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Multinational Companies in World Affairs

Raymond Vernon of the Harvard Business School, maker of vivid phrases and pundit on the multinational corporation, wrote one book on the subject in each of the 1960s and the 1970s. The first was entitled *Sovereignty at Bay*, the second *Storm over Multinationals*. Both titles reflect conflict. In the first the nation-state is seen as under attack from an aggressive, highly mobile set of corporations which can be restrained only with difficulty; in the second the implication is that the tide of battle has changed, and the storm rages over the corporations themselves, beset, presumably, by governments and especially by public opinion.

For the 1980s I propose to stay clear of a judgment as to how the contest is coming out but to deal with continuing conflict more generally. Such conflict abounds: between states and firms; sometimes more narrowly between parts of governments such as the tax collector and firms; between two or more governments through the corporation, as one government tries to tell subsidiaries of its national firms abroad how to behave on such issues as "trading with the enemy"; within the corporation between head office and subsidiary, or top management and its agents; between the peoples and culture of the host country and those of the home country, using "host" to signify the country where the subsidiary of a multinational corporation is located, and "home" for the country where the head office is located. Home labor may resent the export of jobs to foreign subsidiaries, and within the host country there may be antagonism between the multinational firm and the work force. If one lists various groups, divided into host and home—firms in the industry and their owners, managers, labor, consumers, voters and governments—a bewildering variety of conflict is

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possible among two or more groups. One is tempted to say not only possible but inevitable.

Conflicts are the essence of politics and interpersonal relations. In economics we assume often, perhaps too often, that buying cheap and selling dear in competitive markets is a form of cooperation with persons frequently unknown to the buyer or seller, who is dealing in effect with Adam Smith's "invisible hand." Conflict exists in economics, however, when a monopoly buyer forces prices down or a monopoly seller forces them up. It is present also in a pie when it is not growing—over the distribution of income among profits, salaries, wages, and rents—often resulting in inflation as each group seeks to shove a burden onto others. A popular book by my MIT colleague, Lester Thurow, calls the United States *The Zero-Sum Society* in which one person's gain is another's loss. Anne Krueger, then of the University of Minnesota, now at the World Bank, calls much economic activity today "rent seeking," rent being the term for payments to a factor of production that is limited in amount but much in demand, so that additional payments do not increase the supply. Those of us interested in sport are aware that there are large scarcity rents from the desire of fans to watch on television the Superbowl, World Series, Stanley Cup, and the like, not to mention the game of the week. The limited (?) number of such attractive spectacles, plus scarce television channels, at least for the moment, produces enormous rents that are fought over by networks, TV stations, advertisers, sports-club owners, and most recently, with great success, by the athletes themselves. Most economists I know have more than a touch of Henry George about them—he wanted a "single tax" on land to divert the rent from a scarce resource provided by Nature from private gain to public use—and we should like, for example, to see government auction off scarce broadcasting channels, as lately it has done with offshore oil-drilling rights. Few, however, have much expectation of such an outcome.

Conflict over rents is intense at the level of the multinational corporation, but the range of conflict goes wider. To the neoclassical economist the multinational corporation may start with a scarce resource, or a new technology yielding a product or process innovation that it has patented and owns alone. Initially rents are substantial, but the corporation usually fails to hold them for long. The rent may be taken over by the host government, as in higher royalties and taxes on companies operating oil or mineral rights, or the initial monopoly advantage from the innovation in product or process may be dissipated by diffusion of the technology and entry of competitors who drive down the price of the output and the rent. In this last case the rent may be said to be captured by consumers, as an addition to "consumers' surplus," a term that measures the difference between what the consumer would be willing to pay for a good and the lower price he actually pays in a competitive market. High profits are a signal that more of the good is desired by consumers. So long as there are competition and free entry, such high profits are an essential part of the market mechanism and prove to be transitory.

Let me retrace a step or two to underline that the theory of foreign direct investment, involving the ownership and control of business in one country by a business in another, starts out with the concept of rents. Stephen Hymer who initially developed the theory in 1960 insisted that to operate abroad, a firm must have a clear and distinct advantage over other potentially competitive businesses in the host country. Operating at a distance from its headquarters where decisions are made constitutes an important disadvantage. Distance inhibits effective communication. If the cultures of the home and host countries differ—as they must do to at least some degree—there is another disadvantage, as the foreign corporation will put its foot wrong from time to time when the native competitor will not. To overcome the disadvantages of working in a strange environment at a distance from its control center, the investing firm must have a strong initial advantage on which it seeks to appropriate the rent. In this effort it finds itself in conflict with others.

