GIANT MULTINATIONAL CORPORATIONS: MERITS AND DEFECTS

By KIYOSHI KOJIMA*

I. *Introduction*

Giant multinational corporations have been much condemned in recent years. They gain profits from direct foreign investments stretching around the globe, systematising these investments via vertical and horizontal integration to make even greater profits. This necessarily leads to monopolistic or oligopolistic conditions in the industries in which they operate. The costs and gains of this type of economic organisation must be carefully examined, and it is the aim of this paper to consider the merits and demerits of the giant multinational corporation.

Multinational corporations achieve two types of economies of scale: the first are "genuine economies of scale", which contribute to a savings of real resources in world-wide sourcing; the second, "pseudo economies of scale" which result in increased profit for the corporations, but with no corresponding savings in real resources. Examples of this second type are transfer pricing, tax havens, and foreign exchange manipulations. A comparison of the merits of the first type of economies of scale and the demerits of the second, pseudo type, will produce an evaluation of the worth to society of these multinational giants (Section II).

Even in the category of "genuine eonomies of scale", however, all operations by the corporations do not lead to benefits for society. These economies of scale have limitations and easily turn to diseconomies of scale. Distribution, transportation and sales of products as well as management of firm's assets may be performed more efficiently and in a more competitive way by independent trading firms, shipping companies or banks instead of by intrafirm integration of giant multinationals (Section III).

In this context, the role of Japanese trading companies (Sōgō Shōsha) is evaluated. Japanese direct investments abroad are still in their incipient stage. A limited number of direct foreign investments are scattered to various area from each Japanese enterprise. These scattered independent investments are functionally integrated with each other by trading companies, making it possible for the Japanese enterprises as a group to operate much like the giant multinational corporations. This is the only way for the Japanese economy to compete with American and European giant multinationals (Section IV).

The biggest defect of the giant multinationals in their contributions to economic development and porsperity of international society comes from the fact that their behaviour and performance are justified merely from the point of growth of the firm, entirely neglecting the division of labour between nations. This is the conclusion of the present paper and from

* Professor (*Kyōju*) of International Economics.

this, a new guideline for the conduct of multinationals is derived (Section V).

II. *Characteristics of Multinational Corporations* *——Systematisation of Economies of Scale*

Definition of MNC

Each writer seems to have his own definition of the multinational corporation.[1] "Multinational" literally means a firm operating in more than one country. A UN report defines transnational corporations as "enterprises which own or control production or service facilities outside the country in which they are based. Such enterprises are not always incorporated or private; they can also be co-operative or State-owned entities".[2] This is too broad a definition. Rather, it is a definition of direct foreign investment itself.

In order to confine the discussion to the controversial international operations which are the subject of this paper, the term "multinational corporation" will be defined in a narrower sense for the purposes of this discussion, as follows: "a multinational corporation is a gigantic oligopolistic enterprise which spreads a network of a great many factories and distribution bases in suitable places all over the world, and pursues profit maximisation with this global strategy."[3] Therefore, the following qualifications are added to the broad definition: (1) it is a big enterprise (such as the top 200 companies in *Fortune's* ranking), (2) it is operating in at least six countries, (3) the operation is not limited only to exportation (sales) or overseas assembly of parts, but is extended to full-scale production (in manufacturing, mining and agricultural industries), (4) its activities abroad account for a rather high percentage (over 20-25 per cent for example) in sales.[4]

As typical examples, we may mention oil producing companies such as Exxon and Shell, machine industries such as GE and IBM and a conglomerate such as ITT. These companies, as if "invisible empires,"[5] possess more capital than the national income of all but the largest sovereign nations.

Let us try to analyse the characteristics of a giant multinational corporation in economic terms. It is an enormous enterprise which pursues the maximisation of profit on a global scale so that it may develop and survive. To do so, it fully utilises every possible "economy of scale," including both internal and external economies, through the systematisation of each of these individual "economies of scale."

Without the rapid development of transportation and communications media in recent years, giant multinationals would not be able to operate in their current form. It was these developments which were the stimulus for the world-wide markets which now exist for

[1] See Yair Aharoni, "On the Definition of a Multinational Corporation," A. Kapoor and P.D. Grub, eds., *The Multinational Enterprise in Transition*, Darwin Press, Princeton, 1972, pp. 3-20.

[2] *The Impact of Multinational Corporations on World Development and on International Relations*, United Nations, New York, 1974, p. 25.

[3] A similar definition is presented in Giichi Miyazaki, *Shihon wa Kokkyo o Koeru* (Capital moves beyond Sovereign Frontiers), Asahi Shinbun Sha, Tokyo, 1970, p. 91.

[4] For example, Vernon (or Harvard Business School group) chooses 187 mulitnationals according to similar qualifications in Raymond Vernon, *Sovereignty at Bay—the Multinational Spread of US Enterprises*, Penguin Books, 1971, pp. 17-27.

[5] Louis Turner, *Invisible Empires*, Harcourt Brace Jovanovich, New York, 1971.

suppliers and buyers. Operation in these global markets requires a global information network and the utilisation of the economies of scale in transportation as well. A firm must be large enough to realise these economies, and the multinationals are a response by profit-maximising businessmen to these changing conditions.

Thus, by reducing time and money spent, recent development of transportation and communication promoted international trade of products and direct foreign investment as well. But it cannot be said definitely yet that the development of these media was more advantageous for the promotion of direct foreign investment than international trade. Although freight costs were reduced, tariffs and other trade barriers, which are thought to be artificial transportation costs, have become relatively more important, and because of that, foreign investment has presumably been stimulated, as in the case of the American investment into the European Economic Community.

