

# The Importance of Multinational Enterprises

# 1

Multinational enterprises (MNEs) are business organizations that underpin much of the U.S. economy and the international system of trade and investment. They are increasingly global in their origins, sourcing, communications, production, and outlook. The foreign affiliates of MNEs control a substantial portion of the world economy, perhaps as much as one-quarter of all economic activity in their host countries. Intrafirm trade, that is, goods and services exchanged among parent companies and their foreign subsidiaries, may account for more than 40 percent of U.S. imports and 35 percent of U.S. exports.<sup>1</sup> Because they are so important and powerful, MNEs evoke a wide range of concerns from home governments, host governments, rival firms, and strategic partners.

Intensifying competition among firms in almost every sector of the international economy is changing the structure of multinational industry (see chapter 2). At the same time, increasing competitiveness concerns and trade frictions among nations have led to a heightened awareness of the **activities** of MNEs. Because MNEs are the major force in international trade and are deeply enmeshed in local economies, they are influential in national politics and essential to industry. But because they span national borders, many MNEs are less concerned with advancing national goals than with pursuing

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<sup>1</sup> See notes 21, 22, and 23 below. In 1990, worldwide sales of foreign **affiliates** in host countries reached an estimated \$5.5 trillion as compared with **approximately** \$4 trillion in total world exports of goods and **nonfactor** services. See United Nations Conference on Trade and **Development, Programme** on Transnational Corporations, *World Investment Report 1993* (New York, NY: United Nations, 1993), p. 13.

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**objectives** internal to the firm—principally growth, profits, proprietary technology, strategic alliances, return on investment, and market power. MNEs are highly flexible and can **take** many different forms (see **table 1-1**).

Congress is concerned about MNEs for several reasons. In the broadest sense, the globalization of business, transportation, and communications is disrupting the post-World War II system of international trade and, in the post-Cold War period, threatens to increase trade friction among nations to unmanageable levels. As tough talk on trade escalates between the United States and its principal trading partners, pressure builds for a coordinated response from Congress, the Administration, and U.S. business leaders. MNEs are increasingly the focus of this debate because they are international conduits of goods and services as well as major providers of the technology, jobs, and capital that support high standards of living in the industrialized nations.

At a more fundamental level, Congress should be concerned when **the interests of MNEs, both domestic- and foreign-based, increasingly diverge from those of the United States**. Foreign MNEs that penetrate U.S. markets, make few investments, and drive local firms from the marketplace cannot be considered national assets. Affiliates of foreign-based MNEs that import high percentages of complex parts for assembly operations, that do not provide commensurate pay, benefits, and training for American workers, and that extract excessive subsidies from state and local governments are not acting in the national interest. Similarly, if a U.S.-based firm principally operates screwdriver assembly plants in the United States, exports critical technology development functions, and moves most or all of its production facilities abroad to take advantage of low wages and lax environmental standards, it would not be acting in the Nation's interest.

As a further complication, the distinction between foreign and U.S. companies is breaking down. As U.S.-based MNEs commit ever more

**Table 1-1—Types of Multinational Enterprises (MNEs)**

For purposes of this report, OTA has identified and analyzed six principal types of MNEs. They are not intended to be rigid or mutually exclusive, but instead to capture the major differences that are relevant to the development of public policy. The six types of MNEs listed below are described in greater detail in chapter 2.

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*Resource-based MNEs*

organize around the extraction of natural resources, or agricultural products, and their processing for sale in the industrialized countries.

*Export-oriented MNEs*

maintain the preponderance of their production and R&D base in their domestic market. Export high value-added products to other national markets, often through intrafirm trade. Typically establish final assembly, service, support, sales and marketing operations abroad.

*Regional MNEs*

optimize their activities, including production, around a regional market but have not yet achieved significant sales and operations outside their region of origin.

*Translational MNEs*

have begun to locate production facilities globally, but still depend heavily on their domestic market and operations for their competitive position, economies of scale and scope, key production operations, and R&D.

*Global MNEs*

replicate much of the full value-added chain, including substantial product development and research operations, in more than one national or regional market.

*Distributed MNEs*

optimize the location of their sourcing, production, and R&D on a global basis.

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SOURCE: Office of Technology Assessment, 1993.

resources to foreign affiliates, and foreign-based firms produce and invest in America, the question of what constitutes an American company for purposes of public policy becomes even more critical. The rapid expansion of the number and scope of international strategic alliances among MNEs adds complexity to this already difficult question (see chapter 5).

What do nations want from multinational enterprises? In the end, **the United States wants MNEs to conduct business here and interact with local firms in ways that generate and retain wealth and quality jobs within its**

**borders. This** is what all nations generally want and increasingly demand from MNEs. For the United States, it translates most immediately into high-wage, high-value jobs for Americans, indigenous technology development, advanced manufacturing that draws on local talent, an expanding tax base, and ultimately, generalized economic well-being. The connection between the location of technology leadership, both product and process, and the health of national economies and living standards is becoming ever **more apparent to governments.**

The answer to the policy question of what should constitute an American company is tied not so much to the ownership or home base of particular MNEs, but rather to how a firm affects **the** well-being and standard of living in the local and national communities where it operates. In this view, MNEs should be considered American if and when they act in the national interest, and as American companies, they should be entitled to a higher standard of consideration.

The ultimate test of whether the United States should contemplate requiring standards of performance from foreign companies would be its willingness to see the same standards applied to U.S.-based **firms operating abroad.** In that case, the objective would not be to maximize benefits for the United States, but rather to reach a balance in trade and investment that did not confer large advantages on one nation at the expense of others. Some analysts note that creating such a regime would require joint development of performance standards among the principal trading countries, with the intent to avoid unilateral actions that might heighten trade conflict. Within that general approach, they suggest, it would then be appropriate to require foreign-based MNEs that enjoy the benefits of a nation's markets and national infrastructure to act in ways that contribute to the national interest of the host nation.

These concerns arise for two reasons. First, in some industrialized nations, increasing global-

**ization of research and development (R&D) and production is detaching firms from their national origins.** As competition heats up within the Triad of North America, Europe, and Japan, many MNEs seek global economies of scale, and efficiencies of R&D, production, sales, and service, tied not to particular nations, but located within different national markets around the world. Because U.S. firms were first to globalize their operations in large numbers, this process is particularly pronounced for the United States.

Second, some very large firms organize their operations around what might be termed a "globalization" strategy, that is, around vertically integrated supplier networks, both in their home base and with respect to their foreign assembly operations. These MNEs tend to retain higher value-added R&D and production functions at home, and to export sophisticated parts and components to their foreign subsidiaries. Typically, they exert strong influence over their supplier networks, often requiring them to take on substantial design and engineering responsibilities, and help absorb losses when business is bad. Many analysts associate this model most closely with Japanese-based MNEs and their affiliated keiretsu business groups. (See chapter 4 for a discussion of the keiretsu system.)

Most corporate managers and analysts argue that setting up the full value-added chain in all principal markets—from R&D through manufacturing and after-sales service—would be highly inefficient and probably impossible, given existing networks of facilities and supplier relationships. The trend, they contend, is precisely the opposite, toward dispersed sourcing and greater international division of labor at all levels of business operations. **Many managers believe they cannot remain competitive unless they have access to low-cost components, high-quality labor, and flexible production arrangements—wherever and whenever these are available.** These concerns cannot and should not be taken lightly.

