U.S. Direct Investment in the United Kingdom and National Economic Objectives

Introduction

This paper poses two questions. First, what is the contribution of U.K. subsidiaries of U.S. firms to U.K. economic welfare and, second, what action (if any) might the U.K. Government take — either unilaterally or multilaterally — to ensure that the net benefits of this contribution are maximised? We propose, first, to make some general observations on these two questions, and then to illustrate our argument more specifically by reference to the impact of U.S. investment on U.K. technology.

1. National economic objectives

For many years now, U.K. Governments have had two primary economic goals — the maximisation of real output from the resources available (at any given moment of time); and the advancement of real output per head (over time). Governments have also pursued certain non-economic objectives — e.g. the maintenance of a certain amount of national political and economic independence, and, in the field of social welfare, adequate provision for the less privileged. But to the extent that the realisation of these aims require the use of scarce resources, they may affect, one way or the other, the success of economic policy. Likewise, there are various practical constraints on the primary economic objectives being achieved, e.g. the balance of payments. But, important as many of these may be in the short run, over a longer period of time their consequences,

for good or bad, are reflected in the gross national product (g.n.p.) or rate of growth of g.n.p.

In this paper, we shall consider only the two primary objectives. This is not to ignore the importance of the others, but simply to contain our argument within reasonable limits. Moreover, our purpose is to assess the contribution of U.S. financed firms which is due specifically to their association with American companies — i.e. their "American" effect.

The problem can be broken down into two parts:

1) What has been the actual contribution of American investment in the past — and what might it be in the future within the framework of past or existing Government policy and institutional arrangements?

2) An estimate of whether this contribution has been (or is likely to be) the "first best", or optimum contribution to U.K. economic welfare. This implies both estimating whether U.S. subsidiaries have been as socially productive as they might have been, and whether or not the resources used by such firms could have been better deployed elsewhere.

2. How far have U.S. firms advanced U.K. economic objectives?

A. As judged by the actual contribution

The current Board of Trade survey on foreign direct investment in the U.K. conducted by Max Steuer (of the I.S.E.) and his colleagues will shed a great deal of light on the operations of U.S. (and other foreign) firms in the U.K. It would be wrong of me to give his statistics, so far unpublished, at this stage. I can say, however, they are broadly corroborative of earlier research on the subject — or, at least, consistent with the trends revealed by such research. May I just summarise these in a paragraph or two.

1) Resource utilisation. Directly or indirectly U.S. firms have added to total employment in the U.K. In the less prosperous areas of Wales, Scotland and North East England it is estimated they are currently providing jobs for about 125,000 people, who would otherwise have remained unemployed.1 We calculate that this has added about 0.3% to the g.n.p. of the U.K.

1 Assuming existing Government policy.
of American origin) is one of the most valuable contributions they have to make.3

As we have described elsewhere, such a contribution may be vertical — i.e., affecting suppliers and customers of U.S. firms; or horizontal — i.e., affecting competitors — regional or industrial. More generally, knowledge and ideas are spread by the mobility of personnel, by the informal interchange of ideas among executives and by the publicity of various management and administrative practices. However much it may be possible to protect innovations in product or process technology, advances in "human technology", e.g. in management marketing, labour relations and capital budgeting etc. are very difficult to keep quiet. In a variety of ways such as these, U.S. knowhow penetrates the U.K. economy. No less important is the added competitive stimulus provided by these subsidiaries, the parent companies of which are among the industrial leaders in the U.S.

Most of these gains reflect the advantages which U.S. subsidiaries derive because of their U.S. associations — or, at least, because they are more closely identified with the American industrial machine. Of course, not all such productivity can be so attributed. In some cases, size is an important consideration; size not only of the subsidiary but also that of the parent company. Another factor is the organisational structure of the multinational enterprise of which the subsidiary is part — for example, the extent to which its foreign operations are closely integrated and harmonised. However, one has to be careful not to take this argument too far, else one will explain away all the advantages. Equally, one must not ignore the drawbacks which might possibly arise from the American impact.7

Finally, even if it were possible to isolate and quantify the "American" impact, we would still be little the wiser about the comparative efficiency of U.K. industry today. Quite a lot of the current advantages U.S. subsidiaries enjoy arise from the economic

2 In 1969, of 21 industrial groups, foreign firms had a higher labour productivity than U.K. firms in 11 cases.
4 P. H. Dunning, op. cil., p. 151.
environment in which their U.S. associates operate or are the results of management decisions taken in the past.  

