains the difficulty of separating the firm's desire to increase earnings capacity from its intention to expand domestic and foreign sales and investment (23). Thus, according to the conclusions of the NICB report: "In the almost universal judgement of producers, maintaining competitive position requires continuing investment. Growth is considered indistinguishable from earnings ability; 'to stand still is to lose'" (24).

The Benefits of Foreign Investment

The textbook argument for foreign investment is based on a consideration of capital and labor endowments in the individual countries. Under the assumption that the conditions of production are everywhere the same, it will be profitable to invest in the country where the amount of capital per worker is smaller, and the flow of capital will lead an improvement in the allocation of resources in the world as a whole. Indeed, both countries are assumed to benefit from foreign investment; the investor gains by obtaining a higher profit abroad while the recipient benefits from increases in labor productivity and wages (25).

(23) Note the difference between this argument and that of W. J. Baumol. In my view, the expansion of earnings is the ultimate objective which is furthered by the growth of the firm, while Baumol regards growth as an objective *per se*, subject to a profit constraint in the form of the minimal acceptable rate. W. J. BAUMOL, "On the Theory of Oligopoly", *Economica*, August 1958, pp. 187-98.

(24) *U.S. Production Abroad and the Balance of Payments*, p. 133. Elsewhere in the same report, it is noted that "marketing strategy was clearly the dominant element in investment decisions. This fact bears directly on the characteristic view of businessmen that normally investment, even where it appears as new or expansionary, is necessary to maintain competitiveness, and is made to strengthen the continued ability of the enterprise as a whole, not just to produce additional profits". (*Ibid.*, p. 59).

(25) In turn, wages would fall in the first country and profits decline in the second but these changes would be numerically smaller than the beneficial ones and, if we abstract from income distributional considerations, there will be a net benefit in both countries.

But while profits remain the principal consideration on the part of the investor, improvements in productivity under the assumption of unchanged technology provide only part of the benefit to the recipient country if the conditions of production differ internationally. In the case of the European Economic Community, for example, the contribution of American capital in adapting productive facilities to larger markets, the effects of increased competition, and the "apport" of new technology and technological knowledge are likely to be of much greater importance than the static benefits of foreign investment described by traditional theory. The EEC countries derive further gains from the taxation of U.S. subsidiaries located in the Common Market.

Within Western Europe, the United Kingdom has the longest history of the inflow of U.S. capital and she also leads in terms of the value of U.S. investment; hence, it is of especial interest to consider the contribution of American subsidiaries to competition and technological improvements in Britain. Dunning reports that, beginning with the establishment of the Diamond Match Co. in 1896, American investments have often served as an "anti-monopoly device" in Britain. Automobile tires, boilers, and margarine provide examples in the interwar period while, in the years since World War II, the establishment of American subsidiaries has thwarted potential monopolies in the production of office appliances, watches, television tubes, refrigerating machinery, and excavating equipment (26).

Similar instances have been observed on the Continent. According to a German observer, "U.S. capital tends to enter oligopolistic markets where there has been little competition in the past. Here the U.S. firms play the typical role of the outsider who brings movement into these markets" (27). The increase of competition associated with the establishment of American subsidiaries has also been noted in France where the "live and let live" attitude of firms has been especially strong in the past.

Intensified competition following the implantation of U.S. firms has often provided inducement for improvements in national firms but the implantation of American subsidiaries has had a bearing

(26) *American Investment in British Manufacturing Industry*, pp. 158-60.

(27) H. D. LÖSENBRUCK, "Der deutsche Markt bleibt attraktiv", *Der Volkswirt*, 1964,

on technological and organizational knowledge in the host country in other ways, too. For one thing, these subsidiaries have introduced a number of new products in Western Europe which had been previously imported from the United States. The products in question include various industrial instruments, excavating and earthmoving machinery, and petroleum refining equipment, chemicals and pharmaceutical products (e.g. carbon black, synthetic rubber, detergents, and ethical drugs) as well as new consumer goods, chiefly domestic appliances and cosmetics (28).

In introducing new products and applying modern technology and organizational methods, American subsidiaries have utilized the experience of the parent company. This transfer of knowledge extends to blueprints and prototypes, as well as to know-how pertaining to such diverse matters as design and layout, waste utilization and material handling. Aside from raising productivity in American-owned plants, these improvements influenced the methods and the organization of production in some national enterprises through the interchange of knowledge, the publicity given to research and developments, and the incentives provided for making licensing arrangements with other American companies (29).