Thus, the appearance of this enormous international or world-wide market created an environment in which the giant multinationals could develop. What are the "economies of scale" which multinationals can achieve because of large-scale management all over the world? I would like to discuss these kinds of economies of scale by dividing them into "economies of scale in production" and "commercial economies of scale."

Economies of Scale in Production .

A1) It is said that research and development (R & D), invention of new products or new processes of production and commercialisation into mass production depend upon the scale of investment in research and development (although there are differences of opinion on this matter). If it is true, only a gigantic corporation which is able to invest on a large-scale can achieve economies of scale in research and development and create new products and new production methods. This is much more obvious in the exploration and development of natural resources, such as in oil. A big enterprise which is able to carry forward exploration simultaneously at many different deposits would find it profitable if at least one of those explorations would be successful. On the other hand, because a small enterprise such as Japanese mining company can undertake only one exploration, it might be a total loss if it should not succeed.

A2) Choosing the optimum size for each factory belonging to the same enterprise: there is an optimum size for a factory, though it depends upon the employed production techniques, product line and the division of production processes. Up to the optimum, economies of scale are cultivated and cost is reduced, but beyond that, diseconomies of scale begin to appear. These are genuine internal economies. If a firm is large enough to have many factories, it can organise the factories in such a way that each of them may produce the sepcialised products or parts at its optimum size. If a firm is small, at a single factory, it cannot but produce small amounts of various kinds of products. In the case of small firms, even though each of them has almost the same production cost, the production cost can be reduced if several of them are integrated and the products for each factory are specialised. This concept also applies in the choice of optimum size for each of the transportation, refining and sales sectors in a giant vertically-integrated enterprise.

A3) The choice of international optimum locations: it is possible for a big enterprise to seek the optimum locations with a world-wide perspective for its various factories, pro-

cesses, and sales bases so as each reaches optimum size. Its production process is divided into several factories each placed at the most suitable location. For example, research and development are placed in the home country, raw materials, in a resource-rich country, labour intensive production process, in a developing country where the wage level is low; the final assembly or refining, in the big consuming markets (of course, the freight costs needed between each location should be taken into consideration). This is another internal economy of scale of an enterprise which utilises the advantage of international comparative cost difference. Only a gigantic multinational corporation can take this advantage through "vertical intra-firm integration" which systematises all the processes from production of raw materials to sales of final manufactured goods. It should be remembered, however that even such an integration has limitations which would turn the advantages to diseconomies of scale.

Commercial Economies of Scale

Gigantic multinationals, with their activities spread all over the world, can realise another type of economies of scale in addition to the economies in production; these are the economies of scale in sales and finance. I would like to call them collectively *commerical economies of scale*. They can also be explained as economies of scale derived from the bigness of "commericial", which is distinguished from industrial capital or long-term production investment. It is almost equivalent to the economic term "pecuniary external economies". It may be analogous to a big department store as compared with a specialised retail store: the department store has many advantages such as diversification of risks by dealing with many kinds of goods, cost reduction through bulk purchase, as well as large lot sales and delivery. Moreover, people buy at a department store because the goods bear a certain brand-name. Because of its higher credibility, a department store has an easier and advantageous access to outside funds.

Similar to the department store, a big multinational corporation can realise various commercial economies of scale from the following elements:

B1) ability to establish an information network all over the world;

B2) ability to set up distribution bases and production bases behind a tariff-wall of host countries. Only a big firm has enough information and ability to establish these bases;

B3) ability to make full use of the patent system and the granting of franchises in order to restrict exportation from the host country to competitive markets;

B4) economies of scale in advertisement, sales and after-care services;

B5) accumulative increase in value of the brand-name along with the enlargement of the scale of business;

B6) ability to utilise incentives and concessions in taxation both in the investing[6] and the host country;

B7) ability to utilise transfer pricing[7] and tax havens;[8]

[6] On the tax incentives the USA provided to her multinationals, see Robert Gilpin, *US Power and the Multinational Corporations*, Basic Books, 1975, pp. 128-34.

[7] See for example, Jack Hirschleifer, "On the Economics of Transfer Pricing," *Journal of Business*, Vol. 29, 1956. J.R. Gould, "Internal Pricing in Firms When there are Costs of Using an Outside Market," *Journal of Business*, Vol. 37, 1964. Lars N. Nieckels, *Transfer Pricing in Multinational Firms*, Almqvist & Wiksell International, Stockholm, 1976.

[8] See Milka Casanegra de Jantschei, "Tax Havens Explained," *Finance and Development*, March 1976.

B8) advantage in raising funds[9] (big multinationals have higher credibility to raise money easily and with favourable terms, and it is also possible for them to get funds from countries where the interest rate is lower, because they have subsidiaries abroad; they have the ability to raise large amounts of funds and can readily take over small enterprises);

B9) ability to do foreign exchange operation and speculation (the multinationals can easily avoid the risks of exchange rate changes but also could make profits positively by exchange operations because they have huge amounts of liquid assets accumulated in foreign countries);

B10) ability to exercise political pressure (the multinationals may be able to exercise their political pressures to the governments of both investing and host countries).

Although the list is not limited to the above, the first five items are major economies of scale in sales, the remaining five concern financing. The "horizontal integration" within a firm is promoted mainly for taking more avdantage of economies of scale in sales. To sell some other goods in addition to the major products of a firm at a certain sales base abroad would help to develop the base into optimum scale and to decrease the sales cost per unit. It would also expedite internal cross-subsidisation between the sales of one product and the others, and would disperse risks by diversification. In order to be able to deal with various kinds of products, some multinationals merge with other specialised manufactures, becoming conglomerates.[10] ITT and Singer are typical examples.