We conclude. Such evidence as we have suggests U.S. participation in U.K. industry has added both to the efficiency or resource usage, and the growth of output in the U.K. Making a "guess" for the spillover effects of U.S. direct investment the g.n.p. of the U.K. is probably better off by 2-3½%. This assumes that in the absence of foreign direct investment, U.K. Government policy and institutional arrangements would have remained unchanged — a pretty tall assumption.

**B. Is this a first best solution?**

But is U.S. direct investment in the U.K. — or, more realistically, the present trend in U.S. investment — the first best way of realising the U.K.'s economic objectives? Two further questions now need to be answered.

First, are U.S. subsidiaries contributing the most they can to the g.n.p. (or growth of g.n.p.)? If they are not, this may be because, either they are not operating at optimum efficiency, or because the share of the value added by them (i.e. net output) which is remitted to their parent companies (profits, dividends, royalties, etc.) — and hence the "price" which the U.K. economy has to pay for their presence — is, in some sense, too high.

Second, is the U.K. economy organised in such a way that the decisions taken by, and the behaviour of, U.S. firms will bring "first best" results?

Both these issues are very policy oriented, in the sense that Governments can affect their outcome. For, firms, both foreign and domestic, react to actions taken by Governments and apart from a withdrawal of investment (or reduction in new investment) their power is very circumscribed.

**Maximising efficiency.** — At any given moment of time, economic policy is a package of individual measures designed to achieve a variety of ends. Some of these measures — particularly those of macro-economic origin — are general and unconditional, in the sense that they are not influenced by inward investment — even though the need for them may be enhanced by it. An example of such a general and unconditional policy is one aimed at promoting a competitive environment. If, for example, there is a tendency for U.S. firms to promote a more monopolistic or concentrated industrial structure, then the case for such policies becomes the more urgent. Similarly, measures to deal with structural unemployment arising from innovations, rationalisation schemes and so on, become more pressing when multinational companies are organised on a geocentric basis, and seek to integrate their operations throughout the world.

If, however, it appears that there are certain differences in the behaviour of U.S. firms cf. domestic enterprises, then blanket type policies may be insufficient. In a different field, the general instruments used by the U.K. Government to maintain full employment do not fully meet the needs of certain geographical areas; these have to be supplemented by more selective and discriminatory measures, e.g. the regional employment premium. Similarly, because, as we have described, U.S. subsidiaries sometimes enjoy certain advantages (or disadvantages) over indigenous companies (because of their multinational links) — which, inter alia, may affect the competitive structure — more specific policies may be necessary to ensure that their contribution to the g.n.p. is maximised. This applies equally to the dissemination of knowledge and the effect on the efficiency of U.K. firms. One of our knowledge gaps is the size and character of the productivity "multiplier" of U.S. investment on the rest of the economy. Here we could certainly benefit from a input/output matrix for U.S. firms in the U.K., though, as far as I know, none has yet been compiled.

There is another aspect of this problem to maximising economic welfare (in the limited sense in which we have defined it) which arises from the character of the operations of U.S. subsidiaries. Particularly among multinational enterprises in high technology industries, there is an increasing movement towards geographical product or process specialisation. This brings with it a new kind

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9 Again, we come from consideration, the effects of such investment on the distribution of the g.n.p.
of economic interdependence between firms and industries, based on organising the global operations of a multinational enterprise in the most efficient (or at least, the most profitable) way. This has important implications for nations. Even if this process were shown to raise world economic welfare (and this, though probable, is by no means proven) it certainly does not imply that the g.n.p., in each and every country in which the multinational enterprise produces, economic welfare is advanced. If for no other reason, Government constraints on the free trade of goods and factor services would inhibit this. Hence, it may be that foreign firms choose to produce certain products or processes in the production chain which are less valuable to the host economy than some alternative and perhaps less specialised “package” of output. On the other hand, the U.K. may gain more than it loses by this form of international division of labour. One thing seems very probable; the way in which multinational enterprises organise their world production is likely to have increasingly important consequences on the economies in which they operate, and the implications of this for policy are quite extensive.