Some part of the rent may be siphoned off by employees of the corporation, who are in at least some sense in conflict with the owners. Corporate finance is now addressing this question as "the agency problem," as it recognizes that employees have different economic interests than corporate owners. The agency problem consists in the costs of monitoring their activities to keep top management and salaried staff working for the corporation and not for their personal interests, and bonding those with access to the corporation's assets. Another expensive device to win fidelity to the stockholders' interest is to give management the right to buy stock at below-market prices (so-called stock options), but this is typically not available to local employees of the multinational corporation, since the firm seldom issues extra stock applicable to a subsidiary in a given host country. The agency problem is not new of course. Berle and Means discovered the conflict between management and stockholders back in the 1930s, and the problem has been further addressed by James Burnham in *The Managerial Revolution*. More recently J. Kenneth Galbraith has written about the technocratic structure that manages the corporation, not always in the interest of the stockholders.

Even these discoveries are far from new. Nepotism was sensible in primitive societies when maintenance of high ethical standards was frequently limited to the narrow circle of the family, and outsiders had little sense of wrong in stealing from an unrelated master. In the eighteenth and nineteenth centuries, fixed pricing in retail stores came into practice to replace the bazaar practice of bargaining that persists in some underdevloped parts of the world today, when retail establishments grew in size beyond that which could be managed by a single family, and outsiders could not be counted on, in dealing with the public, to bargain in the interest of the proprietor, especially when the customer might be a member of the employee's family, or a friend. The problem was enormous in those early exemplars of multinationalism, the chartered companies of the seventeenth and eighteenth centuries, like the Royal African, the Levant, and especially the British East India Company, where the company's civil servants in India all ran personal businesses on the side, the company's directors siphoned off profits by selling supplies to the company at high prices from their personal private firms, ship captains took on freight for their own account, and especially the Clives and Hastings received "presents" from the local rulers, whom they helped to choose. The agency problem has been greatly moderated since the eighteenth century and the East India Company. It has not been solved.

The Chicago school of economics which helped formulate the problem in these terms appears less concerned with the ethical than with the economic aspect of the conflict of interests. Economic man maximizes. This means, if he is risk-neutral, that in contemplating any action in self-interest which is against the law, he calculates the benefit of the transgression and compares it with the probability of getting caught times the penalty if caught. The decision is then made on the basis of a cost-benefit comparison. Or society may choose to invest resources in internalizing a high moral standard of behavior for its members, another cost-benefit problem but with public costs and private benefits in reducing the monitoring and bonding costs needed to be paid by principals to keep agents in line, or to limit the damage when they go astray. Ethical standards may grow up without conscious implantation, but there is considerable likelihood that these standards will differ in at least some respects from one sociopolitical entity or country to another, confronting the corporation that straddles national boundaries with a problem of conflict.

The agency problem probably differs somewhat within the multinational corporation, depending on whether the agents or employees—the salaried management that runs the subsidiary—are members of the home or host society. If home, they have a problem of choosing between the advice of Polonius "To thy own self"—read country or culture—"be true," on the one hand, and "When in Rome do as the Romans do," on the other. An American representing an American international accounting firm in Milan once told me that the Italian corporate income tax system is fair. Everyone knows that the tax authorities will double the declared statement of income and of tax, so that each native corporate taxpayer halves its statement of profits and what it deems is the appropriate tax. But American managers have great difficulty in deliberately understating what the letter of the law says to be the tax due. This was said to have been one of the reasons that the Ford Motor Company ultimately decided against buying Ferrari. On the other hand, American managers have less compunction than their native counterparts in taking development subsidies to start up a plant, say in a development region abroad, and then closing it down when the subsidies run out and it proves unprofitable, something that is not in violation of the letter of the law but that the Italian authorities promoting the development of the south—and Italian businessmen—regard as unethical. The biggest issue today is over the fine line that must be drawn among commissions, finder's fees, presents, and bribes in different cultures. The issue hardly presents itself for countries where differences in the traditions of home—say the United States—and host countries—take Australia, Canada, Great Britain, or New Zealand—are relatively narrow. In others, where the head office hires local managers, there may be the sort of cultural clash that is evident in the uproar over recent U.S. legislation on bribery. The Securities and Exchange Commission requires firms only to disclose bribes for the sake of communicating fully to stockholders, but American definitions of what constitutes a bribe—in the Congress any present worth more than $5, or was that the lofty private rule of the late Senator Paul H. Douglas?—do not always converge to those in other countries.