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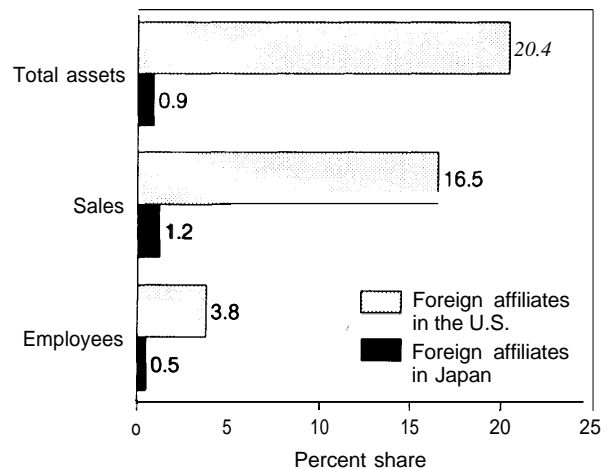
But these concerns can also be overemphasized. They reflect the needs of managers in particular companies to meet specific corporate objectives. And they do not give sufficient credit to the ability of MNEs to adjust and reconfigure to meet changing economic and political conditions. The U.S. economy (or any other, for that matter) cannot remain competitive unless MNEs that sell and conduct business in America also contribute **to its research and technology base, employment, manufacturing capabilities, and capital resources.** (See chapter 6 for a discussion of MNEs and international capital markets.)

Recognizing these requirements, many industrialized countries have imposed local content rules and have set up technology promotion programs that encourage companies to implement strong local commitments. Such rules have decreased penetration of key sectors in several European countries by Japanese exports, and have forced U.S. and Japanese companies to adopt more locally oriented production strategies as a condition of market access. Surely there must be some balance or compromise that can be reached between maximizing efficiency at the level of the firm, and the needs of host governments to ensure that firms act in ways that contribute to national well-being.

Although companies and governments may pursue different objectives, the interests of MNEs and those of nations are not necessarily incompatible. Governments can and do offer inducements or impose sanctions that encourage MNEs to act in ways that further the national interest. And companies, for their part, can adjust their approach, commitment, and investments to meet local economic and political conditions, particularly if constraints and opportunities are applied fairly and uniformly.

Problems occur when the rules of different nations that affect MNE behavior diverge from one another, or when one nation favors MNEs based in its own territory, or discriminates against the products and affiliates of foreign-based firms, and the target country does not. Solutions may lie

**Figure I-1—Percent Shares of Employment, Sales, and Total Assets of Foreign Affiliates in the United States and Japan, 1989**



SOURCE: Ministry of International Trade (MITI), "Measures for Promoting Foreign Direct Investment In Japan," January 1992, chart 6; as taken from MITI, "Survey of Foreign Affiliates in Japan"; Ministry of Finance (MoF), "Corporate Business Statistical Annual Report"; U.S. Department of Commerce, *Survey of Current Business*.

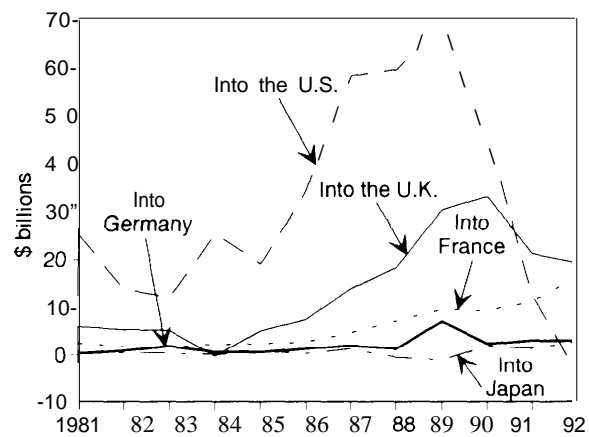
either in no discrimination or in reciprocal and equal discrimination. **The key is to keep the system of MNE business from interacting with the system of nation states in ways that create unfair advantages for some national economies at the expense of others or, in the extreme, set one nation against another.** Despite recent progress at the 1993 G-7 Economic Summit, obstacles to harmonizing trade and investment regimes remain substantial.

The present system of international trade and investment can be characterized as one in which the interests of nations and MNEs have been drawn too tightly (as in Japan) or, conversely, have been allowed to drift too far apart (the U.S. case). This is the result of basic asymmetries, both in the different national systems of policy that regulate trade and investment, and in the organization of business (and business practice) within the Triad of modern industrial economies. **Ultimately, widely divergent policy systems and business practices among trading nations may disrupt the international economy.**

At one extreme, the United States has permitted and encouraged foreign companies to take advantage of extraordinary access to its markets for trade and investment purposes. Even in the automobile sector, for example, where voluntary export restraints were employed in the 1980s to limit Japanese imports, the United States permitted unfettered foreign direct investment (FDI), which helped the Japanese automakers capture even more of the U.S. car market. Thus, foreign affiliates in the United States account for a significant share of total U.S. assets, sales and, to a lesser extent, employment (see figure 1-1). In 1992, Japan's direct investment position in the United States reached \$96.7 billion, exceeding that of any other nation,<sup>2</sup> (Chapter 3 discusses FDI and the special case of Japan.)

Moreover, the United States has constrained the cooperation of competing U.S. companies through pervasive antitrust legislation and litigation. For much of the post-World War II period, the United States championed the system of free and open trade, and to that end, tolerated some unfair trade practices of both developing and industrialized nations.<sup>3</sup> Foreign-based MNEs, operating from a protected home base, have amassed capital and technology sufficient to mount highly sophisticated and successful assaults on key elements of important American industrial sectors and markets, such as automobiles, machine tools, semiconductors, and consumer electronics. At the same time, they have also contributed to the quality and low cost of goods available in the United States. In the automobile sector, there is no doubt that the competitive challenge of Japanese auto companies has forced improvements in product quality and production efficiency at GM, Ford, and Chrysler.

**Figure 1-2—Inward Flows of Foreign Direct Investment into Selected Countries, 1981-1992**



NOTE: Data are calculated on historical cost basis and are in nominal dollars. Reinvested earnings were not included in statistics for France, Germany, and Japan. Differences in data and calculation may account for discrepancies between OECD and Department of Commerce statistics.

SOURCE: Organization for Economic Cooperation and Development (OECD), *International Direct Investment Policies and Trends in the 1980s* (Paris, 1992), p. 15, table 3; OECD, *Financial Market Trends*, June 1993, p. 44, table 1.

At the other extreme, Japan has restricted foreign investment and imports, and has permitted foreign MNEs limited access to its markets, typically only through joint ventures with Japanese partners.<sup>4</sup> (See figure 1-2 for a comparison of FDI flows into Japan and several other Organization for Economic Cooperation and Development (OECD) countries, and figure 1-3 for a comparison of the domestic sales of foreign affiliates in the same countries.) Proprietary technology has often been extracted as a condition of market access. As a prominent Japanese industrialist wrote in 1993, "Japan has much to do to open its domestic market. . . Although overt protectionism has been curbed, it is clear that many

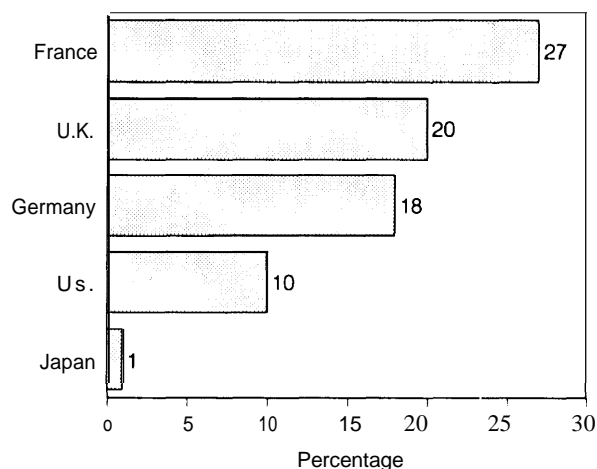
<sup>2</sup>U.S. Department of Commerce, Bureau of Economic Analysis, "U.S. Net Investment Position, 1992," press release, June 30, 1993, p. 8 and table 3. See fig. 3-3 and table 3 of this report.

<sup>3</sup>For a survey of foreign trade barriers, see Office of the United States Trade Representative, *1993 Trade Estimate Report on Foreign Trade Barriers*, Mar. 31, 1993.

<sup>4</sup>For a description of unfair trade practices directed toward Japan, see Industrial Structure Council, Uruguay Round Committee, Subcommittee on Unfair Trade Policies and Measures, *Report on Unfair Trade Policies by Major Trading Partners*, May 11, 1993. The Industrial Structure Council is the official advisory body to the Japanese Minister of International Trade and Industry.