In some instances, American firms have also influenced the production methods of their suppliers and the structure of the industry. An interesting, and widely reported, example is that of Libby McNeil, and Libby who has established fruit and vegetable processing plants in the Lower Rhône region. Libby has signed long-term contracts with the farmers of the region for supplying its processing plants with fruits and vegetables and has, in turn, provided them with grains, as well as with advice for improving their methods of cultivation. Besides benefiting the suppliers, the improvements obtained in quality and yield have induced several French firms to follow Libby's example and we witness the beginnings of a transformation of the processing of fruits and vegetables from inefficient small-scale establishments into a modern industry in France.

(28) The introduction of new products by U.S. subsidiaries in France is emphasized in GILLES-Y. BERTIN, *L'investissement des firmes étrangères en France*, Paris, Presses Universitaires de France, 1963, p. 223.

(29) According to Dunning, "it cannot be entirely coincidental that the industries in which American representation is most evidenced are also those which are both most dynamic in character and which rely for their success on those variables which the U.S. economy is best suited to supply" (*American Investment in British Manufacturing Industry*, pp. 189-92).

By reason of their greater mobility and fewer geographical preconceptions, American firms have also played a role in implementing regional policies in some European countries. Thus, according to *Le Monde* (June 15, 1965), "without Libby the program for the Lower Rhône region would have been a failure". More recently, it has been reported that Motorola has established a plant for making semiconductors in the depressed Toulouse region while the French government had difficulties in inducing domestic industry to locate plants in the area (30). The establishment of a Caterpillar Tractor plant in a declining Belgian mining region promises to have similar effects.

Last but not least, in accordance with international agreements on the taxation of foreign corporations, the host country shares in the profit of the subsidiaries of American companies. Since taxes paid by the parent company in the United States are reduced correspondingly, the double taxation agreements in effect represent a redistribution of incomes from the investor to the recipient country. Now, since the location of plants will respond to differences in after-tax profits, the social profitability of foreign investment for the investor country will be less than its private profitability — the difference being the amount of the tax.

American Investment and the National Interest

In contrast to the benefits of American investment for the Common Market, several real or presumed drawbacks of the inflow of capital have received attention in recent years. Some have pointed to the losses suffered by national firms due to increased competition from American subsidiaries, while others have objected to the alleged ruthlessness of these firms in the search for high profits. Thus, in commenting on the dismissal of several hundred workers in Remington's Caluire plant, Jacques Gervais, who is otherwise sympathetic to American investment, exclaims, that "we are not in the U.S.A., where one hires or fires workers in response to business conditions. This way of action — although it may have its advantages for productivity — is not accepted in France" (31).

(30) *New York Times*, March 24, 1966.

(31) JACQUES GERVAIS, *La France face aux investissements étrangers*, Paris, Les Editions de l'entreprise moderne, 1963, p. 189.

While these criticisms find their origin in existing differences in attitudes towards productivity and equity, other objections relate to the influence exerted by the parent companies on the activities of their foreign subsidiaries. Thus, it has been argued that the interest of these companies may easily come into conflict with the national interest and with the policies followed by European governments. In France, some have suggested that the investment and production policies of American subsidiaries may interfere with the national plan, while in Britain reference has been made to the difficulties that the Government may experience in carrying out countercyclical policies in an economy where the influence of foreign firms is strong.

But, with the loosening of the structure of planning that followed the "opening" of the French economy through the elimination of quantitative restrictions and entry into the Common Market (32), the objections against foreign investments based on the presumed conflict between U.S. subsidiaries and the Plan have declined in importance. And while considerable attention was given to the possible political motivation of the decision taken by Ford's British subsidiary to adopt a four-day week in August 1965 when deflationary measures were introduced by the Labor Government, these suspicions do not seem to have been based on actual fact (33). At the same time, there is no evidence that the activities of U.S. subsidiaries would have interfered with countercyclical policy in Canada although Americans control over one-half of manufacturing establishments in that country. To all appearances, neither had the operation of U.S. subsidiaries come into conflict with the Canadian national interest until the United States published guidelines for American corporations with the aim of reducing the U.S. balance of payments deficit (34).

