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THE ECONOMIC ANALYSIS OF THE MULTINATIONAL ENTERPRISE: READING VERSUS JAPAN?

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I. *The Context*

Recent publications may have given the impression of a confrontation of views between economists who base their analysis of the multinational enterprise on the internalisation paradigm and those who follow a "stages of development" or "an international division of labour" theory of foreign direct investment [Kojima and Ozawa (1984b), p. 87]. This article uses the term "Reading School" for the former and "Japanese Approach" for the latter [key references are Kojima (1978) and (1982)] merely as convenient shorthand. This two-cornered confrontation is a simplistic view of a situation where the major contributors are searching for an improved theoretical explanation of the nature and pattern of the operations of multinational enterprises.

There is substantial agreement between the parties on several points.

(1) Both approaches pay considerable attention to the role of location factors. Both Reading explanations of foreign direct investment [Buckley and Casson (1976) (1985), Dunning (1981) (1985)] and Kojima's approach [Kojima (1982), Kojima and Ozawa (1984a)] emphasise factor endowments.

(2) The form of foreign involvement is deemed to be important. This has been an essential theoretical plank in Reading approaches from the beginning when the choice between licensing and foreign direct investment proved to be a crucial illustration of the explanatory power of the internalisation rubric. This seems to be implicitly acknowledged by Kojima and Ozawa (1984b) in their analysis of the range of activities performed by Sogo-Shosha. Paradoxically, it still receives little attention in their latest theoretical paper (1984a).

(3) Both approaches acknowledge the importance of the welfare implications of foreign direct investment. The Kojima/Ozawa view here is direct, unequivocal and is stressed as a major outcome of the so-called "general equilibrium" approach. The welfare implications of the Reading micro theory are more contingent and subtle but are perhaps less explicitly developed. There is undeniably, an underlying clash of ideology or worldview as acknowledged, albeit very crudely, in the Kojima and Ozawa 1984 paper (p. 18). We return to these crucial points in Sec-

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tion II.

(4) Account is taken by both schools of the "new forms" of foreign involvement. Kojima and Ozawa (1984b) refused to acknowledge the large amount of attention paid to new forms by Reading economists [cf. Buckley (1983a), revised version in Buckley and Casson (1985)]. The emphasis on transactions costs minimisation in the Reading approach is a powerful device in explaining and predicting forms of involvement. The interesting and perceptive analysis of the operations of Sogo-Shoshas given by Kojima and Ozawa (1984b, particularly pp. 84–86) concentrates on the trading company's abilities to minimise transactions costs. Indeed, they acknowledge "when all transactions are internalized, there is no more business left for transactional brokers." Their careful specification of the precise conditions where internalisation costs outweigh benefits is a model of Reading technique. It is precisely this careful analysis of the incidence of transactions costs which gives the general concept of internalisation its specific predictive and explanatory context. Their analysis takes the understanding of the role of Sogo-Shosha a large step forward.

(5) Implicit in both approaches is the understanding that economic systems differ and this affects institutional design. This point is expanded in Section III.

(6) Despite Kojima and Ozawa's surprising assertion to the contrary (1984b, p. 80), both Reading and Japanese approaches acknowledge the importance of market-making as a raison d'être of multinationals. Indeed, Casson [(1982) revised version in Buckley and Casson (1985)] explicitly considers the market-making functions of multinationals as a means of reducing transactions costs. The domain of intermediating or brokerage activities of trading companies parallels this train of thought.

(7) The specialisation of function brought about by the market, by cooperation or by new forms of international involvement (quasi-internalisation in Kojima and Ozawa's terms) has again been analysed by Reading economists [see Casson (1982)]. However, Kojima and Ozawa persist in detecting "pseudo-economies of scale" which are economies conferring private benefit but social cost (1984b, p. 84). Transfer pricing is of course easier between wholly owned units of the same firm than between units organised on a group basis but this is to detect shades of grey, not a rigid dichotomy. The role of general traders as information networks, reducing uncertainty in transactions whilst appropriating the rewards is an example of institutional arrangements with mixed welfare outcomes. The Sogo-Shosha's reputation as honest brokers is a non transferable asset conferring private benefits whilst reducing trading costs. This is expanded in Section IV.

(8) Alternatives to the operation of the multinationals are discussed in the two approaches, but from widely different perspectives. Following Buckley and Casson (1985 px), "Focussing on the firm alone can give a very misleading impression of the special characteristics of the MNE." The sole alternative discussed in the Kojima/Ozawa theoretical model is trade and arms' length trade at that.

II. *Welfare Implications*

Kojima and Ozawa (1984a) allege that "The most serious weakness of the micro-theoretic approach to DFI is a total disregard of social costs or benefits" (p. 16). The Reading approach is indeed concerned specifically with the maximisation of profit and has not dealt explicitly with social welfare, although various welfare implications have been drawn. It is in this direction that the Reading approach is currently progressing.