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**Figure 1-3--Foreign Affiliates' Share of Domestic Sales In Selected Countries, 1986**



SOURCE: C. Fred Bergsten and Marcus Noland, *Reconcilable Differences? United States-Japan Economic Conflict* (Washington DC: Institute for International Economics), 1992, p. 66, table 3.3.

foreign products still have trouble with entry into and distribution in the Japanese market.”<sup>5</sup> Foreigners have often found it extremely difficult to invest in Japan, whereas Japanese investors have found many opportunities abroad. (See figure 1-4, which shows the trends in the position of inward and outward Japanese foreign direct investment, and figure 1-5, which offers a comparison of inward and outward direct investment in selected countries on a per capita basis.) In Japan, then, the conception of national interest is tightly coupled to preserving market and investment opportunities for Japanese-based companies, although in recent years, “overt protectionism” has played a less important role than nontariff and structural barriers to foreign products and investment.

The policy questions turn on two issues: 1) how to achieve a rough balance between the needs of MNEs to achieve global efficiency on the one hand, and the need of nations to retain technical and industrial competitiveness on the other; and 2) the exact mechanisms to be deployed for the

distribution of advanced R&D and manufacturing capabilities among competing economies.

Greater coordination among the advanced industrial nations is probably required to harmonize the rules of business and of trade and foreign investment. Until that can be accomplished, however, Congress may wish to consider a range of policy instruments based on the notion of specific reciprocity. Such policies could facilitate the transition to a more global and internationally consistent set of rules for the conduct of international business. (Specific reciprocity is addressed in the Policy Discussion section at the end of this chapter.)

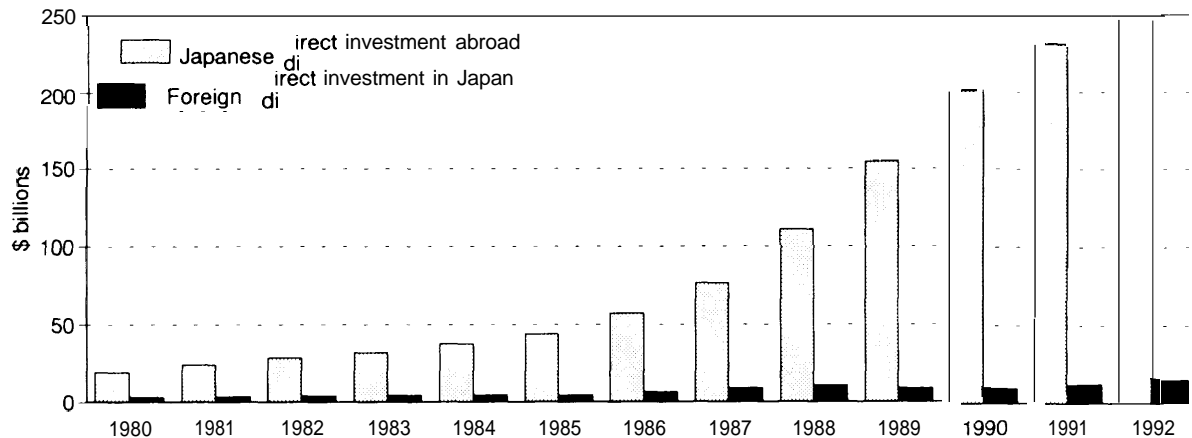
### BACKGROUND AND ADDITIONAL CONSIDERATIONS

As technology and industrial power diffuse around the globe, fewer of the largest MNEs (as ranked by sales) are based in the United States (see figure 1-6). Since the late 1960s, U.S.-based companies have dropped steadily from the list of the 500 largest firms, at a rate of about 6 firms per year or about 150 firms altogether. They have been displaced largely by Japanese firms. During the same period, however, the number of European-based MNEs on the list increased moderately, and in 1991 edged past the number of U.S. firms. The aggregate sales of U.S.-based companies on the list were also exceeded in 1991 by the Europeans, and competition from the Japanese companies continued to escalate (see figure 1-7).

Foreign MNEs, primarily based in Japan and Europe, have thoroughly penetrated most sectors of the U.S. economy, putting pressure on indigenous firms, acquiring some, weakening many, and forcing others to become more efficient or exit the competition. This pattern is reminiscent of the extension of U.S.-based firms to European markets in the 1960s. Nevertheless, sustained concern has focused on the activities of Japanese-based MNEs in the United States, ranging from

<sup>5</sup> Akio Morita, “Toward a New World Economic Order,” *The Atlantic Monthly*, June 1993, pp. 90,96.

**Figure 1-4-Japanese Direct Investment Position Abroad and Foreign Direct Investment Position in Japan, 1980-1992**



NOTES: Data are calculated on a historical cost basis and are not adjusted for inflation. Amounts for 1992 are Bank of Japan estimates.

SOURCE: MITI, "Measures for Promoting Foreign Direct Investment in Japan," January 1992, charts 1 and 3; Bank of Japan, *Balance of Monthly Payments*, March 1993.

Japanese investment in small, high-technology start-ups and university research programs, to the domination of whole industries by Japanese-based MNEs (see chapter 4). While U.S. firms are major players in most industries in Europe, they have, with some important exceptions, faced significant barriers to investing and gaining market share in Japan.

The competitiveness of U.S.-based MNEs is not necessarily the principal concern. Many analysts contend that the issue of national ownership or origin of firms is less important than the contributions that all firms, foreign and domestic, make to a nation's economy. In this view, governments should be concerned with funding basic research, educating a skilled workforce, improving infrastructure, and providing a stable fiscal and monetary environment attractive to MNEs. In practice, however, governments have structured trade, investment, financial, monetary, and industrial policies to benefit their economies and to create advantages for their firms, both at home and abroad.

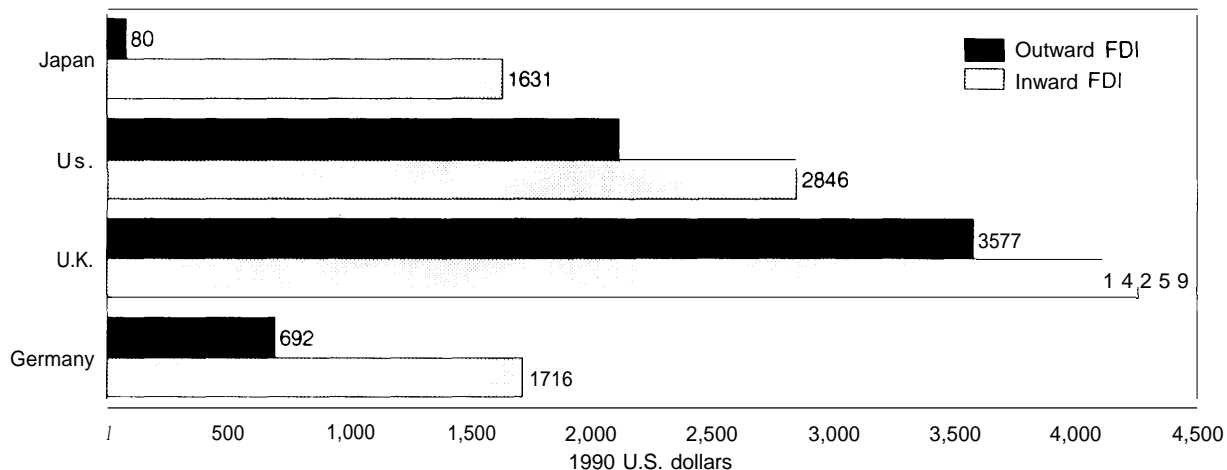
This has led to broad asymmetries and increasing divergence in the national policy regimes of Europe, the United States, and Japan that, taken

together, constitute the rules of the game for the conduct of multinational business. In the area of foreign direct investment, to cite one example, the United States and Britain typically have applied free market principles to the inward and outward flow of investment capital. The other major trading nations, particularly Japan, have imposed a variety of restrictions and conditions on FDI. While France and Italy have consistently applied limitations, Japanese restrictions appear to be qualitatively different and even structural in character.