I want to leave the question of the clash of cultures, but before doing so, cannot escape the mention of two problems very much in the news: apartheid in the Union of South Africa, and the Nestlé company's promotion of bottle-feeding of babies in less developed countries where, in particular, water supplies are often contaminated, mothers' views on sterilization may be rudimentary or nonexistent, and breast-feeding is believed by many to be safer as well as more nourishing than formula milk.

On apartheid, I have long adopted a schizoid attitude that irritates purists on one or the other side of the issue. The views on race of the dominant Afrikaner party in the Union of South Africa are repugnant and even abhorrent to most Americans—although perhaps few of us remember the extent to which they mirror attitudes in the Deep South of this country half a century ago and bear in mind the enormous difficulty with which those attitudes have now been largely changed. As a political and ethical animal, I want to put people with such views in Coventry, have nothing to do with them, and cut them off from normal social, sporting, and commercial intercourse. This is the attitude that has led many church groups, and some investing bodies, most recently including Harvard University, to refuse to buy the securities of U.S. corporations that have subsidiaries in the Union, and in fact to dispose of those they own. Some would embargo trade as well, although the dependence of our country on South African supplies of chrome, platinum, vanadium, and manganese gives commercial authorities unhappiness when they contemplate such a course.

The political economist in me, however, recognizes that discrimination against blacks and coloreds in the Union will break down faster the more the rest of the world trades with and invests in South Africa. The big advances of black people in reducing adverse discrimination in this country occurred during the inflations of World Wars I and II, when labor was in very short supply and employers had strong economic incentives to break the color line. On the other hand, discrimination increased during the Great Depression of the 1930s when the last-hired blacks were the first fired. If this experience is applicable by analogy to South Africa, as I think it is, more trade and investment will ease the problem of apartheid, and less will make it worse. The formula has a certain element of "Killing the cat by stuffing it with cream." For multinational corporations to set up investment in South Africa to put pressure on employers, both multinational and native, to break the color lines first in hiring and then in housing, is, I suspect, a counsel of perfection. It is true that Polaroid blunted the opposition of their black employees in the Cambridge area to investment in South Africa by sending a delegation of them to that country to interview Polaroid black and colored employees on the issue. The idea of an embargo or a pullout was greeted by these employees as highly dysfunctional. As between the extreme positions of the embargoists and the Machievellian economic tactic of full steam ahead, I suppose the most practical policy that addresses our ethical condemnation without making native Africans pay for our emotional catharsis is the General Motors tightrope worked out by the Rev. Leon Sullivan, which calls for continuous operation, obeying the law at the edge of it nearest equal rights, and applying continuous pressure to redress the imbalance.

Those who want to crunch Nestlé instead of eating Nestlé Crunch (i.e., embargoing the products of the largest food company in the world because it applied methods appropriate to the developed world in less developed countries) have been successful in getting the company to modify its practices. In particular, Nestlé is undertaking to advertise the importance of proper handling of their formula milk powder—providing what we call today the software that teaches people how to use a given product, whether hardware or materials—and to stop some subtle practices of providing free samples to doctors and hospitals which have had the effect—and probably the intention—of getting mothers to embark early on bottle-feeding. The embargo has thus been a great success. Before its organizers switch to another company and another problem, however, rather like the March of Dimes which found it impossible to shut down after polio had been defeated, it may be useful to give a moment's thought to whether the experience should be generalized. One of the highest rules of ethics is the categorical imperative of Immanuel Kant, which calls on us to take only those actions which can be generalized, that is, to refrain from undertaking those actions that can succeed only so long as only a few people do so. Do we want economic vigilantes running about the world deciding whether given products are suitable in given milieux and enforcing their decisions by embargo when they prove negative, or is that a matter for local governments? Many such governments, to be sure, are inadequately staffed both in numbers and in education and experience, and on this account are frequently overwhelmed by the myriad tasks they have to discharge. It may be granted that the success of the Nestlé embargo is likely to be highly salutary in leading other multinationals to reflect whether they are taking undue advantage of the ignorance of customers. Nonetheless, I have a sneaking nostalgia for the invisible hand of Dr. Adam Smith, operating in anonymous markets in which I do not know and need not know the character and intentions of the people from whom I buy or to whom I sell. Perhaps the size and prominence of the multinational corporation makes a return to that qualified Paradise impossible. And surely any egregious violation of human rights is of concern to men and women of goodwill worldwide.