This argument takes us right into the core of the nation state controversy. I will not dwell on this here to suggest that as the world is at present organised, the maximisation of the national economic welfare and the freedom of the multinational enterprise to behave exactly as it wants, are, to some extent at least, inconsistent objectives. Moreover, I would suggest that the truth of this claim varies in direct relationship to the degree to which (a) a country is nationalistic in outlook [cf. for example, the attitudes of France and Germany towards foreign investment] and (b) foreign subsidiaries dominate economic activity (or particular sectors of economic activity) in host nations [cf. for example, the attitudes of the U.K. and Canada].

Sharing of output. — It is possible that even though they may operate at maximum efficiency, U.S. firms may not be benefiting the United Kingdom economy as much as they could, because the share of the output they produce which is remitted back to the U.S. is higher than it might be. The extent to which U.S. firms earn economic rent or surplus profits is dependent not only on the factors already mentioned, but on their ability to remit income by disguised means e.g. the manipulation of intra-group prices — not only of goods but of services. It is here where more specific Government policies may be needed to deal with the situation. Such evidence as we have suggests that there is not a great deal of “leakage” of income from the U.K. in this way, but obviously the possibility of the benefits of inward investment being eroded in this way needs to be kept under close scrutiny.

3. Towards an international approach

A. The need for multilateral policies

By contrast, it may be that the contribution of U.S. firms is not as much as it might be due to deficiencies in the host country’s economic policy or institutions. To a certain extent, this is the situation in Europe today. The American challenge is serious, precisely because of the fragmented and unco-ordinated policies and inappropriate institutions of European countries to deal with their economic and technological situations. Or to give another example, rather than argue that inward investment should be curtailed where it is shown to result in an adverse balance of payments situation, it may make better economic sense for the Government of the host country to arrange its economic affairs so that this kind of effect does not matter.

In some cases, however, bilateral or multilateral policies may be required. For example, most issues of extra-territoriality involve investing and recipient countries, and can only be settled by bilateral specific policies. On the other hand, attempts to prevent recipient countries from using “unfair” practices with respect to encouraging (or discouraging) inward investment (hence driving up its “price”) require multilateral general policies: so, indeed, may policies of investing countries to influence the dividend remittance and financing policies of their foreign subsidiaries.11 Outside the economic sphere, there is a need for harmonisation of policy with respect to legal and accounting procedures. The concept of a “European” company is already firmly established; the idea of a “world” company is no longer a pipe dream. Accompanying this, there may well be need for a parallel to the International Court of Justice to deal

11 Witness the widespread effects on European capital markets following the restriction placed on U.S. direct investment by the U.S. Government in January 1978.
with international disputes arising from the operations of international firms.

Finally, mention should be made of a group of problems arising out of the international company, which only a sectoral unilateral or multilateral policies can resolve. Of these, the best example is of the attitude of labour towards the international company. There are two issues of particular importance here. First, trade unions may well seek for a general harmonisation of wage rates in all countries in which the company operates; second, there is the question of the effects of the operations of the international company on employment. Each of these issues could raise serious problems in the not too distant future; a glimpse of these is shown in the Trades Union Congress Economic Review for 1976.\textsuperscript{12}

B. Alternatives to inward investment

There remains the question, "Could the benefits of U.S. investment be obtained better (i.e. more cheaply) by alternative routes?" This really is an exercise in trying to evaluate the opportunity cost of U.S. participation and/or different types of participation. It may be asked why there is a problem? Why cannot market forces decide this issue? If the Government creates the right kind of economic environment, surely decisions can be left to the private sector?

I think there are three reasons why this is not the case — and each reflects imperfections in the market. First, there is the relatively high cost of obtaining certain types of knowhow — and sometimes, of even knowing where to obtain the right kind of information. Second, at least part of the cost of producing knowledge (and we have already suggested that knowledge, in one form or another, is the most valuable commodity U.S. firms have to offer the U.K. economy) is financed by the public sector, where market considerations may be secondary to others. Third, there are important external social costs and benefits associated with inward investment which do not fully enter the calculations of multinational enterprises when deciding their investment programmes. For these

\textsuperscript{12} The ideas in this section are further taken up in a prepared statement written by the author for the Joint Economic Committee of the U.S. Congress (Sub-Committee on Foreign Economic Policy), July 1976.

\textsuperscript{13} Alternatively, the market might overrate the net benefits of inward investment, and rather more constraints on foreign firms might be called for.

reasons, a cost/benefit analysis of inward investment and its alternative becomes necessary.