MNEs, for their part, have responded to asymmetries in market access or ease of investment by configuring their operations differently, for example, by engaging in minority joint ventures or licensing technology and marketing rights to indigenous firms in more exclusive national markets. But asymmetries in the rules of multinational business have not affected all firms to the same degree. MNEs based in Japan, for example, enjoy easy access to both Japanese and American markets, but many U.S.-based MNEs, while facing barriers in Japan, must still battle Japanese and European competition for market share in the United States. Such imbalances in market access

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**Figure 1-5-Per Capita Inward and Outward Direct Investment Position in Selected Countries, 1990**



SOURCE: MITI, "Measures for Promoting Foreign Direct Investment in Japan," January 1992, charts 4; MITI, "Measures for Promoting Foreign Direct Investment in Japan," Sept. - Dec. 1992, charts 1,2 and 2.2; as taken from Bank of Japan, *Balance of Monthly Payments*; U.S. Department of Commerce, *Survey of Current Business*; Bank of England, *Quarterly Bulletin*; Deutsche Bundesbank, *Monthly Report*.

and in national treatment are partially reflected in the stubborn U.S. trade deficit with Japan, which has persisted despite substantial devaluation of the dollar against the yen. The concern is that in some nations, sanctuary markets have been preserved for indigenous firms, and that the participation of foreign-based companies, far from being free and open, has been structured to serve the host government's conception of the national interest.

The question arises: Why has the United States tolerated asymmetries in market access and investment with some of its trading partners, when such practices create disadvantages for U. S.-based MNEs and, in the long term, can inflict damage on important sectors of the U.S. economy and technology base? The answer is part history and part ideology, and goes beyond the question of MNEs. In the immediate post-World War II decades, the U.S. economy and technology base dominated the world. The United States championed the system of free and open international trade, in large measure by opening its own economy to imports and foreign investment, even if nations with less developed economies did not reciprocate. Since many companies in Europe and Japan could not have withstood head-to-head

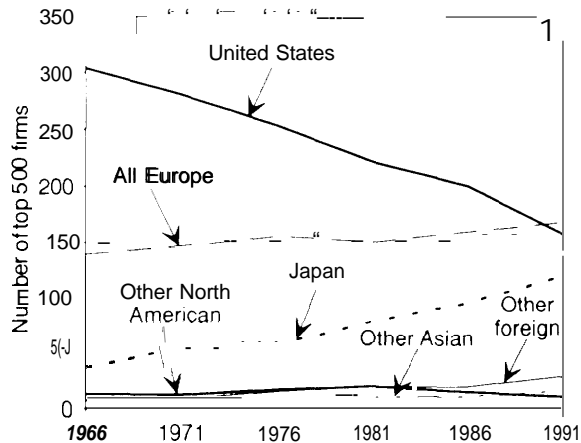
competition with U.S.-based MNEs, foreign countries with recovering economies took steps to protect and subsidize infant industries, establish trade barriers, and regulate FDI.

Policymakers in the United States tended to view these developments as necessary for the recovery of the war-torn European and Asian economies, and for the establishment and maintenance of a global trading system that could support an increasing gross domestic product (GDP) and standard of living in both advanced and developing nations. For over three decades, the Bretton Woods system generally increased the wealth of the advanced industrial nations, and enabled remarkable economic progress among newly industrialized countries.

But since the early 1970s, the technology assets and industrial power of Japan, and to a lesser extent Europe, have grown to challenge and even surpass the United States in many areas. During the 1980s, the commitment to free and open trade, and the fear of igniting trade wars or a global recession, limited U.S. policy initiatives to a patchwork of ad hoc, protectionist policies. These were often designed to aid U.S. firms in industries like steel, textiles, automobiles, and machine tools, and culminated in the Super 301 provisions



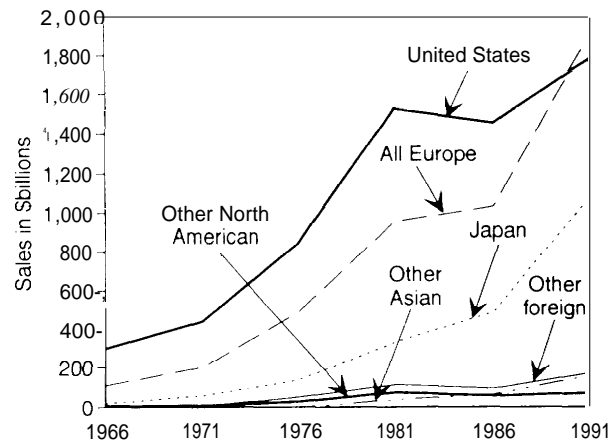
**Figure 1-6—World's 500 Largest Firms by Region of Origin, 1966-1991**



NOTE: Firms are ranked by sales as listed in the International Fortune 500. Some analysts suggest that this figure would be less dramatic if adjusted for exchange rate fluctuations.

SOURCE: OTA database compiled from annual reports, Fortune 500 International, and Standard and Poor's Register.

**Figure 1-7—Sales of World's 500 Largest Firms by Region of Origin, 1966-1991**



NOTE: Sales are calculated in nominal dollars. Some analysts suggest that this figure would be less dramatic if adjusted for exchange rate fluctuations.

SOURCE: OTA database compiled from annual reports, Fortune 500 International, and Standard and Poor's Register.

of the Omnibus Trade and Competitiveness Act of 1988.<sup>6</sup> Despite these measures, for most of the 1980s, the U.S. manufacturing base continued to erode and the U.S. standard of living slipped, both in absolute terms and relative to our major trading partners.<sup>7</sup>

Concern about MNEs is heightened when firms based in a single nation or region appear to win more than their expected or fair share of the global economy, and the suspicion persists that nationalist policies helped them to do so. In the late 1960s, for example, European journalists and policymakers warned that if the “invasion” of Europe by American MNEs was not stemmed, Europe would become a subsidiary, with industrial and technological development directed by MNEs based in the United States. In words echoed in recent

discussions of Japanese investment in the United States, one journalist described the “assault” in Europe by U.S.-based MNEs: “Most striking of all is the strategic character of American industrial penetration. One by one, U.S. corporations capture those sectors of the economy most technologically advanced, most adaptable to change, and with the highest growth rates.”

This view helped mobilize government policies intended to foster indigenous European technology development and industrial competitiveness. Most of the major industrial powers of Europe created national champions, protected their infant industries, restricted inward FDI, sponsored government-funded R&D programs, and subsidized essential industries. This pattern continues within the European Community (EC),

<sup>6</sup> Super 301 authorized the U.S. Trade Representative to retaliate against trading partners for persistent unfair trading practices, but has now lapsed due to sunset provisions in the 1988 legislation.

<sup>7</sup> On the erosion of the U.S. manufacturing base, see U.S. Congress, office of Technology Assessment, *Making Things Better: Competing in Manufacturing*, OTA-ITE-443 (Washington, DC: U.S. Government Printing Office, February 1990); and on the relative decline of the U.S. economy, see U.S. Congress, Office of Technology Assessment, *Competing Economies: America, Europe, and the Pacific Rim*, OTA-ITE-498 (Washington DC: U.S. Government Printing Office, October 1991).

<sup>8</sup> Jean-Jacques Servan-Schreiber, *The American Challenge* (New York, NY: Atheneum, 1968), p. 12.

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with the implementation of EC directives that extend R&D subsidies and preferential government procurement to EC firms. That these policies encourage firms to establish production within the EC is supported by evidence of the continued high rate of FDI, despite recessionary conditions.<sup>9</sup>

In contrast, the U.S. Government appears not to have articulated a strategic concept of the national interest. It has, instead, continued to define the national interest in terms of the more global objective of promoting free and open trade and investment among the advanced industrial nations—and has deviated from these principles only under extreme pressure from special interests. As the U.S. technological and industrial lead diminishes relative to its trading partners, this approach is proving more difficult to sustain.