But to turn at last to economic conflicts! A favorite device proposed to reduce the turbulence in multinational direct investment is the joint venture. In this sort of arrangement a foreign corporation takes a local partner, perhaps on a fifty-fifty basis, and the local partner instructs the outsider how to behave in the particular sociopolitico-cultural-economic framework. One hears less of this proposal these days. When it was continuously put forward in the 1960s, one student and advocate of the practice, Professor Wolfgang Friedman of the Columbia Law School, wrote at least two books on the subject. The salient fact to emerge from these studies, as I saw it, was that most attempted joint ventures failed. Although both foreign and local investors are presumably interested in maximizing income, they frequently operate with different time horizons and different interests in space. The local owners tend to want dividends sooner, are generally less able and/or willing to plow back profits or to sustain initial losses, and in particular concern themselves with the profits of the particular subsidiary rather than those of the multinational corporation as a whole. Joint ventures have thus proved to be a device for exacerbating conflicts of interest at the business level, rather than reducing them between business and the local society, and in most cases after a time one partner buys the other out. In some Japanese companies, for example, the American partner was prepared to wait several years for profits and to put in more money meanwhile; the Japanese partner was not. Or when profits are earned, the local partner may want to have them distributed immediately, whereas the foreign investor, operating at a lower implicit rate of interest, prefers to reinvest dividends and defer payouts for the future. The most troublesome cases are those where the multinational corporation has two subsidiaries in different countries, A with a local partner and B without, and chooses to divert sales from A to B so as to take over 100 percent of the profit instead of only a portion.

Where governments tax corporate profits, every company has a silent partner with which it is obliged to share, and in the case of the multinational corporation with local partners there are four interests at stake: multinational corporation, local partner, home tax collector, host tax collector. One of the first outstanding multinational tax cases arose when an Australian tax commissioner woke up a number of years ago to the fact that two oil refiner-marketers in that country using imported crude oil had very different profit performances. Company A was 100 percent owned by an American oil giant; Company B was 50 percent foreign owned with the other half in local hands. The 100 percent owned company had no profits in Australia and paid no Australian corporate income tax; the joint venture did have profits and did pay taxes. Investigation showed that the 100 percent owned company was paying a higher price for its imported oil. This was a period now seemingly lost in the mists of antiquity when Middle East oil was sold at a discount from posted prices of under $3 a barrel. The joint venture was furnished petroleum at the discounted price and made profits which kept the local partner happy. With no partner the 100 percent owned subsidiary could divert profit to the oil-producing arm of the multinational organization where it could apply the U.S. depletion allowances and thus reduce the total income tax of the corporation worldwide. Later discoveries that U.S. pharmaceutical companies were overcharging their Colombian subsidiaries for the materials used in pill making, to divert profits from Colombia into a Panamanian tax haven, compounded the problem of different interests among the tax departments of the United States, the Colombian government, presumably Panama where taxes were not zero, as well as home office and subsidiary.

Conflict over taxes between corporation and government, and between government and government, has been reduced by widespread attention to the possibilities of arbitrary transfer prices on transactions between parts of a multinational corporation, as opposed to the legal but often national standard that such prices should conform to those that would be set in arm's-length transactions. United States corporations, in particular, have been persuaded to adopt an austere standard by the threat of the Internal Revenue Service that it would determine the income to be taxed where it found evidence of tax avoidance or evasion by arbitrary pricing. Tax havens have been shrunk in number and size by provisions of the revenue code which refuse tax deferral on profits earned in jurisdictions where less than 30 percent of manufacturing processes are carried on. The recent accusation of an employee against Citicorp that it had indulged in wash exchange dealings at fictitious prices to transfer profits to a tax haven in the Bahamas dealt with an alleged attempt to evade British and French but not U.S. taxes.