Gains from Systematisation

Giant multinational can organise either vertical or horizontal integration or both, which I would like to call "a systematisation of economies of scale." The intra-firm integration brings about, through the systematisation, additional economies of scale which are over and above the economies of scale which each production and/or sales unit realises.

In order to analyse critically the gains from intra-firm integration of a giant multinational, it may be appropriate to review the two previously introduced concepts of economies of scale, genuine and pseudo.

Here, the "genuine economies of scale" refers to economies of scale which save real resources (inputs) and which reduce production costs or sales costs. They are beneficial to both private enterprises and society (the national economies of both investing and host countries, or the world economy, including both of them), so there is no contradiction between private and social costs. On the other hand, the "pseudo-economies of scale" does not bring about any benefit for society, because it helps a firm to increase its private profits, but it does not economise real resources. A typical example of pseudo economies of scale is the utilisation of transfer pricing. The contribution of multinational corporations to the society should be to realise genuine economies of scale all over the world and thus to provide benefits to the users by supplying less expensive products, but not to increase private profits through the realisation of pseudo-economies of scale.

Genuine economies of scale in production include finding optimum scale and selecting

[9] From the viewpoint of advantage in raising funds, Aliber presents a theory of multinationals: Robert Z. Aliber, "A Theory of Direct Foreign Investment," Charles P. Kindleberger, ed., *The International Corporation: A Symposium*, The M.I.T. Press, 1970, pp. 17-34.

[10] On the definition of "conglomerate", see, Fritz Machlup, *The Political Economy of Monopoly*, 1952, p. 110.

the most suitable location for each factory. These two kinds of genuine economies of scale cannot be realised until the big multinationals carry out their vertical integration properly. Moreover, vertical intra-firm integration creates additional gains to a giant multinational corporation.

The specific reason why the vertical integration by a big multinational corporation is advantageous is usually explained as follows. As a single firm deals with every process from obtaining raw materials, transporation, refining and to selling the products, it can supply the world with a steady amount of the product at a stable price. They can compensate for a one period loss of one sector with the profit from the others (that is, cross-subsidisation). In this way a firm can survive and grow. This certainly is an economy of scale of systematisation due to vertical integration and increases the profit margins for a private enterprise. However, most of these ceomonies do not result in social benefits but in private profits, for they depend upon the imperfection of the market at each production—sales stage. In other words, they are only "pseudo economies of scale". Benefits for society are increased when the market of every production—sales stage becomes more perfect through free trade and free inverstment, instead of intra-firm integration.

Market imperfections are the source of extra profit, that is, the pseudo-economies of scale for big multinationals. And so, they are far from an organisation for correcting the defects of the markets; the more imperfect the markets are, the more advantageous it is for them.[11] It is inevitable for firms to become fewer and for market to become less competitive because of the rise of the big multinationals.[12]

As for commercial economies of scale, the contradiction between private and social costs is much more serious. There are almost no genuine economies of scale in sales and financing; most of them are pseudo-economies of scale. An exception may be the fact that it is better to sell many kinds of products than to sell only a specialised one in a shop abroad; a shop selling various goods achieves economies of scale in sales and is able to economise sales costs. These are genuine economies of scale. However, it is clear that there is a limit to these economies of scale. There would be few chances to obtain these genuine economies of scale by increasing the number of production sectors by merging with other firms as in the case of conglomerate. Even though it would work to disperse risks by dealing with many kinds of products, it may turn out to be a diseconomy of scale, for it retains the products which have to decay.[13]

There is a rationale for the creation of the conglomerate structure for real economies of scale involved in performing sales operations for several products within one organisation, but all the remaining elements of commercial economies of scale except an information network, are related to market imperfections which only the big multinationals can utilise through intra-firm integration, vertical and/or horizontal. Their gains and maximisation of their excessive private profits are not real economies of scale.

For example, first, while tariffs and other barriers to trade are kinds of market imperfec-

[11] It is well illustrated how oil majors survive and grow through making oligopoly, in Raymond Vernon, "The Location of Economic Activity," John J. Dunning, ed., *Economic Analysis and the Multinational Enterprise*, George Allen & Unwin, 1974, pp. 89-114.

[12] Cf., "Multinational corporations enlarge the domain of centrally planned world production and decrease the domain of decentralized market-directed specialization and exchange." Stephen Hymer, "The Efficiency (Contradictions) of Multinational Corporations," *American Economic Review*, May 1970, p. 443.

[13] Cf., "The conglomerates have not been highly profitable in the economic sense of efficiency, but only in the accounting sense." Robert Gilpin, *op. cit.*, p. 133.

tion, almost all the direct investments induced because of these barriers bring about only pseudo-economies of scale. Some may argue that if it had not been for direct investment, a certain industry would not have been established. However, the purpose of the imposition of tariffs is to set up a certain industry by an indigenous firm of the host country. If an industry should be established by a foreign firm and the products should be more expensive than those imported, the genuine economies of scale for the society would not be realised.[14]

Secondly, the utilisation of tax incentives, transfer pricing and tax havens is also made possible due to market imperfections. Although the private profit of a giant multinational corporation may increase by taking advantage of these measures, it does not always bring about benefits to the society. It is a pseudo-economy of scale that would not be fulfilled if the markets were to become more perfect (e.g. if the same tax rate were imposed all over the world).

Thirdly, the economies of scale in financing are also pseudo-economies of scale derived from the imperfection of the capital market. It can be eliminated if competition in the capital market becomes more perfect and the international monetary system is well stabilised.

Finally, it goes without saying that political power of a firm is an undesirable pseudo-economy of scale.