The interests of all nations ought to be fairly straightforward—quality jobs, a rising standard of living, technology and industrial development, ensured rights of workers and consumers, and a high-quality environment at home and globally. But the interests of nations diverge when there is a zero-sum economic game; for example, during a sustained global recession, or when one or more advanced industrial nations adopts a mercantilist perspective on world trade. They can also diverge over time when differences in the policy systems of disparate nations or regions become too extreme, when the principle of national treatment is applied by some states and not by others, and when MNEs doing business in one country can operate with considerably more latitude than in other countries.

As compared to nations, the interests of MNEs are far more situation-oriented and linked to opportunity. The specifics differ from industry to industry and from firm to firm within particular sectors. Because of their internal flexibility and ability to adapt to external circumstances, MNEs can reconfigure their operations and assets to

meet the requirements of markets and host governments around the world. Increasingly they seek skilled labor, intellectual resources, finished components, capital, and physical infrastructure in different national jurisdictions. In this sense, they are well-equipped to deal with the various asymmetries among the policy regimes of Europe, Japan, and the United States. What they fear most is unpredictable change, change that can take the form of shifting market factors, government regulation, or labor relations—such as the violent labor upheavals in South Korea in 1988 and 1989. Such changes can force MNEs to abandon established strategies, and thereby internalize the costs of adjustment, either as direct financial losses or as lost opportunities. Firms desire what only nations can provide: a stable and predictable political and economic environment conducive to international business.

In specific cases, the interests of MNEs and nations may diverge sharply. From a firm's perspective, moving assets abroad may be necessary to meet competition that has access to lower-wage labor, less onerous taxes, government support for R&D, or even a protected home market. But from a policy perspective, the firm may represent part or all of a key national asset. Because of their ability to adjust to a wide range of external factors, many MNEs can play one national political jurisdiction off against another. Their motivation to do so may increase as global competition heats up and once-proprietary technologies become widely diffused around the world.

Some analysts believe that globalization of MNEs may collectively exert a steady downward pressure on wages, environmental standards, health and safety, and worker benefits. Some are concerned about the erosion of democratic principles, as decisions made in corporate boardrooms and among trade negotiators increasingly affect

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<sup>9</sup> FDI flows into the EC from non-EC countries were approximately \$86 billion in 1990, \$67 billion in 1991, and \$70 billion in 1992 (estimate). Bank for International Settlements, *63rd Annual Report*, 1993.

workers and consumers around the world.<sup>10</sup> This scenario echoes the more parochial conditions of 19th century America, when one state lost major firms or whole industries to another state. The difference today is that the winners might not reside in the United States.

While the social impact of MNEs is not the focus of this study, policymakers are finding that the debate increasingly extends beyond narrow questions of economic advantage. As the European nations are now discovering, the dynamics of cost competition in the global economy can set up a basic and continuing conflict with the social standards long advocated by governments in industrial societies. These include worker benefits, environmental quality, and progressive tax codes, among others. To the extent that global finance and production function in a relatively unregulated environment, this conflict may be inescapable, not just for the United States but for competitor nations as well. The Office of Technology Assessment (OTA) has recently addressed these issues with regard to the proposed North American Free Trade Agreement.<sup>11</sup>

The structure of multinational industry is undergoing a transformation, and it is transforming national economies with it. The change is characterized by globalization of markets and some firms, widespread excess capacity in mature industries, a tendency toward consolidation in many (but not all) sectors, deepening international cooperation and competition among firms, decreasing product-cycle times, and rapidly escalating costs of technology development. The potential consequences of these changes are unclear. Nevertheless, many MNEs appear to be moving toward a more widely distributed pattern of sourcing, foreign investment, and strategic alliances with other firms. (See chapter 5 for an overview of international strategic alliances.)

Their reasons are complex: some seek to optimize global resources, some to hedge against unfavorable national policies; others hope to reduce technical, financial, and market risks. Responding to these changes presents enormous challenges both to nations and to companies. **The principal concern is that MNEs are too important to national and global well-being to have this process proceed in a totally ad hoc manner, and that doing so could lead to economic dislocation and heavy costs of adjustment for nations and companies alike.**

## ABOUT THIS REPORT

This report is the first publication of OTA's assessment of Multinational Firms and the U.S. Technology Base. It was requested by the Senate Committee on Commerce, Science, and Transportation and the Senate Committee on Banking, Housing, and Urban Affairs. The major findings of this report are presented immediately following this section. Although the findings suggest a number of policy options, this chapter does not propose specific policies for congressional consideration, but instead it presents a framework for a discussion of new and largely untried approaches to international trade and investment. The final report of this project, to be published in 1994, will propose specific policy options in the context of particular industries.

The goal of this assessment is not to formulate a series of unilateral national regulations, although that course should not be dismissed out of hand, but to suggest a framework for concerted multilateral action to construct a system of international commerce—one that constrains mercantilism, balances interests among nations and between nations and firms, and facilitates business conditions conducive to international commerce. Fundamental to such a system is the

<sup>10</sup> William Greider, *Who Will Tell the People: The Betrayal of American Democracy* (New York, NY: Simon & Schuster, 1992), pp. 377-378.

<sup>11</sup> U.S. Congress, Office of Technology Assessment, *U.S.-Mexico Trade: Pulling Apart or Pulling Together?*, ITE-545 (Washington, DC: U.S. Government Printing Office, October 1992).

maintenance of a high standard of living in the industrialized world and the continued improvement of less developed economies. This would have to be accomplished in the context of the protection of the rights of labor and convergence toward higher environmental standards throughout the world.

The problems besetting the system of international business and trade are exceedingly complex. The structure of multinational industry is evolving far more rapidly than the rules that govern its conduct. And, as already stated, the policy approaches of major industrialized nations have diverged significantly in ways that may ultimately undermine the post-World War II system of international trade and investment. With these thoughts in mind, this first report should be read as a primer, which develops a common understanding around which future policy issues and choices can be articulated.

The body of the report, chapters 2 through 6, describes and analyzes some of these issues, starting with an overview of the way in which multinational industry is organized and has developed over the past 25 years (ch. 2). Chapter 3 provides a comparative framework upon which to evaluate worldwide foreign direct investment. The chapter analyzes the critical policy differences between the United States, Japan, and the European Community, as well as the costs and benefits of the current U.S. policy of national treatment. The difficulties presented to foreign firms trying to invest in Japan are provided as a special case. Chapter 4 concentrates on the activities of Japanese MNEs in the United States—activities that have been the focus of discussion and congressional debate over the past several years. Chapter 5 addresses the growth of

strategic international business alliances, and their implications for the evolution and regulation of multinational commerce. The final chapter traces the emergence of global capital markets during the past two decades and examines some of the principal implications for MNEs and policymakers. Each of the chapters begins with a brief summary that is followed, when appropriate, by the major findings of the particular chapter.

This report concentrates on large-scale MNEs, many of which appear on the Fortune 500 international list, although it does not exclude analysis of smaller companies with overseas subsidiaries. The OTA database, on which several of the tables and figures rely, is comprised of basic statistics on the 500 largest MNEs in the world.<sup>12</sup> The emphasis on large MNEs stems from their ability to marshal tremendous economic, technological, and political resources. Some of these companies can mobilize technology on a scale matched by only a few nations. Individually, some MNEs are powerful enough to affect significantly the balance of trade among nations in particular industries.

The report also concentrates on manufacturing MNEs, although it does not exclude services or other sectors of international commerce.<sup>13</sup> This is due to the critical linkages among technology development, advanced manufacturing, and the competitiveness of nations, as well as the established concerns about the relative decline of manufacturing in the United States.<sup>14</sup> It is also partly in response to concerns expressed about manufacturing by the congressional committees that requested this assessment. This report draws extensively on the analysis and findings of previous OTA work, particularly on *Competing Economies*, which addressed America's com-

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<sup>12</sup> The database, which contains about 40,000 data points, was drawn from three sources: statistics published from 1966 through 1991 in the *International Fortune 500 List*; data purchased from Standard & Poor's; and data culled from over 500 annual reports of major corporations.