There is still a long way to go, however, in resolving conflicts among taxing governments, head offices, and subsidiaries. Most have to do with how income and expenses are defined, and how to allocate costs, for the purpose of determining the location of profits subject to tax in a given jurisdiction. Assuming that the tax rates are the same in host and home country, differing definitions of income can result in a sum of income to be taxed in home and host which is more than the total income as seen by the corporation, resulting in some degree of double taxation, or less, leading to tax avoidance. The Internal Revenue Service in the United States has lately become more demanding that some portion of joint costs of running a multinational company—for example, the expense of maintaining the headquarters and the salaries of top management, or the cost of research and development undertaken in the United States—be allocated to foreign operations, not those in this country, thus increasing U.S. taxable income. Host governments on the other hand are reluctant to see a deduction from the net income of the subsidiary for the maintenance of laboratories thousands of miles away and for glass cathedrals in the canyons of New York City. Work on appropriate definitions of income by country is going forward in bilateral tax agreements. Perhaps by the end of the decade the world will arrive at the analytically sloppy, but highly practical, method used for allocating U.S. national corporate income by states and for determining state tax obligations where these are levied. Given the theoretical impossibility of allocating joint costs, a state is assigned a share in the corporate net income earned nationally by the application of a percentage representing the average share of the state in the corporation's national assets, gross sales, and employees.

Apart from taxes, multinational corporations can find themselves squeezed from several sides by governments in the application of other laws, such as antitrust, financial disclosure and the like, and in foreign policy. This last includes the widely discussed trading with the enemy issue, in which countries may have different views on the wisdom of embargoing trade with a given country—for example, the Soviet Union, the Peoples' Republic of China, or Cuba. A number of countries have resented it when, say, the United States wants to extend the range of its foreign policy jurisdiction by directing the head office of a corporation or bank to order its subsidiaries abroad to behave in a certain way. When the U.S. government asks General Motors, for example, to direct its Argentine subsidiary not to export trucks to Cuba, the Argentine government perceives an intrusion by the United States into its jurisdiction and a suborning of its authority. The issue is an old one and turns on the question whether a wholly owned foreign subsidiary of an American corporation should be regarded as American, and required to conform to American policies, or must be entirely subject to the laws of the state in which it is legally incorporated. In domestic law, as I understand it, American courts typically "pierce the corporate veil," to look to the true ownership of assets, and not to the formal arrangements. In Britain the practice is not to pierce. But in foreign policy both countries make exceptions when it meets their immediate interests. The most recent intrusion by the United States of course relates to the blocking of Iranian assets in American banks outside the United States at the time of the taking of the Embassy hostages in 1980. In this case an obviously extralegal action was taken by the United States, allowed by the banks concerned and tolerated by the countries where the various branches were located. The banks cooperated partly because there was no opposing pressure from Britain, Switzerland, Luxembourg, and so forth, and partly because they had countervailing claims on Iran which they wanted to be in position to collect. The foreign governments consented because they approved the purpose of the action and did not want to take action of their own. Nonetheless, the precedent of accepting an assertion of extraterritorial power is seen by lawyers as disturbing.

Thus far we have dealt with conflicts within the corporation, between host and home country owners of a joint venture and between cultures and governments affecting different portions of a corporate entity. We have still to break down separate countries into component classes (or factors of production) and show how the interests of these classes or factors may be competitive or complementary. It would be tedious to lay out a taxonomy of all the possible permutations and combinations. I discuss two: the relations between foreign management and the local business elite, and those between labor groups in two or more countries.