It is pointed out that many of the giant multinationals have already become too big, and have fallen into diseconomies of scale.[15] The merit with which the multinational can make a contribution to the society through vertical and horizontal intra-firm integration is to realise genuine economies of scale. But in attempting to realise these genuine economies of scale, most of the present giant multinationals might have already become too large. In spite of that trend, they still continue to become bigger and bigger. The cause of this may be found in the fact that giant multinationals earn huge profits from pseudo-economies of scale in the sales and finance area, which are enough to over-compensate the genuine diseconomies of scale in production.[16]

This is a kind of vicious circle, for as long as the imperfections of the markets exist, the possibility of pseudo-economies of scale will not be eliminated, since it is in the interest of the multinationals to exploit market imperfections, the opportunities for pseudo-economies tend to increase. From a discussion of these points, a set of criteria can be developed with which to order a discussion of the problem of multinational firms. That same criteria can be used to evaluate the effectiveness of government policy toward the firms.

III. *Multinational Corporation versus Market Integration*

Multinationals' intra-firm integration, either vertical or horizontal, is a kind of "institutional" integration. Economic activities in the world are divided into and performed

[14] We have developed fully this argument in Kiyoshi Kojima, "Direct Foreign Investment between Advanced Industrialized Countries," *Hitotsubashi Journal of Economics*, June 1977, pp. 1-18.

[15] Cf., "Most parent firms are large enough to have exhausted economies of scale." Stephen Hymer, *op. cit.*, p. 441.

[16] See R.J. Barnet and R.E. Muller, *Global Reach: The Power of the Multinational Corporations*, 1974, Chapter 12. Also see, Alan M. Rugman, "Motives for Foreign Investment: The Market Imperfections and Risk Diversification Hypotheses," *Journal of World Trade Law*, September / October 1975, pp. 568-73.

by billions of sepcialised firms and agents, each integrated with each other through "markets". This is especially true under a system of free competition, free trade, free investment and a stable international monetary system. This may be called "functional" or "market" integration.[17]

It is a conclusion of the previous section that the bigness and intra-firm integration of a multinational corporation are favourably evaluated as far as this cultivates genuine economies of scale, whereas such integration is not justified when the firm seeks pseudo-economies of scale. Given this conclusion, we must ask one additional question: Is market integration a realistic alternative for achieving the genuine economies of scale achievable by the large multinationals? If it is, countries may realise these genuine economies of scale without the threat of losses from pseudo-economies.

First, there is a limitation even for a giant multinational corporation as it tries to extend intra-firm integration, either vertical or horizontal: a) if the organisation of the firm becomes too big, this generates diseconomies of scale. b) The limitation of conglomerates has already been mentioned. c) In many cases, vertical intra-firm integration cannot cover all the processes but is truncated at a certain stage. For example, an automobile company first establishes an assembly factory abroad, then the factory for engines and other parts but it may not have a steel mill which provides raw materials necessary to produce these engines and other parts.

In short, an institutional integration of a multinational corporation has its limitations and has to be supplemented by functional integration through markets. Market integration is based on a kind of mutual dependence of external economies (e.g. a firm can realise economies of scale depending upon the fact that other firms provide it with appropriate amounts of intermediate products at a less expensive price). In contrast, international vertical integration internalises these links of external economies within a giant multinational corporation.

Secondly, it should not be economical for even a giant multinational to embrace every activity into its intra-firm integration. For example, even for a giant oil major, it is not economical to own tankers capable of handling the maximum capacity, but it is better to supplement with chartered tankers in case of heavy business. Moreover, if all the transportation of oils is handled by a shipping company, it could be done more efficiently and economically. Similarly, a general trading company may be able to handle export and import business of a great number of commodities with a certain market more efficiently than each producer or conglomerate does. This is also applicable to the case of international banking. In other words, as long as the market integration is more economical than intra-firm integration, the latter should be unpackaged into several independent companies, each of which performs specialised functions with its optimum size.

Thirdly, a multinational corporation grows to be bigger and bigger for it can create through intra-firm integration pseudo-economies of scale even after it has exhausted available genuine economies of scale. This means that giant multinational corporations usually pursue monopolistic or oligopolistic profit maximisation through global strategies. This monoplistic or oligopolistic behaviour should be rectified. If the complicated intra-

[17] The EEC is a regional institutional integration whereas a global free trade and free convertibility system is a functional integration. Therefore, much of the results of regional integration theory may be applied to the analysis of intra-firm integration.

firm integration of a multinational corporation is divided into several specialised companies, each of which performs its function in a more competitive fashion and with greater efficiency, markets as a whole would become more perfect and competitive, avoiding most of pseudo-economies of scale which only monopolistic or oligopolistic multinationals can obtain.

Thus, a basic principle to cope with monopolistic or oligopolistic behaviour of giant multinational corporations is to remedy various imperfections of markets and to make them more perfect and competitive. As long as the markets are imperfect, under capitalism, it might be difficult to prevent a firm from taking advantage of the market defects. If such is the case, to make markets perfect and to promote competition ought to be the basic to counter the behaviour of the big multinational corporations.

One of the problems is derived from the fact that a firm has to be of considerable size in order to realise the genuine economies of scale mentioned before. This originates from the indivisibility or lumpiness of the production activities. In order to utilise the complicated advanced modern technology, capital equipment has to be enormous. The scale of the entire firm has to be of such a size that each factory can specialise in specific lines, making each of them optimum size. This fact, in relation to the size of the specific market, would easily lead the firm to monopoly or oligopoly. This may be an unavoidable imperfection of the markets. It can be the same kind of problem that requires a firm to have an information network so wide as to spread over the world.