<sup>13</sup> For an overview of the services sector, see U.S. Congress, Office of Technology Assessment, *International Competition in Services*, OTA-ITE-328 (Washington, DC: U.S. Government Printing Office, July 1987).

<sup>14</sup> For more detail on problems associated with manufacturing in the United States, see *Making Things Better*, op. cit., footnote 7.

<sup>15</sup> *Competing Economies*, op. cit., footnote 7.

petitiveness problems as compared with Japan and the European Community .15

## MAJOR FINDINGS

### Finding 1:

The modern MNE is a highly flexible and adaptable form of business organization. It can take many different forms (see table I-1). MNEs configure and reconfigure their operations to meet diverse requirements, including those imposed by different governments, or to take advantage of opportunities and inducements offered to them by governments.

### Finding 2:

Technology differences have decreased among competing firms since the late 1960s. The absolute technology superiority of an IBM, AT&T, or Boeing has been offset by the rise of capable competitors worldwide. The traditional U.S. advantages of privileged access to broad, deep, and liquid capital markets, as well as large economies of scale and scope, have similarly leveled off. In this context, the policies and actions of governments may be decisive in determining which MNEs prosper in global competition. At a minimum, they will influence both which competitors will succeed and where state-of-the-art technology development and manufacturing take place.

### Finding 3:

The structure of the MNE system is changing rapidly. Excess capacity and increasing competition are leading to consolidation and shakeout in many global industries such as consumer electronics, automobiles, pharmaceuticals, and steel. A coherent system of international trade, investment, and monetary policies has not emerged to meet the challenges of the global economy.

### Finding 4:

Instead, broad asymmetries in the policy regimes of the major trading nations have developed—especially market access, foreign direct investment, financial, and industrial policies related to the activities of MNEs. These asymmetries, when combined with major shifts in the global economy and protectionist responses to them, contribute to increasing trade frictions and tensions in international relations.

### Finding 5:

Public policies and private sector initiatives have combined to restrict foreign direct investment in some OECD nations to a level far lower than that of others. (See figure 1-8.) In Japan, for example, the ratio of outgoing to incoming FDI in 1990 was 20 to 1 as reported by Keidanren, Japan's premier business association.<sup>16</sup> The Japanese Government has acted both to assist domestic firms and to ensure that the domestic economy remains self-sufficient in designated industries and technologies. Some analysts suggest that the climate for FDI in Japan is improving, in part due to efforts by the Japanese Government. But the increase in FDI into Japan is moderate, and the evidence of real opportunities for foreign investors in Japan is inconclusive.<sup>17</sup>

### Finding 6:

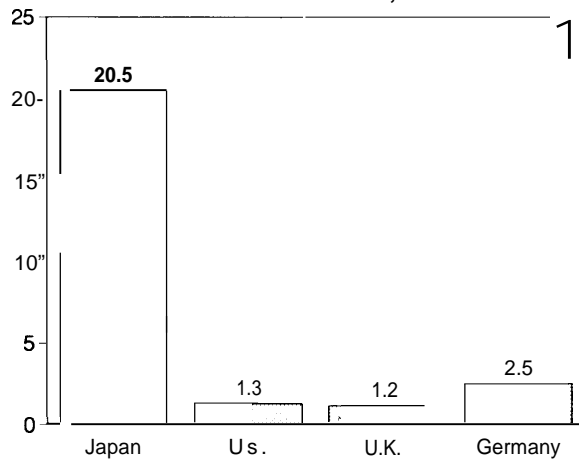
Governments remain influential in dealing with MNEs. The U.S. Government, however, has opted to minimize its influence over many aspects of MNE behavior in the United States. This attitude, as reflected in government policies, is in stark contrast to Japan and several EC member states. Twenty-five years ago, the United States was the center of gravity for world commerce and technology development. Today that center is slipping away, as foreign MNEs increase their penetration of U.S. markets and U.S.-based MNEs

<sup>16</sup> Keidanren Committee on International Industrial Cooperation, "Improvement of the Investment Climate and Promotion of Foreign Direct Investment Into Japan," Oct. 27, 1992.

<sup>17</sup> See c. Fred Bergsten and Marcus Noland, *Reconcilable Differences? United States-Japan Economic Conflict* (Washington DC: Institute for International Economics, June 1993), pp. 81-82.

## 14 | Multinationals and the National Interest: Playing by Different Rules

**Figure 1-8-Ratio of Direct Investment Abroad to inward Foreign Direct Investment in Selected Countries, 1990**



NOTE: The ratios are derived by dividing outward by inward FDI.  
SOURCE: MITI, "Measures for Promoting Foreign Direct Investment in Japan," Sept. - Dec. 1992, chart 3.

shift their attention and assets to expanding Asian markets and Europe. The U.S. Government has not developed sophisticated and flexible policy instruments or the institutional capacity to address this shift.

### Finding 7:

Many MNEs are increasingly "multi" and less "national" than in the past; there appears to be a growing divergence of national needs and the needs of these MNE organizations. This finding is less true of Japanese and some European-based MNEs, where companies tend to retain a stronger national identity. In the European case, some major MNEs are owned or directly subsidized by the state. In Japan, formal government policies and informal administrative guidance—as well as the signals effectively embedded in the structure of business networks—have encouraged companies to consider and act in the national interest.

### Finding 8:

The interests of U.S.-based MNEs frequently diverge from the U.S. national interest at least in part because the U.S. Government has not

specified what that interest is. In the past, the U.S. Government defined the national interest in abstract and international terms, as the maintenance of free and open trade, with the understanding that an expanding global economy means a rising standard of living for all major trading nations. Several high-ranking corporate officers told OTA that in order to survive, they are taking actions they believe are not in the national interest, including selling off key U.S. assets and placing R&D facilities and advanced manufacturing plants abroad.

### Finding 9:

U.S.-based firms no longer dominate the list of the largest MNEs. This decline reflects in part the relative decline of the U.S. economy and the rise of Japan. Of the 500 largest MNEs in the world today, 157 are based in the United States, 168 in Europe, and 119 in Japan. In the late 1960s, 304 were U.S. companies, 139 were European, and 37 were Japanese. Of the 147 new foreign-based firms on the list, 82 are Japanese, 29 are European, and 36 are spread among 14 additional nations (see figures 1-6 and 1-7). The steady rise in the number of foreign-based MNEs is exerting pressure on U.S.-based companies and on the viability of important industrial sectors in the United States.

### Finding 10:

The number and importance of international strategic alliances (ISAs) are increasing rapidly, but their overall significance is not well-understood. This trend is partly a result of intensifying international competition in many industries, and partly a result of dramatically escalating costs associated with technology development and bringing new products to market. There is concern that strategic alliances may weaken U.S. technology leadership in some industries by transferring technology to foreign-based firms. Conversely, some analysts cite the beneficial transfer of process technologies to the United States, particularly from Japanese-based manufacturing firms. In industries and product

areas characterized by high barriers to entry and oligopolist competition, ISAs may present the potential for cartelization and even collusion among alliance partners. Until such time as egregious examples are brought to light, companies involved in strategic alliances will have to exercise a discipline of self-restraint.

**Finding 11:**

For an increasing number of firms, multinationalization represents a strategic response to a changing financial environment characterized by rising international capital flows, more open capital markets, expanded financing options, and volatile exchange rates. Because they have diversified operations in a number of national jurisdictions, many firms can take advantage of remaining regulatory and tax differences to hedge some of the risks created by increased financial uncertainty. Notwithstanding such strategies, productive new investments can still be undercut by the complexity of risk management in rapidly changing national and international markets.