Let me give a very simple illustration. Suppose U.K. consumers are interested in obtaining a particular drug at present manufactured in the U.S. Several possibilities arise. The product could be imported: U.K. firms could produce it but import (by one means or another) the necessary technology; an American firm might set up a subsidiary in the U.K. to manufacture the product; U.K. firms might try to produce a similar product, using their own technology. Left to the market, it may be best for a U.K. firm to manufacture the drug, but buy the necessary technology through a licensing agreement. But this would not necessarily be in the best interests of the national economy. Compared with the setting up of a foreign subsidiary, the direct impact on the U.K.'s g.n.p. may be more favourable, but the technological spillover effects — which obviously the investing firm is not really interested in — could be much less; and though a new product would be added to the range of products supplied by the U.K. pharmaceutical firms, the technological dependence on the U.S. would be no less. For these reasons, host Governments may wish to intervene in the market process to tilt the balance towards inward investment.\textsuperscript{13}

The question nevertheless remains; what kind of inward investment? The impact of the subsidiary of a U.S. firm — even within a particular industry — on the U.K. economy may differ considerably according to both the way in which it is financed and how its activities are integrated with those of the rest of the enterprise of which it is part. The technological spillover effects of a U.S. subsidiary in the machine tool industry may be no greater if it is 100% financed rather than 51% financed; but they may differ considerably according to the extent to which its operations are vertically integrated.

Nor is it possible to get very far with a macro cost/benefit analysis. By studying the ways in which different industries (or size of firms) obtain their technology and expertise, it may be possible to formulate general principles as to the conditions in which the subsidiaries of U.S. subsidiaries are most likely to max-
multinational enterprises play an important role, is more susceptible to the winds of economic change than one which is self-sufficient. This is a price which, at times, and to particular sectors of the local economy, may appear a heavy one. Certainly this instability can be cushioned by appropriate Government policy towards redeployment and retraining, but it is a cost that any economy which seeks to keep pace with changes in world technology and conditions of demand has to pay.

4. Technology: a case study

It is difficult (and sometimes not very meaningful) to separate the various effects of inward investment, but, as technological advances are one of the main sources of economic growth, it is not surprising that attention has sometimes been focused on this issue.

First, again a few facts. U.S. firms in the U.K. are concentrated in high technology industries and their share of the output of these industries is growing. The obvious advantage to the U.K. economy is the access to the research and development of the parent company and latest management techniques — providing that the price paid for such knowledge is less than that for which they could be obtained elsewhere. The result of these benefits are shown in higher productivity and an accelerated rate of innovation, which, in turn, keeps advanced the U.K.'s international competitive position. Certainly, one of the main reasons for the improvement in Europe's export of high technology products in recent years has been the increasing participation of U.S. investment. It has been estimated that these American financed firms accounted for one-third of the total increase of such products between 1955 and 1964.46

There are two main views about the technological impact of U.S. investment in the U.K. One is that it is all — or very largely — to the good. The basic premise upholding this view is that the permeation of new U.S. products and techniques throughout the

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34 Similarly, with the alternative forms of outflow of resources, though this paper has concentrated very much on the effects of the inward transfer of resources.

45 In the form of royalties, fees or profits.

economy adds more to the g.n.p. than could have been obtained from any alternative use of resources, including payments made for this knowhow.

The other view, expressed most forcibly by the Ministry of Technology, emphasises two main dangers of this trend. The first is that the U.K. may become technologically too dependent on the U.S. to the detriment of her own indigenous research. The second danger is that, since the U.S. is itself a competitor to the U.K. in world markets, it follows that if she can obtain the fruits of U.K. research cheaply, then this could operate to the U.K.'s long-term disadvantage.

Where the balance lies between these two views can only be settled by the facts. These will differ, inter alia, according to both the quantity, distribution and efficiency of U.S. participation in particular industrial sectors. No general conclusions would seem possible. It is also necessary to distinguish short and long run effects.

However, let us make one or two general points before turning to some unanswered questions.

In principle, it should be possible to get some idea of the value of the technology — including management technology — imported from the U.S., in relation to the price paid for it. One does not pretend this would be an easy thing to do, but a broad "guesstimate" should be possible. What is much more difficult is to calculate whether this is the "first best" solution to obtaining the technology in question — assuming that it is thought desirable to buy the technology in the first place. I know of no comprehensive study which has attempted to assess the comparative advantages to the host country of importing technology through licensing agreements vis à vis direct investment.