There can be no other way of encountering this problem other than to bring up in the host country big enterprises having the optimum size which can be a countervailing force and compete with the foreign multinationals and thus re-establish competition in the host market. The measures taken by European countries and Japan to cope with the direct investment activities of the US multinationals were to develop this kind of countervailing power. There remains, however, a difficult problem: how a developing country which cannot bring up its own countervailing power should face this problem.

Other reasons for market imperfection have been raised earlier. These too can be corrected by functional integration through markets. For example, if free trade should be realised, with tariffs being reduced or removed, direct investment that only seeks pseudo-economies of scale to overcome these trade barriers would be eliminated. If a stable international monetary system, instead of floating, is reconstructed, exchange arbitrations and speculations by the multinationals could become fewer. If the financial market becomes more perfect and competitive, not only the big multinationals but also others would be treated on an equal footing. The favourable discretional taxation provided to the multinationals by both investing and host countries should be eliminated. Although it would be difficult to have consolidated tax systems and tax rates which vary according to the conditions of each country, there is much room for improvement. Firms are to be refrained from attempting tax evasion and bribery. This mostly depends upon each multinational corporation's self-discipline, to which the disclosure of information on publicly traded firms may have an influence. Finally, anti-monopoly and anti-trust policies should be enforced with international uniformity throughout the world, though it involves many practical difficulties.

What should be questioned is that the postwar U.S.A., as she found the direct foreign investment advantageous from the viewpoint of improving her balance of payments and employment, adopted a policy of treating the multinationals favourably; this resulted in

further imperfection of the market;[18] she should have given priority to promoting functional integration, that is, the promotion of free trade and the reform of the international monetary system. Although the trade policy should have been fundamental, direct foreign investment being its complement, the US policy has been the other way around.[19]

IV. *The Group Multinational Activity of Japanese Companies*

In Japan, general trading companies (Sōgō Shōsha) play a very important role not only in foreign trade business but also in direct foreign investment, making Japanese industries multinationalised as a group.

The trading company is more heavily involved than other enterprises in direct foreign investment. Most Japanese direct foreign investments consist of joint ventures where, typically, 20 to 30 percent of the equity is held by a manufacturer, 15 to 25 percent by a trading company, and the remainder by local interests of the host country. Sometimes it is called as "three-person four-legged" joint venture. Even in development projects of natural resources, which Japan intends to import back, trading companies are usually involved and hold a part of the equity. In 1973 the ten leading trading companies owned at least a 5 percent equity interest in 696 foreign affiliates. As in the area of foreign trade, the four largest trading companies—Mitsubishi, Mitsui, Marubeni, and C. Itoh—led the way. Together they had an ownership interest in 496 or roughly 71 percent of all the subsidiaries participated by the ten largest trading companies. Although there were subsidiaries in every sector, over 65 percent of them were found in the manufacturing industries and 10.5 percent in extractive and other resource development.[20]

Since Japanese direct foreign investment has still been in its incipient stage, each of the manufactures, mining and other resource-development enterprises is not big enough, lacking sufficient information, monopolistic technology and skilled management, to do several direct investments abroad, making intra-firm integration, vertical or horizontal, like American giant multinational corporations; all they can do is to scatter numbers of small scale direct overseas investments with the help of a trading company which has accumulated enough experience and skilled personnel to do business and management abroad. However, if these scattered direct foreign investment activities are systematically linked together and consolidated with each other through the function of trading companies as intermediator, organiser and free trader, a *de facto* integration, vertical and/or horizontal, is established. In other words, Japanese companies as a whole achieve "group multinational activities". This is the only way for Japanese enterprises to compete with the American type giant multinational corporations which are already too big and too strong.

Japanese direct foreign investment activities are an overseas extension of, and are facilitated by the existence of *Keiretsu* groups in the home economy. The *Keiretsu* is an industrial group, mostly originating from the former *Zaibatsu* groups, which are functionally conglomerated in a mutually complementary way, with a major general trading company

[18] This was pointed out seriously by Robert Gilpin, *op. cit.*, Chapter V.

[19] See Kiyoshi Kojima, "A Macroeconomic Approach to Foreign Direct Investment," *Hitotsubashi Journal of Economics*, June 1973, pp. 1-21.

[20] M.Y. Yoshino, *Japan's Multinational Enterprises*, Harvard University Press, Cambridge, 1976, pp. 95-6.

and a leading bank as their nucleus.[21] There is also a number of sub-*Keiretsu* which are a network of small, independent manufacturing firms loosely organised by a large trading company or manufacturing firm.[22] Japan's internal *Keiretsu's* performance in the internal market is now closely complemented by international operations of these same *Keiretsu,* making each group possible to undertake a world-wide strategy.

Professor Yoshino points out as follows:

> The Keiretsu offer a number of advantages. First, a Keiretsu gives a small Japanese subsidiary abroad performing only limited manufacturing operations benefits associated with vertical integration. Since it imports most of its intermediate materials from the large enterprise with which it is associated, it gains from the economy of scale in production at the fiber stage. The local subsidiary can also obtain credit from the Keiretsu's trading company at favorable terms, not an insignificant competitive advantage, particularly in a developing country. Since its output is marketed locally through the trading company, it also benefits from the economy of scale in distribution. Moreover, it has direct access to new technological developments generated by the Keiretsu parent company in Japan. The intimate relationship nurtured through years of close association and the mutuality of interest sustained by closely interwoven interests in Japan facilitates communications among the various partners in the subsidiary.[23]

Concerning direct investment on resource development abroad, Professor Ozawa observes as follows:

> Even if a particular Japanese company may not profit directly from a given extractive venture itself, some other Japanese companies are likely to capitalize on profitable opportunities generated by such a venture in related business activities—new demands for equipment, machinery, plant, technical and marketing assistance, etc. Here, the strategy of a group investment is essentially a systems-focused strategy pursued by a group of companies operating in mutually-complementary fields. Japanese companies are increasingly investing as a group in extractive ventures in order to share in linkage opportunities. Immediate spill-over linkages might be newly-created demands for plants and capital equipment to be used for a venture. Some capital-goods producers in the group will be able to profit from these exports.[24]

I want to stress that the "*de-facto* integration" of Japanese direct investments abroad with a trading company being an organiser, or "group multinational activities" of Japanese companies, is not an institutional intra-firm integration which constitutes the characteristic of Western type giant multinational corporations, but is made up of a functional integration.[25] Since the function is performed under keen competition, it is very close to "market" integration. And this characteristic of a Japanese-type integration is brought about by the fact

[21] Terutomo Ozawa, "Japan's Resource Dependency and Overseas Investment," *Journal of World Trade Law*, Jan. / Feb., 1977, pp. 70-1.
[22] M.Y. Yoshino, *op. cit.*, p. 69.
[23] *Ibid.*, pp. 70-1.
[24] Terutomo Ozawa, *op. cit.*, p. 70.
[25] A Japanese type "development import *cum* long-term contract" method in resource access is a functional integration and a superior substitute for a Western type "captive development *cum* vertical integration" method.

that the integration is consolidated through the intermediary function of the trading companies, which play their role in quite competitive and efficient ways.

To use trading firms as functional integrators has many advantages. These have brought about various economies of scale as follows:

1) With bases all over the world, staffed by persons with excellent knowledge of the host countries' language, culture and business condition, the general trading company's information network spans the globe. This is an asset beyond the reach of an individual manufacturing and mining company. A manufacturer can achieve significant pecuniary economies of scale when it uses this network in cooperation with the general trading company.

2) Manufacturers who want to market or purchase limited amount of low value products in a specific foreign market find they run up large costs in handling such transactions. It simply is not profitable. Combining a number of these transactions will often lead to a profitable activity, however, and that was the reason for the establishment of the conglomerates. General trading companies are perhaps the companies which have carried out this horizontal integration on the largest scale, thus contributing to a substantial reduction in the costs of transactions in international trade.

3) General trading companies deal in a seemingly unlimited number of products, handling not only exports but imports as well. Since they routinely evaluate comparative costs in Japan vis-à-vis the foreign country in the course of their normal trading activities, they are able to look at production decisions from the point of view of the international division of labour. In joint ventures, with the general trading company acting as intermediary to bring the parties together, the general trading company can again perform this function, giving to the operation the ability to fully consider international comparative costs. Individual manufacturers, in contrast, concentrate on their own line of products. Thus, they do not concern themselves with a comparison of their current profitability with that of other lines; nor do they concern themselves with international cost comparisons. A manufacturer might thus easily misjudge and expand his overseas business—by establishing a marketing base or setting up an assembly plant—in what will prove to be an inappropriate location. It is even more unlikely that the manufacturer would, on his own, think of establishing a competitive production unit abroad with the intention of importing that output back into his own country. If there were no unit such as the general trading company, there would be no participant who could look at a given situation from the point of view of international cost comparisons.

4) Since general trading companies deal not only in exports, but balance this volume with their import trade, they have a large degree of flexibility to cover the risks which arise in markets and foreign exchange. In so doing, they are able to carry out the function of cushioning the manufacturers against risk inherent in such transactions. If the general trading companies have the flexibility to hold buffer stocks for their own account, then they are frequently able to perform the function of stabilising short-term price fluctuations in traded goods.

5) General trading companies take an appropriate low commission for each import and export they handle, playing the role of an intermediary in trade. The business is very competitive, so much so that people often describe the situation as "excessive competition." This is in contrast to American-style large multinationals, which achieve monopolistic or oligopolistic commercial economies of scale through institutional intra-firm integration.

General trading companies carry out the necessary integration in a functional—that is market-like—and competitive atmosphere. The result is efficient operation.

I am not saying that no problems remain in the overseas activities of the general trading companies. One special problem is that the expansion of these vast, efficient multinationals may be supressing the activities of the developing country's own trading firms. There is probably an appropriate scale at which trading company activity can result in the savings of real resources. It is necessary for the developing country itself to cultivate a trading company of its own until it reaches that scale (some countries have already initiated that process). In cases where that is not easily accomplished, then Japanese general trading companies should let trading firms in developing countries participate in general trading activity.

Although we should like to recommend a group multinational activity for Japanese companies, certainly in Japan there is a growing trend among big manufacturers of steel, automobiles, electronic machines and synthetic textile to extend activities abroad by themselves, getting rid of the help of trading companies. This may be called "the multinationalisation of manufacturers." Many American and Japanese scholars,[26] perhaps under strong influence of Professor Vernon, recommend that the multinationalisation of Japanese manufacturers should be encouraged, similar to the American giant multinational corporations. On the other hand, they suspect that the role of trading firms will decrease in significance, for they are not appropriate to handle modern technology goods[27] and their internal organisation is rather too flexible and unsystematic to become that of a multinational corporation.[28] This kind of recommendation means, however, that the Japanese foreign economic activities should also become monopolistic or oligopolistic, similar to American giant multinationals. Some Japanese manufacturing companies may become like this, for their line of products is sophisticated and differentiated, and they are big enough. However, I cannot accept this forecast on the future of Japanese multinational activities, for I prefer the functional and competitive integration.