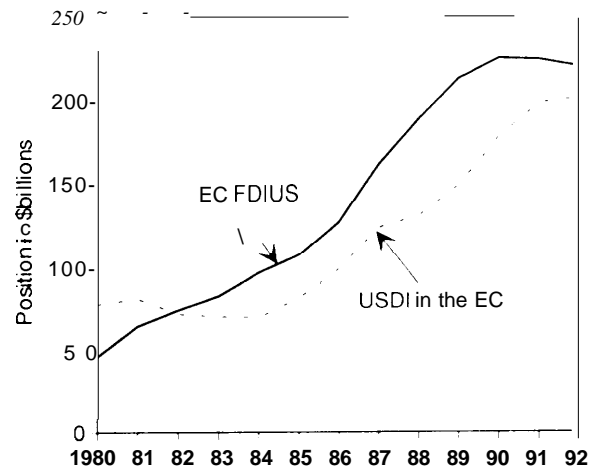
**Finding 12:**

Many U.S.-based MNEs have learned to optimize their operations on a regional or global basis. It is, therefore, likely that movement toward a more managed trading system or a more highly regulated financial environment could force firms to adapt and reconfigure their operations.

**Finding 13:**

**Japanese** MNEs have used both domestic government support and the support of the keiretsu corporate ties to move aggressively into U.S. markets in numerous key sectors such as autos, semiconductors, and consumer electronics. They have drawn effectively on the technological resources of U.S. assets such as innovative small firms and world-class university research.

**Figure 1-9-U.S.-European Community Direct Investment Position, 1980-1992**



NOTES: FDIUS is foreign direct investment in the United States; USDI is United States direct investment abroad. All data are determined on a historical cost basis and are not adjusted for inflation. EC data after 1981 includes Greece and after 1986 includes Spain and Portugal.

SOURCE: U.S. Department of Commerce, *Survey of Current Business*, August issues, 1982-92; U.S. Department of Commerce, Bureau of Economic Analysis, "Net Investment Position, 1992," press release, June 30, 1993.

## POLICY DISCUSSION

Asymmetry in the national policies that influence MNE trade, investment, and market access among Europe, Japan, and the United States is stark. European governments, caught in the intersection of national sovereignty and the evolving rules of the EC, often vacillate on trade and investment issues between promoting policies that tend toward closure and others that stress bilateral reciprocity.

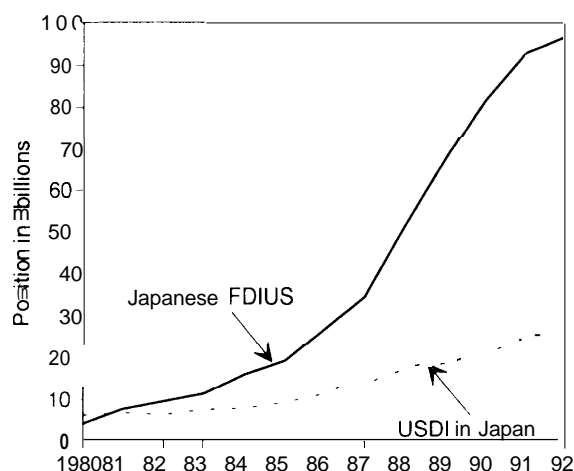
It is difficult to generalize about a European position because countries vary in the policies they promote. French and Italian initiatives often place conditions or restrictions on trade and MNE investment, while the British seek greater access, at least in FDI. In the aggregate, however, the European direct investment position in the United States is comparable to the U.S. direct investment position in the European Community (see figure 1-9). Even though German governments have consistently advocated an open trade and invest-

ment system, they nevertheless often acquiesce to French and Italian demands for constraint of imports, foreign investment, and the activities of foreign-based MNEs. Many German firms have enjoyed the best of both worlds, as exporters and advocates of free trade on the one hand, and as beneficiaries of European protectionism on the other?

Japanese behavior bears little comparable ambivalence. Successive Japanese governments have favored or tolerated market closure in both trade and investment since 1945—to the increasing detriment of many foreign-based MNEs. In recent years, many formal legal barriers have come down, but structural ones have increased, offsetting the legal gains. Although Japan has liberalized outward FDI, joint ventures remain the principal avenue of market access for U.S.-based MNEs. These often involve minority investment positions for the U.S. partner, a significant transfer of American-origin technology to Japanese concerns and, on occasion, apparently preset limits on the market share the joint venture company can attain in Japan.<sup>18</sup> At the same time, some Japanese affiliates in the United States have transferred important management techniques and process-related technologies to U.S. companies. Figure 1-10 shows the disparity in the U.S.-Japan direct investment position over the past decade.

Both the structural impediments that exist in the private sector, and the reluctance of many foreign-based MNEs to commit resources to overcome de facto barriers to investment and trade, contribute to the failure of many U.S.-based MNEs to achieve a credible and commensurate presence in Japan. There is, nevertheless, growing

**Figure 1-1 O-U.S.-Japan Direct Investment Position, 1980-1992**



NOTES: FDIUS is foreign direct investment in the United States; USDI is United States direct investment abroad. All data are determined on a historical cost basis and are not adjusted for inflation.

SOURCE: U.S. Department of Commerce, *Survey of Current Business*, August issues, 1982-92; U.S. Department of Commerce, Bureau of Economic Analysis, "Net Investment Position, 1992," press release, June 30, 1993.

evidence that many problems faced by foreign firms in Japan could be alleviated by concerted action on the part of the Japanese Government, and there is increased interest in pursuing a more activist approach that includes quantitative goals for U.S. trade and investment with Japan, both in the U.S. Government and the private sector.<sup>19</sup> In a recent example, foreign-based firms achieved 20.2 percent penetration of the Japanese semiconductor market in the fourth quarter of 1992—in large measure due to administrative guidance promulgated by Japan's Ministry of International Trade and Industry (MITI).<sup>20</sup>

The relationship between translational investment and trade is the subject of much recent

<sup>113</sup> Several companies told OTA that their Japanese joint venture operations have been limited to a specific market share.

<sup>19</sup> Council on Competitiveness, *Roadmap for Results: Trade Policy, Technology & American Competitiveness* (Washington DC: June 1993), pp. 10-11.

<sup>20</sup> "Upon the conclusion of the [20 percent semiconductor] agreement, the Japanese Government attempted frantically a series of persuasions vis-à-vis the Japanese end-user industries." Yui Kimura, "Inward Foreign Direct Investment in the Semiconductor Industry in Japan," a paper presented at the Conference on Foreign Direct Investment in Japan at the School of Organization and Management, Yale University, May 14-15, 1993, p. 18. The critical role of MITI's administrative guidance in meeting the 20 percent goal by the end of 1992 was confirmed in discussions between OTA and staff of the U.S. Trade Representative.



analysis. Intrafirm trade may already exceed that of international trade among unaffiliated firms.<sup>21</sup> One authority calculates that, for both Japan and the United States, intrafirm trade combined with the exports of foreign-owned affiliates accounted for about half of all trade in the mid-1980s.<sup>22</sup> Using a more conservative measure, another authority estimates that in 1988, intrafirm trade accounted for approximately two-fifths of all imports to the United States, and for about one-third of all exports of U.S. firms.<sup>23</sup>

These figures indicate that, to an increasing extent, trade is closely coupled to and follows from investment by MNEs; that is, parent companies tend to supply their foreign subsidiaries and vice versa. Accordingly, if a nation closely controls or restricts the investments of foreign-based MNEs, then it also controls or restricts a significant proportion of related international trade. Conversely, a policy aimed at attracting inward FDI, if successful, would also attract more imported goods and services from foreign corporate investors. This helps to explain the simultaneous increase in Japanese direct investment in the United States and the increase in the balance of trade deficit with Japan, for example, in the automobile sector in the late 1980s.

The evidence of asymmetry in national FDI policies (documented extensively in chapter 3), and the structural importance of translational investment to the global pattern of trade, raises the question of whether the United States might reconsider its present policy of national treat-

ment.<sup>24</sup> Throughout the 1980s and into the 1990s trade tensions remained high, and “industrial countries resorted increasingly to non-tariff measures to protect trade-sensitive industries from foreign competition.”<sup>25</sup> With a general propensity toward trade blocs and with the Uruguay Round unresolved, the issue of translational investment takes on increased importance. As the foundation of intrafirm trade, such investments provide a safety valve against global market closure. The United States appears to be presented with three broad policy approaches.