However, the sweeping welfare conclusions drawn by Kojima and Ozawa remain unjustified as my 1983 article attempted to show. In that article, it was shown that the perfectly competitive assumptions of Kojima's model (1982) were violated by introducing the imperfections necessary to achieve his results in the host country. Criticisms have also been made by Ardnt (1974), Mason (1980), Gray (1982), Geroski (1979) and Lee (1984) among others.

The reformulation of the theory [Kojima and Ozawa (1984a)] remains unsatisfactory. All non capital and labour production conditions are lumped into 'E,' the "entrepreneurial endowment." A hierarchy can thus be created of high-E endowed countries, medium ones and low-E endowed countries. These can then be characterised respectively as the USA, Japan and the South. Direct investment on the North-North model flows between "the USA" and "Japan" on the basis of E endowments, leaving North-South investment to be determined either on a traditional Hecksher-Ohlin basis ("Japan" to "South") or on an E endowment basis analagous to technology gap investment ("USA" to "South"). Welfare implications as before [Kojima (1982)] favour "Japanese type" investment over "American type" investment in North-South trade and produce a "mutually agreed upon international division of labour" [Kojima (1970), Kojima and Ozawa (1984), p. 14)] in North-North investment. "Japanese" foreign direct investment is everywhere welfare improving and only US trade restrictions prevent adjustment to global equilibrium!

Briefly, the Reading approach recognises both welfare gains and welfare losses from the establishment and growth of multinational firms. Welfare gains arise where the replacement of an imperfect external market results in a superior allocation of resources internally and where a new market is created where none existed before: "internalisation of an externality." Welfare losses arise where multinationals maximise monopoly profits by restricting the output of (high technology) goods and services and where vertical integration is used as a barrier to entry. Further, multinationals may reduce social efficiency because they provide a more suitable mechanism for exploting an international monopoly than does a cartel, i.e., by internalising a collusive agreement multinationals make the enforcement of collusion more effective [Buckley and Casson (1985)]. This tension in the static welfare implications of Reading analysis is between the 'asset power' of multinationals [Teece (1983), Williamson (1980)] and the transactional economies brought about by internalisation [Buckley and Casson (1985)].

It is, however, much more important to see the dynamic elements in the Reading paradigm. The internal market allows greater inter-plant and functional cooperation (e.g., between production, marketing and R & D) and in the long run this will stimulate both the undertaking of R & D and its effective implementation in production and marketing. Consequently, dynamic welfare improvement is likely to result.

The Japanese approach is based on the national economy and it is at the level of nation states that "welfare implications" arise. The criteria of welfare maximisation is volume of trade in a free trade, restrictionless, frictionless world. Indeed, the final sentence of the Kojima and Ozawa article (1984a) notes the role of foreign direct investment as a "crucial catalyst" in achieving long term dynamic comparative advantage for the source country. Returns to labour and capital and by industry can be obtained by the Kojima Ozawa approach but it is national advantage which interests them. 'Direct investment mercantilism' is an appropriate description of their policy conclusions. The normative element in their analysis remains as Buckley (1983b) pointed out. (See also Dunning [1985)].

III. *The Influence of National Institutional Backgrounds on Outward Direct Investment*

It is undeniable that the amount ,nature and industry structure of outward direct investment are influenced by the source country's institutional economic structure. Recognition of this fact has been a feature of Reading analysis as well as Japanese writings: e. g., "MNEs exhibit certain characteristics which are attributable to their nationality" [Buckley and Casson (1976, p. 31]. An obvious example of "push factors" is the absence of domestic raw materials and the need of multinationals to control key inputs. The relevance of this motive to Japanese direct investment is obvious. Uniquely, this is often done through 'group' investiments co-ordinated by Sogo-Shosha and with Government backing.

The influence of source Government controls or encouragement to foreign direct investment can have a major impact [Bergsten, Horst and Moran (1978)]. Government permission, exchange control regulations, capital controls or "restraints" can reduce direct investment below its 'natural rate.' Exchange rate policies fostering overvalued currencies facilitate outward investment. Government encouragement to foreign investment by tax incentives, "administrative guidance," easing of bureaucratic interference or by Government to (foreign) Government negotiations can have an enormous impact on outflows.

The form of outward investment is also influenced by home institutions. Low cost labour as a pull factor will be stronger when domestic labour is expensive (or troublesome). Tax havens are more attractive to multinationals from high tax source countries and so on. The relative position of source and host countries on these attributes of course influence direct investment flows. In these background influences can be found some explanatory power. The institutional configuration of countries can be included as a location factor.

In the particular instance of the analysis of Sogo-Shosha, their use of specific information in a confidential manner has a great deal in common with the international merchant banks from Western economies. [See Yannopoulos (1983)]. The relatively underdeveloped nature of the pure capital market in Japan is a major reason for this development. Thus, the use of internal capital markets within Sogo-Shosha is a response to the institutional conditions of the source economy. In contrast, such services from Western economies have developed within specialised banks operating in the external market for capital.