In order to succeed in becoming multinational corporations, Japanese manufacturers alone must become enormous enough and have networks of bases for production and sales for themselves. This is necessary in order to encounter or even surpass the big American multinationals. However, it is quite difficult for Japanese enterprises to do it. Several of the Japanese representative enterprises which aim at multinationalisation possess sales

[26] Raymond Vernon, "Can Japanese Enterprises be Multinationalised?" (in Japanese), *Daiyamondo*, September 29, 1973. M.Y. Yoshino, *Japan's Multinational Enterprises, op. cit.*, Chapter 4. Yoshi Tsurumi, *The Japanese are Coming*, Ballinger, 1977, Chapter 5. Kiyoshi Yamazaki, *Kokusai Keiei Nyumon* (Introduction to International Business Management) (in Japanese), Nikkei, Tokyo, 1972.

[27] Tsrumi suggests that only standardised goods which require little afterservice can be handled by trading companies. See Yoshi Tsurumi, *ibid.*, p. 141. Similarly, Raymond Vernon, *ibid.*, p. 34 and Yoshino, *ibid.*, p. 119.

[28] The Viewpoint of Yoshino's analysis is a bit different. He is quite skeptical of the abilities of the trading companies to become multinational one. "Though the trading companies have played and will continue to play important and varied roles in the multinationalization of Japanese industries, the prospects of these companies themselves becoming mulitnational enterprises with strong central system-wide coordination are limited indeed. My findings suggest that their primary role is likely to be confined to facilitating multinational moves by others". (M.Y. Yoshino, *op. cit.*, p. 95). Whether or not big trading companies are multinationals depends upon the definition of multinational corporation. It seems to me that Yoshino looks at the issue strictly from the point of internal organisation and management control, neglecting the mulitnational role of trading companies.

bases or assembly factories outside the country, but have not yet undertaken full-scale production abroad. The multinationalisation of manufacturers and the extent of the intra-firm integration depend upon the size of the firm. No matter how big it becomes, there certainly is a limit and there always exists some process which is to be complemented by functional or market integration, especially through international trade.

Moreover, what is necessary for Japan is not the American type multinational corporation activities. What Japan need is, (1) to try to acquire resource goods and raw materials safely and advantageously through long-term contracts and small equity participation, if necessary, since Japan's capital is not yet abundant;[29] (2) to transfer labour-intensive industries to developing countries (investment with a medium sized factory should be sufficient) to import back the products to Japan as well as exproting them to other third countries; (3) to invest in developing countries with medium sized factories and establish intra-industry specialisation between Japan and those developing countries when the transfer of such key industries as steel and chemical industries becomes necessary.[30] On the other hand, (4) direct investment in advanced countries should be limited to the extent that it helps to reduce the export transaction costs, such as subsidiaries of trading companies and assembly factories abroad.[31]

Taken together, Japan's direct overseas investments mainly aim at "offshore sourcing"[32] either natural resources, raw materials and food or manufactured goods and parts from cheaper supply sources throughout the world. Japanese interests are not strong in the ownership and control of, and profits from, the upstream activities of production abroad, which I think should eventually belong to the host country, but mainly in those of downstream or international trade.

To foster a functional integration through trading firms, making possible group multinational activities for Japanese companies as a whole, is thus a logical solution to be commended. On the other hand, I do hesitate to recommend that some of the big Japanese manufacturing companies become monopolistic or oligopolistic multinational corporations similar to Americans, especially when recently those are criticised strongly by both developed and developing countries and their prospect is rather gloomy.[33]

V. *Code of Conduct for Multinational Corporations*

Recently much debate has been focused on drawing a code of conduct for multinational corporations. One of the most radical codes was drawn by the Andean Group, *The Foreign Investment Code* in November 1970. After several attempts at code making in advanced countries,[34] OECD declared the *Guidelines for Multinational Enterprises* in June

[29] See, Kiyoshi Kojima, "Japan's Resource Security and Foreign Investment in the Pacific", a paper presented to the 9th Pacific Trade and Development Conference in the San Francisco Federal Reserve Bank from 22-26, August, 1977.

[30] See, Kiyoshi Kojima, "Direct Foreign Investment to Developing Countries: The Issue of Over-Presence" (in Japanese), Nihon Yushutsunyu Ginko, *Kaigai Toshi Kenkyu Sho-ho*, October 1977.

[31] See, Kiyoshi Kojima, "Direct Foreign Investment between Advanced Industrialized Countries", *op. cit.*

[32] Cf., G. Adam, "Multinational Corporations and Worldwide Sourcing," Hugo Radice, ed., *International Firms and Modern Imperialism*, Penguin Books, 1975, pp. 89-104.

[33] See, the undergoing 1980s Project of the Council on Foreign Relations on the future of the multinationals.

[34] For example, those done by International Chamber of Commerce, in November 1972, Pacific Basin

1976 which are modest. Now, the United Nations Commission on Transnational Corporations has been working hard to make a new code mainly in the interest of the Third World.[35] It would take another one or two years to draft it. I expect that a UN code would be in the middle between the above two codes but closer to the former, and may be one of the declarations concerning the so-called A New International Economic Order and, therefore, cover very broad issues not directly pertinent to multinational corporations. Those codes focus on how to control behaviour of multinational corporations such as tranfer pricing, tax evasion, restrictive business practices, bribery, among others. It is certainly important to rectify those kinds of conduct which are mostly monopolistic or oligopolistic behaviour. It may not be controlled through direct measures but only through making markets more perfect and competitive, as already discussed in the previous sections. Moreover it is not sufficient to draw up those measures but a code of conduct for multinational corporations should take into consideration a macro-economic viewpoint on dynamic international division of labour which is a common principle both for international trade and direct investment. I would to recapitulate these points[36] since they are also an important conclusion of the present paper.