### ■ Three Possible Approaches

#### 1. Unilateral National Treatment and Open Markets

The first approach, the currently employed policy of unilateral national treatment, is predicated on the principles of open markets, free trade, and unimpeded investment. The United States has tolerated defections from these principles by other nations that have employed overt industrial policies or more subtle, structural barriers to imports, trade, and investment. On the positive side, investments of foreign MNEs have helped compensate for the low savings rate in the United States, added financial liquidity, and instituted various organizational initiatives in manufacturing production. These benefits cannot be dismissed lightly.

In contrast, there is increasing evidence that a partially open system, characterized by asymmetries in national policy frameworks, may have

21 John M. Stopford and Susan Strange, *Rival States, Rival Firms: Competition for World Market Shares* (Cambridge, MA: Cambridge University Press, 1991), p. 17; and *World Investment Report 1993*, op. cit., footnote 1.

22 DeAnne Julius, *Global Companies and Public Policy: The Growing Challenge of Foreign Direct Investment* (New York, NY: Council on Foreign Relations, 1990), p. 74.

23 Dennis J. Encarnation, *Rivals Beyond Trade: America Versus Japan in Global Competition* (Ithaca, NY: Cornell University Press, 1992), p. 28.

24 The member states of the OECD formally subscribe to the principle of national treatment, which means that governments shall not discriminate against or in favor of any firm based on the nationality of its owners.

25 International Monetary Fund, *Issues and Developments in international Trade Policy*, **World Economic and Financial Surveys** (Washington DC: International Monetary Fund, August 1992). This report also noted that in the 1990s, “. . . protection persists in agriculture and declining sectors and has spread to newer ‘high-tech’ areas (aerospace, electronics, biotechnology). . . . In this uncertain trade environment countries are tending increasingly to address their concerns in the context of bilateral and regional trade arrangements,” pp. 1-2.

significant disadvantages for U.S.-based MNEs, for technology development in the United States, and for the overall vitality of the U.S. economy. Over time, it may lead to the loss of many high value-added jobs in the United States. A primary question addressed in this report is whether the United States can afford to sustain an open, unilateral system of largely unregulated MNE access—both in trade and investment—while MNEs based in several OECD nations enjoy barriers that preclude or reduce comparable imports and investments, for example, in the automobile and electronics industries. The issue is a vital one if, as many now contend, trade and FDI are so inextricably linked in the 1990s that FDI has become ‘trade-creating,’ rather than ‘trade-destroying.’

The competitive decline of many U.S. firms, and the increasing evidence that the U.S. economy has not benefited fully from the influx of trade and investment in the 1980s, suggests that a reconsideration of a unilateral policy of national treatment may be warranted. But the fear of advocates is that attempts by the United States to redress this imbalance could lead to a series of undesirable outcomes—for example, increased protectionism, prolonged global recession, or trade wars. Any adjustment in policy must address these legitimate concerns.

### 2. Enhanced Protection in the United States

The second possible approach would be to restrict foreign-based MNE investment and selected imports in the United States severely, as some appear to advocate. The introduction of wholesale sanctions against foreign direct investment in the United States (FDIUS), or an increase in protectionist trade practices, would likely generate domestic problems for the United States,

as well as problems for the effective functioning of an integrated capitalist system. Neoclassical economists call for maintaining a free trade and investment system because they fear any limitations will cause a spiraling descent into a 1930s-style depression.

Movement toward trilateral trading zones in Europe, Asia, and North America provides evidence of the allure of protectionist trade and investment practices, despite claims that reduced internal barriers are a sign of growing trade liberalization. The United States has worked diligently to avoid the growth of protectionist barriers through the GATT, although the problems of the Uruguay Round persist.

### 3. Specific Reciprocity

An intermediate approach embodies, more directly,<sup>26</sup> the notion of reciprocity in policy”

Reciprocity emphasizes equivalence and contingency. Equivalence suggests a balanced exchange of benefits among nations, while contingency emphasizes conditional action to attain that balance.<sup>27</sup> Collectively, they might reasonably be expected to contribute to a doctrine of fairness, whose instruments are flexible and directed toward a policy of openness, but also amenable to greater closure in particular sectors if circumstances demand.

Some critics have equated reciprocity with mercantilism and protectionism.<sup>28</sup> Some even suggest that responding in kind to unfair foreign trade and investment practices would constitute a first step toward a descent into worldwide market closure and possibly global depression. In this view, the United States should maintain its stance as exemplar and defender of liberal trade, investment, and financial policies, even when significant damage is thereby inflicted on key sectors of

<sup>26</sup> The principle of national treatment encompasses the notion of “*reciprocity*,” which means that broad, unilateral action to open markets in one country should be reciprocated by other countries, although there is no direct requirement to do so.

<sup>27</sup> Robert Keohane, “Reciprocity in International Relations,” *International Organization*, vol. 40, No. 1, winter 1986, pp. 5-8.

<sup>28</sup> See, for example, Jagdish N. Bhagwati and Douglas A. Irwin, “The Return of the Reciprocity U.S. Trade Policy Today,” *World Economy*, 10: 1, June 1987, pp. 109-130; and Edmund Dell, “OffFree Trade and Reciprocity,” *WorldEconomy*, vol. 9, June 1986, pp. 125-139.

the U.S. economy and technology base. It is clear that specific reciprocity represents a distinct choice.

Specific reciprocity involves calculating a ‘careful equilibration of benefits’ and rules that are “designed to achieve particular behavioral outcomes.”<sup>29</sup> It may provide effective instruments for addressing the problem of asymmetry in policy-by obtaining compliance with the terms of bilateral or multilateral agreements through the implicit threat of reciprocal action. Because it can lead to the elimination of foreign barriers, it can expand free trade and investment.<sup>30</sup>

While reciprocity has sometimes been identified as protectionist, it may also serve as a principle of equity whose strategic instruments can promote greater free trade or comparable FDI rules. In the past, the United States has generally pursued unilateral principles in the realm of FDI that ignored transgressions by its trading partners.

Specific reciprocity emphasizes the contingent nature of the action of other countries with advanced industrial economies. It has its own advantages and disadvantages. Used prudently and conservatively, it could provide leverage for the U.S. Government to ensure access in other

OECD countries for trade and investment by U.S.-based firms. Specific reciprocity has the strategic advantage that it can be applied in the context of bilateral negotiations or multilateral forums, and can carry sanctions that are unilateral in application. If used prudently, reciprocity emphasizes the capacity of the United States for flexibility, allowing appropriate policies tailored to particular market sectors. It supports more, and more varied, instruments of policy, while escaping the simplistic choice between free trade and protectionism.

Countervailing potential problems, however, could arise from implementation of a policy of specific reciprocity. Foremost is the possibility of a shift to closure rather than establishing reciprocity, if it is applied on a *quid pro quo* basis, or not employed with a degree of reserve and acumen. Threats of protectionism might, therefore, escalate in the absence of restraint and diplomacy. Indeed, reciprocity may often call for a less assertive tone, but more consultative forms of coordinated management between the U.S. Government and its major trading partners. Specific reciprocity requires competent management and effective diplomacy, but may present the basis for a constructive approach.

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<sup>29</sup> Stephen D. Krasner, “Trade Conflicts and the Common Defense: The United States and Japan,” *Political Science Quarterly*, vol. 5, 1986, p. 788.

<sup>30</sup> See, for example, Beth V. Yarbrough and Robert M. Yarbrough, ‘Reciprocity, Bilateralism, and ‘Economic Hostages’: Self-Enforcing Agreements in International Trade,’ *International Studies Quarterly*, (1986), 30, pp. 7-21, especially p. 19. Keohane, op. cit., footnote 27, discusses this possibility in more general terms, on p. 27.