As Yannopoulos (1983) points out, there are differences among countries in the availability of information inputs characterised by high communication costs. Performance of services requiring these inputs necessitates a local physical presence. These facts contain the germ of the explanation of the development of transnational banks and the international expansion of Sogo-Shosha.

IV. *Cooperation between Firms in Foreign Direct Investment*

In their analysis of Japan's general trading companies, Kojima and Ozawa (1984b) make much of the trading companies' creation of new markets, apparently suggesting that internalisation must replace markets (p. 80). Indeed the Sogo-Shosha do operate internal markets in brokerage and information activities. The extensive trading network and reputation as honest brokers are non-transferable assets giving them opportunities to effect "new combinations" and earn a return. Such assets are also a barrier to entry facing potential new traders/brokerage agents. The two edged welfare sword applies to Sogo-Shosha as well as conventional multinationals! None of this is incompatible with received Reading theory. To the extent that new markets are created, opportunities for trade increases and welfare is enhanced. To the extent that Sogo-Shosha internalise cartel-like activities and increase price by restricting output over the arms length position (and divert trade away from cheaper sources to linked (Japanese) suppliers) welfare is decreased.

Kojima and Ozawa also emphasise the group investment activities of Sogo-Shosha, particularly where very large foreign ventures are concerned (1984b, pp. 83–84). They emphasise the mix of market and organisational "principles" in the operation of Sogo-Shosha and point to the crucial role of control over information of the companies which they describe following Williamson (1975) as "information impactedness." "Indeed this concept further helps to explain their strategy of keeping their central and regional offices wholly-owned" (1984b, p. 85). This exactly parallels the activities of (non Japanese) multinationals in keeping core skills under total control. In the case of Sogo-Shosha these core skills are knowledge of trading opportunities, margins and brokerage/arbitrage possibilities. In traditional multinationals they are technology or marketing based. [See also Enderwick (1985)].

The role of cooperation between firms is emphasised by Kojima and Ozawa as a third mode of coordination (or third "principle") distinct from market and 'hierarchical' internal fiat. In their theoretical annex to *Japan's General Trading Companies*, G. B. Richardson's 1972 article "The Organisation of Industry" is extensively and approvingly quoted. Richardson points to a "dense network of cooperation and affiliation by which firms are interrelated" (833) and gives subcontracting, supplier relationships in manufacturing and marketing and the pooling or transfer of technology as examples of planned coordination across firm boundaries.

A parallel rediscovery of Richardson's paper is that of Wilson Brown in 'Firm-Like Behaviour in Markets: The Administered Channel' (1984), in which Brown demonstrates that as well as the widely acknowledged market-like behaviour in firms, there also exists firm-like behaviour in markets through administered marketing channels arising from non pecuniary influences of one channel partner on another.

A further development along these lines is the "Interpenetration of Organization and Market" analysed by Imai and Itami (1984), who distinguish "arena" and "principle" in resource allocation mechanisms. They then divide the competing principles of allocation by type of decision making transaction and by membership of participants to arrive at a classification system of resource allocation mechanisms (Figure 1, p. 289). They then compare US allocation systems with Japanese systems, finding that their conceptualisation explains stylised differences between the two economies.

An attempt to classify new forms of international industrial cooperation led Buckley [1983a revised version in Buckley and Casson (1985)] to specify classification in five dimensions: the locus of control, extent and mode of resource transfer, time and space limitations. The incidence of transaction costs and division of returns between the parties were seen as crucial explanatory factors in the design of technology transfer arrangements. The conclusion was that "alternative strategies rest on the ability of firms and host nations to build satisfactory institutional forms partially to reconcile competing interests" (1985, p. 59).

The importance of influences which are non market and non conventionally organisational (non-firm) is acknowledged by all the above contributions. In examining in detail issues of the allocation of resources and rights, a simple two fold dichotomy: firm and market, often will not convey the richness of organisational design. However, we must not forget that the purpose of a theory is to explain as wide a variety of observed phenomena with as parsimonious a set of axioms as possible. Further theory must not slip into simple description or arid taxonomy. In order to be explanatory and predictive, we require the mechanism by which one organisational principle changes into another and the conditions which precipitate that change. Until the incidence of costs and benefits of the cooperative form can be as well specified as the shift from firm to market and vice-versa, its introduction allows theory to decline to description. In other words, Richardson's conceptual framework requires operationalising in the way that Coase's 1937 article has been [by Buckley and Casson (1976) and others]. Only then can predictive statements be derived from an interesting conceptual piece.

V. *Conclusion*

This note has attempted to show that the Kojima/Ozawa theoretical model is an inadequate explanation of the behaviour of multinational enterprises, Western or Japanese. Indeed, when analysing real world activities, such as the operation of Sogo-Shosha, Kojima and Ozawa use the internalisation paradigm to give content to their analysis.

As in many other controversies in economics, a true convergence is beginning to occur as authors focus on the real issues. Attention to concrete issues necessitates an analytical framework with a real cutting edge and my contention is that the Reading approach provides this element. The use of a parsimonious set of axioms to explore a wide variety of phenomena must commend the Reading analysis of multinational enterprises.

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