The shortcomings or defects that are too often detected in the activities of transnational corporations in host countries result from the complete disregard for policy implication inferred from international economics, especially the theory of international division of labour based on the principle of comparative costs. The theory of international division of labour assures that while one country takes an advantage of production and export of one commodity, it porvides an opportunity for the partner country to produce and export another commodity, whatever the difference in size, stage of development and tastes of demand which may exist between the two economies. Therefore, the theory provides a sound basis for co-existence, interdependence and co-prosperity between countries. Thus, direct foreign investment that would otherwise be used in a comparatively disadvantageous industry in the investing country and has found its way into industry with actual or potential comparative advantage in host country will harmoniously promote and upgrade of industrial structure on both sides and thus speed up the trade expansion between the two countries.

Ignoring such logical implications, however, some activities of multinational corporations or direct foreign investments seem to have been decided on and justified solely from individual firms' point of view. A multinational's activity would necessarily result in, because of such factors as its bigness, superiority, stronger competitive power, the stifling of small and medium-sized firms not only in the home country but also in host countries, monopolising or olipogplising world production of its line. If this happened, it might create huge unemployment throughout the world, for the multinational corporation activity is efficient but does not create much mass employment demand except for a small number

Economic Cooperation in May 1972, and Japan Chamber of Commerce and Industry *et al.*, in June 1973, and Nihon Boeki-kai in June 1973.

[35] See United Nations, *Multinational Corporations in World Development*, 1973. United Nations, *The Impact of Multinational Corporations on Development and on International Relations*, 1974. United Nations, Centre on Transnational Corporations, *Transnational Corporations: Issues involved in the Formulation of Code of Conduct*, July 1976.

[36] From these points of view, I have already presented in Kiyoshi Kojima, *Japan and a New World Economic Order*, Croom Helm, 1977, Chapter 4, Section VI, a new form of foreign direct investment which should consist of key elements in the code of conduct. Since the drafting a code of conduct for TNC in the United Nations has still been under discussion, a detailed comment on it will be attempted in due time.

of privileged personnel. This is a fundamental, serious source of international economic and political impact of multinational corporations.

The multinationals' activity may be reconsidered from the point of view of the theory of international division of labour, not from the point of the survival and domination of multinationals. This is important, for workers are not able to move freely between countries and, therefore, economic development and welfare have to be considered with the framework of a national economy and an international division of labour. Under such circumstances, it is rather unfair that only enterprises are allowed to move freely to foreign countries and assured permanent ownership.

The multinationals, particularly big ones, have such capacity as to utilise every possible kind of economies of scale (internal as well as external) through a global strategy of information, R and D, production network, marketing and even transfer pricing, exchange speculation and political pressure. This is the source of the superiority of the multinationals. However, as I have stressed earlier in this paper there is a limit to these economies of scale. Secondly, the multinationals should not be allowed to be monopolistic or oligopolistic, and should not be left free to abuse such techniques as transfer pricing, tax havens, and exchange speculation, but should be encouraged to behave as a free competitor, returning the gains reaped from economies of scale to the people of the world. Thirdly, those economies of scale should be realised, by joint venture and even by independent firms in partner countries, through close trading relationship or long-term contract arrangements, and not by wholly owned subsidiaries as is often the case at present. Fourthly, it should be recognised that even powerful multinationals could not be prosperous if activities in the host country other than multinationals' were stifled. If a multinational corporation enters into a certain market, it must create other lines of activity in which firms in the host country can specialise and export.

In undertaking multinational corporation activity, it is important that such activity has a wide spillover effect to the host economy. The multinational corporation should not stifle or discourage local small and medium size business of the same line, but should transfer such things as technology and management skill to the local firms and encourage new entry of the local firms: both multinational corporation and local firms must coexist and prosper together. Enclave type activity of a multinational corporation is most unwelcome since it has the least spillover effect in a host country. A joint venture is preferable to wholly owned subsidiaries since it has greater spillover effect.

By introducing a new industry into a host country through direct foreign investment, multinationals transfer new technology and management skills. Foreign direct investment, thus, should act as an initiator and a tutor of industrialisation in host countries. Then, through the training of labourers, engineers and managers and with local capital, the establishment of competitive local firms becomes possible; the foreign firms should fade out or gradually transfer ownership and control of management, although the actual timing and speed of the fade-out may differ depending on the nature of industry, difficulty of technology transfer and management.

In deciding on direct foreign investment, comparative costs and economic efficiency should not be ignored. Country A should invest in an industry with comparative advantage in country B, and vice versa, taking into consideration the pattern of comparative advantage, existing as well as potential, that changes over time between the two countries. Then both

countries could increase free import to each other. In the case of direct investment to a labour-abundant developing country, it should begin from labour intensive production in which the host country has potential comparative advantage, and should import the product (that is offshore sourcing). The direct foreign investment should aim at increasing import from the host country at cheaper cost than without direct investment, but it should not aim at increasing export or substituting export from the investing country.

The existence of tariffs and other trade barriers usually encourages direct investments. But this type of direct investment is not beneficial either for the investing or host countries; it only results in the inefficient use of resources.

Therefore, to realise free trade is a priority policy matter. Only in the situation of free trade is the comparative advantage pattern identified. As long as trade barriers exist, countries should refrain from undertaking direct foreign investment, instead of going behind the trade barriers.

The most important rules for ensuring the developmental effect of direct investment seem to be (a) free trade, (b) big multinationals are to compete freely instead of exhibiting monopolistic or oligopolistic behaviour, and (c) direct investment plays a role of a "tutor" with a certain rule of fade out. If these rules are followed, any other regulation is not necessary and any direct and selective regulation is not feasible. Therefore, those rules may be integrated in the GATT agreement, or be established through GATT-like arrangements providing for principles, procedures, consultation, and some rules which are open to any country.