More generally, it has been argued that the inflow of U.S. capital leads to an *Überfremdung* of the industry of European countries and restricts their national sovereignty. But data on the

(32) Cf. my "Whither French Planning?" *Quarterly Journal of Economics*, November 1965, pp. 537-54.

(33) *The Economist*, September 4, 1965, pp. 895-96.

(34) In turn, the Canadian Government made public its own guidelines urging foreign affiliates to handle procurement, disposal of earnings, export policy, pricing and processing of raw materials "with Canadian interest in mind", and requesting a periodical report on operations and financing (*The New York Times*, April 1, 1966).

share of American investment in European industries do not support this contention. Thus, in 1963, spending by U.S. subsidiaries on plant and equipment amounted to about 4 per cent of investment in the manufacturing industries of the Common Market countries (35). Since U.S. subsidiaries have increased their share in new investment over the last decade, the relevant proportion is still lower if the *stock* of capital outstanding rather than the *flow* of investment is considered.

But would American capital gain commanding positions in certain key industries — particularly those characterized by rapid technological progress? It has been argued that this may indeed be the case since U.S. companies derive advantages from their large size in the form of financial power and the ability to engage in research and product development. Considerations of this kind may underlie the position taken by Walther Hallstein, the President of the EEC Commission, who has been quoted as saying that "we welcome a certain amount of long-term American investment, provided it benefits all sectors of the economy without excessive concentration in any single branch" (36).

Competitive Advantages of U. S. Subsidiaries?

I have noted that the availability of internally generated funds and easy access to the New York financial market favor American firms and facilitate the establishment of foreign plants as the opportunity arises. The situation has been aggravated as a result of the so-called voluntary restraint program in the United States. For one thing, limitations have been placed on bank loans that served as a safety valve after the imposition of the Interest Equalization Tax practically eliminated the floating of European securities in the New York market; for another, U.S. affiliates have been induced to rely increasingly on European sources of finance. Alongside the shift of Japanese and Australian borrowing to Western Europe in response to the Interest Equalization Tax, the sale of securities by U.S. subsidiaries has resulted in increased tightness and higher

(35) *Survey of Current Business*, September 1965, p. 33, and Organization for Economic Cooperation and Development, *General Statistics*, January 1965.
 (36) *The Wall Street Journal*, March 22, 1955.

borrowing rates in European capital markets (37). Accordingly, an asymmetry has been introduced regarding access to foreign funds for American and for European firms: the rates paid by the latter in the New York market are augmented by the Interest Equalization Tax while the U.S. voluntary restraint program has reduced the availability of funds, and has led to an increase of rates, in Western Europe.

The research facilities of the parent company, too, often provide a competitive advantage to U.S. subsidiaries over national firms. Nevertheless, the importance of research varies from industry to industry, and one should also take account of the benefits that the host country derives from the research efforts of American companies in the form of the availability of new and improved products to processing industries and to the consumer, and the inducement given to competing national firms for technological improvements. It is of interest, therefore, to examine the experience of individual industries. Let us take first the case of the three industries that have been the main target of American investments in Western Europe: petroleum refining, chemicals, and automobiles (38).

During the interwar period, American companies assumed dominant positions in the Common Market countries in petroleum refining, chiefly because of the advantages of vertical integration from crude oil production to distribution. However, as a result of state action in setting up national firms, especially in France and Italy, the share of these companies in the sale of petroleum products in the EEC has fallen to one-half after World War II. State intervention in this area is likely to continue and to bring further changes in the future.

On the other hand, there is no evidence of American domination in the chemical industry. The largest European firms are com-

(37) *The Economist* (January 22, 1966, p. 348) reports that while bond issues by U.S. subsidiaries in European capital markets were practically nonexistent prior to the introduction of the voluntary restraint program, in the second half of 1965 bonds in the value of \$365 million were floated in Western Europe, accounting for nearly one-half of all funds raised by international issues.