Let me quickly dispose of the relationships of business elites. They can go either way. Domestic business leaders may resent the intrusion of competitors who bid up wages, interest rates, the prices of factory sites and the like, and sell competitive goods more cheaply. They may, as in General Motors in Australia some years ago, be put to work as suppliers to the foreign entity and achieve large gains in productivity by being both instructed in techniques and held up to higher standards of performance. Or, as is widely claimed for less developed countries, the foreigners may combine with the reactionary political forces of the country (e.g., IT&T in Chile), complementing one political group and coming into open conflict with others. I suspect that ideological cases of this last sort, though prominent when they occur and are discovered, are not as widespread as is the common impression. Most corporations choose to maintain a low profile and a thoroughly pragmatic position. And so increasingly do some countries. Charles Goodsell's book *American Corporations and Peruvian Politics* indicates that Peru, after having adopted a highly negative and ideological position on American corporations—nationalizing some, driving others out—has moved to a much more pragmatic position of seeking to solve disputes and work out positive solutions in which Peru gets the benefits of new capital, technology, government revenue, and national income, and the foreign corporations make profits.

The position of labor is more problematic. On the basis of J. Kenneth Galbraith's analysis of the American economy, with corporations rising from local to regional to national stature and in the process inducing the rise in countervailing power of national government, on the one hand, and national unions, on the other, one should be able to forecast a rise of world government—following the loss of sovereignty posed by Vernon through the necessity to harmonize taxes, policies, and the like—and the development of world labor unions. The beginnings of this last have been evident in the International Organization of Chemical Workers in Geneva, Switzerland, organized some years ago by the Canadian Charles Levenson. Automobile workers have been trying for some time to organize so that if Ford, for example, is struck in one country it cannot shift its orders easily to a subsidiary in another. Prospects for international unions are not bright, however. Workers in the separate subsidiaries of a given multinational corporation have conflicting, not converging interests. The capacity of the multinational firm costlessly to shift production from one country to another is doubtless exaggerated, but equally or more so is the power of international unions to counteract such shifting as may take place. About 1910 the Third Socialist International was thought to have had sufficient solidarity across national boundaries to prevent war. As it turned out, the workers proved to be more nationalist than attached to class on an international basis. Such is the likely position if and when a multinational corporation confronts trade union ranks and files in a series of countries.

Thesis and antithesis should be followed by synthesis. If the multinational corporation appeared to be on top in the 1960s, and if in the 1970s it was attacked on all sides and for all sorts of reasons—accused of weakening balances of payments in both home and host country, causing unemployment, worker alienation, malnutrition, the widening gap in incomes worldwide, the oil crisis, and the like—the 1980s offer an opportunity for resolving the set of conflicts on a continuing basis. Conflict is inevitable, since interests frequently diverge and hands on both sides are visible. Moreover there is a fundamental conflict between the economics and the politics of the case. In economics, it frequently occurs that there are economies of scale, and large is efficient; in social relations and political, small, as a rule, is cozy. The optimal economic area, to use a bit of economic jargon, for most goods and services is the world; the optimum sociopolitical area must be small enough so that every individual can have a sense of participation. Belgium is too small to be an efficient economic unit, too large, in the light of the antagonistic history of the Walloons and the Flamands, to be an ideal political unit. The confrontation between the economics and the sociology and politics of the multinational corporation is something the world will learn to live with. The quieter 1980s than the 60s or 70s suggest that peoples are learning to do so.

A number of observers want to resolve the conflict inherent in the multifaceted divergences of interests referred to by writing codes, constitutions, agreements, and the like, setting forth the rights and duties of host and home countries, and of corporations. In some cases, as in the UN Commission on the Transnational Corporation, responding to the Populist sentiments of the UN Assembly, the emphasis will be on the rights of host countries and the duties of corporations; in other cases such as the drafts of the International Chamber of Commerce, the emphasis shifts to the rights of corporations and the duties of host countries.

On the whole these exercises in constitution writing are a vain oblation. It may be possible to paper the cracks with forms of words, but where there is at basis no meeting of minds, the exercise is one in futility. Better than detailed codes of conduct would be a loose framework for dealing with cases, one at a time, within the broadest set of principles, while actual work consists in resolving particular cases pragmatically with an eye to working out reasonable compromises. Common law, not constitutions, is the requirement for the years ahead. The world must learn to live with some minimum of conflict in the field of international direct investment as an inevitable accompaniment of the gains for all parties from combining foreign capital and technology with domestic labor and natural resources. With luck, the passions associated with such conflict will subside, leaving to the various parties the task of working out supportable solutions, not graven on tablets of stone.