It is also extremely difficult to evaluate the technological drawbacks to inward investment. There are, I think, two main issues. First, where a U.S. firm takes over a U.K. firm to gain its technological expertise, is it paying a fair "social" price for this, or is it getting the knowhow too cheaply? The word "social" implies that the value of the knowledge to the selling company may underestimate its value to the economy. Providing that it pays the price which will compensate the U.K. for any worsening of its competitive position (this has to be considered net of any gains consequent upon a reallocation of its research personnel, if the research of the U.K. company is disbanded) then this can be treated as a straightforward sale from the U.K. to the U.S.

The second issue is the control issue. This, in turn, has a number of implications. One is that the U.S. may be able to influence the direction of technological activity in certain U.K. industries, including the methods of production, to its own advantage which might run counter to the U.K. interests. It also suggests that the U.K. may well be technologically dependent on the U.S. and, because of this, lose a certain amount of its economic sovereignty. This latter argument is part of the economic nationalism debate, which cannot be resolved in economic terms only. The best the economist can do is to estimate the costs (if there are costs) of this particular viewpoint.

On the question of the direction of technological activity it is possible to envisage situations where a subsidiary of a U.S. multinational enterprise may not operate to the maximum net benefit of the recipient country. What the host Government then has to decide is whether it should try to influence the behaviour of such enterprises by specific policies of one kind or another, or to encourage other means of achieving the same result. This, of course, it cannot do without a detailed analysis of the appropriate costs and benefits.

5. Some unanswered questions

A lot of questions remain unanswered. Some are more important than others and there is disagreement as to the priority of these. We are still feeling our way on the subject of the impact of multinational enterprises on individual nation states. On the specific questions of U.S. investment in the U.K. economy the results of the current Board of Trade enquiry should greatly advance our knowledge on its actual contribution to the U.K. economy. But, I suspect much will still need to be done before one can assess that it is making a first best contribution. My hunch is that in the great majority of cases, it is coming pretty close to the mark

but, as we have said earlier, there are other than economic issues involved.

On the specific question of technology, in my view what is most needed is a study, first, of the costs and benefits of alternative ways by which the U.K. might "buy" technology — including producing itself and, second, of the extent to which the U.K. economy is properly organised to take the fullest advantage of the technological contribution of U.S. and other foreign firms.

John H. Dunning

Reading

The Debt Bearing Capacity of Developing Countries - A Comparative Analysis

1. Introduction

The increasing debt burden of developing countries has been the subject of extensive international discussion. The rising flow of capital from the rich to the poor countries has contributed greatly to the maintenance of a growth momentum in most countries and the acceleration of growth in some. At the same time, the greater amounts of loans and their terms have resulted in a return flow of amortization and interest payments of such magnitudes as to constitute, in many cases, an obstacle to growth and flexible management of the balance of payments. The situation had led to strong arguments in favor of a softening of lending terms and an increase in outright grants. The creditor countries organized in the Development Assistance Committee of the OECD have recognized the problem by agreeing to the adoption of targets for softening further the terms for their official capital assistance.1

1 The author gratefully acknowledges comments received on an earlier draft of this paper from James McGibbon, Anisul Hoque, and Ilmoo Yoo. K.J. Hong assisted in the preparation of technical material. The views expressed in this paper are not necessarily those of the World Bank, of which the author is a staff member.

1 The DAC countries agreed to certain targets for the terms of official lending in 1969 and subsequently liberalized these targets in 1979. There are at present three alternative (Cf. OECD, The 1969 Report of the DAC Chairman):

(a) at least 70 per cent of all official assistance in the form of grants; or
(b) for at least 85 per cent of official development assistance each particular transaction has a concessional element of 65 per cent. (Concessional element or grant element is defined as the difference between the base value of the loan and the present value, calculated at a 10 per cent discount rate, of the stream of interest and amortization payments, expressed as a percentage of the base value. An example of a qualifying term is 30 years' maturity, 8 years grace on amortization, and 2.5 per cent interest). (c) 85 per cent of the official assistance program (both grants and loans) has an average grant element of 85 per cent.

The Pearson Commission recommends that the terms of official development assistance loans should be: interest of no more than 2 per cent, maturity between 25 and 40 years.