(38) Within the total of \$6.5 billion invested in European manufacturing industries at the end of 1964, the value of American investments in transportation equipment (chiefly automobile) was estimated at \$1.8 billion and in chemicals \$1.1 billion. In the same year, the value of investments in petroleum refining was reported to be \$3.1 billion. (*Survey of Current Business*, September, 1965, pp. 24-27). Comparable figures for the Common Market are not available.

parable in size to the leading American companies: the combined sales of the three successor firms of the IG Farbenindustry exceed the worldwide sales of Du Pont, and the new Montecatini-Edison group as well as the French Rhône-Poulenc are not far behind. At any rate, product innovations in the chemical industry can be adopted relatively easily. Other firms soon followed in the footsteps of Du Pont in manufacturing artificial fibers, for example, and medium-sized firms have often had a better growth record than larger enterprises.

The U.S. share is greater in the European automobile industry but we can hardly speak of U.S. domination in this case either. Volkswagen, Fiat, and BMC precede any U.S. subsidiaries in terms of production volume. Moreover, the subsidiaries of American firms, taken together, account for less than one-third of the total production of automobiles in Western Europe, and in none of the European countries does their share reach two-fifths of domestic output. Nonetheless, there is little doubt that the financial power of the parent companies will assure the survival of the American subsidiaries in the expected reorganization of the European automobile industry which is bound to lead to the disappearance of some smaller national firms.

The dissimilar experience of the three European industries where American investment is concentrated indicates the difficulties of generalizing as to the advantages of financial power and the availability of research facilities (39). U.S. subsidiaries are usually part of a group of competing oligopolists in most other traditional industries also. On the other hand, American enterprises dominate the manufacturing of some new products, the prime examples being synthetic rubber and carbon black. Furthermore, fully or partly owned subsidiaries have assumed leading positions in the French and Italian computer industry.

Few objections have been raised against the monopoly position of American firms in regard to new products. For one thing, many agree with Raymond Aron who expressed the view that, from the point-of-view of European countries, it is more desirable to purchase these commodities from American subsidiaries than to import them from the United States (40). For another, as the example of

(39) For a more detailed analysis of the situation in these three industries, see CHRISTOPHER LAYTON, *Trans-Atlantic Investments*, Paris, The Atlantic Institute, 1966.

(40) *Figaro*, November 25, 1965.

synthetic fibers indicates, European companies may soon follow the lead of American firms in manufacturing competing products; in fact, several European firms have started — or plan to begin — the manufacture of synthetic rubber.

In turn, much attention has been given to the computer industry, where American firms have assumed preeminence largely by reason of their ability to finance research and development on successive "generations" of computers. The case of Olivetti and the *affaire Bull* have created much commotion as they appear to have demonstrated that the financial power of French and Italian companies is not sufficient to withstand American competition in the computer field. Some also fear that in other research-intensive fields, such as the miniaturization of electronic components, integrated circuits, etc. similar developments may take place.

Conclusion

I have indicated that, with U.S. subsidiaries accounting for about 4 per cent of expenditure on plant and equipment in Common Market manufacturing, there is little danger of "Überfremdung" in the industrial sector of the EEC countries. This conclusion is hardly affected even if we envisage a doubling of the share of American investments. At the same time, the inflow of capital appears desirable in order to reduce the time needed for reaching the present U.S. level of productivity and living standards in the Common Market. In this connection, it should be recalled that, according to various calculations, labor productivity is about two-and-half times as high in the United States as in the major European economies (41). These differences cannot be explained by reference to lower levels of labor efficiency in Western Europe (42); rather they have largely been due to the combined effects of small markets and low capital-labor ratios in European countries.

The establishment of the European Economic Community has created a market sufficiently large to permit the use of American

(41) On U.S.-U.K. comparisons, see DEBORAH PAIGE and GOTTFRIED BOMBACH, *A Comparison of National Output and Productivity of the United Kingdom and the United States*, Paris, OEEC, 1959, p. 29.

(42) Cf. M. E. KREININ, "The Leontief Scarce-Factor Paradox", *American Economic Review*, March 1965, pp. 131-40.

production methods in most manufacturing industries. Such a transformation would require capital, however, as well as the transfer of advanced technology. If we assume that capital-labor ratios in the Common Market are about 40 per cent of corresponding ratios in the United States (43), the rate of growth of investment would have to exceed that of the gross national product by a considerable margin in order to reach the U.S. level. And, aside from adding to the stock of capital, investments by U.S. subsidiaries contribute to improvements in production methods in the Common Market countries.

One cannot dismiss the argument, however, that in industries characterized by rapid technological progress, the disadvantages of European firms in regard to the availability and cost of financing, and the ability to engage in research and development, would adversely affect their competitiveness vis-à-vis the U.S. subsidiaries. But the situation can hardly be remedied by excluding American capital from certain branches of manufacturing since the technological lag between the United States and the EEC is bound to widen if obstacles are raised to the transfer of technical know-how and if the inducement provided by the presence of U.S. subsidiaries for improvements in production methods is reduced. Instead of applying restrictive measures, efforts should be made to create the conditions for effective competition on the part of European firms by encouraging concentration and research activity, improving the access of European firms to external financing, and remedying the distortions due to intercountry differences in antitrust legislation (44).

Both the establishment of the European Common Market and the inflow of American capital have provided incentives for concentration in the member countries. The movement toward concentration has taken place largely within the framework of individual national economies, however, and there are as yet few examples of mergers across frontiers. But, in technologically progressive industries, such mergers may be necessary to improve the position of European firms in competition with American producers. This is the situation in the computer industry, for example, where national producers have been unable to stand up to U.S. firms.

(43) This is the upper limit indicated in the Paige-Bombach study for the United Kingdom, *op. cit.*, p. 69.

(44) For similar conclusions, see the excellent article by PIERRE URI, "Pour une politique européenne des investissements américains", *Le Monde*, February 27, 1965.

Various measures would have to be taken to remove the obstacles that presently hinder mergers across national frontiers in the EEC. Among other things, it would be necessary to harmonize corporate tax rates, unify tax provisions on mergers, and standardize legislation on patents. But, in order to ease the present difficulties companies face in attempting to extend their operations across national frontiers, there is further need to provide a legal framework for a "European-type company" (45). A proposal to this effect was made by the EEC Commission (46) but it has run into French opposition.

The integration of capital markets in the EEC countries would also further concentration and would lessen the advantages of American firms in regard to external financing. But it will take some time to overcome national sensibilities that hinder this integration (47) and at any rate, the transformation of national capital markets is a slow and arduous process. In the meantime, the existing asymmetry in regard to access to funds could in part be remedied if the governments of the EEC countries imposed a tax — equivalent to the U.S. Interest Equalization Tax — on the borrowing of U.S. subsidiaries in Western Europe. In this way, at least the conditions of borrowing by American and European firms in each other's capital markets would be equalized (48).

A coordinated policy of research and government procurement, too, would provide assistance to European companies in technologically progressive industries where U.S. affiliates derive advantages from government-financed research and sales to federal agencies by the parent firm (49). Moreover, antitrust legislation on the Common Market level would offset the incentive provided for

(45) It has been reported that, on the occasion of their merger in mid-1964, Belgium's Gevaert and Germany's Agfa found the creation of a single company to be a "fiscal and legal impossibility". Instead, they have transferred stock and have created two jointly-owned companies, one Belgian and other German (*Business Week*, February 26, 1966). In other instances, fiscal and legal obstacles have prevented a merger.

(46) Cf. the five-point program of the Commission, reported in *European Community*, July 1965, p. 11.

(47) On October 26, 1964 the EEC Commission proposed various steps for the integration of national capital markets (*The New York Times*, October 27, 1964) but this proposal has not been acted upon.

(48) Pierre Uri goes even further and recommends levying a tax on all American direct investment in Europe (*Le Monde*, February 27, 1965).

(49) Cf. the discussion in Chapter 6 of my *Trade Liberalization among the Industrial Countries: Objectives and Alternatives*, (to be published).

foreign investment by domestic legislation in the United States and would impede the establishment of dominant positions by U.S. subsidiaries. Such legislation would also reinforce the provisions of the Rome Treaty regarding the domination of particular industries by domestic firms.

It is apparent that none of these measures would interfere with the freedom of establishment in the EEC but they would reduce some of the advantages that U.S. affiliates have over their European counterparts. At the same time, there is little doubt that, in order to institute these measures, steps would have to be taken toward policy coordination in the Common Market. Thus, we face a paradox here: the French opposition to the coordination of policies in the EEC has created obstacles in the way of improving the competitive position of European firms and hence it tends to favor U.S. subsidiaries although the declared objective of the French Government is rather the opposite.

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