SOME ASPECTS REGARDING MULTINATIONAL ENTERPRISE

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Abstract: Firms engaged in international trade, but they produced their output only at home. In this paper, we turn attention to the phenomenon of the international company, which Romania had not enough. Traditional trade theory offers few reasons why companies should become international and conduct foreign direct investment. We seek to understand these issues here. Economics has much to say on the subject. In the beginning we provide some brief background, the we define the multinational enterprise and discuss general principles governing location, production, and sales decisions by multiplant firms. We then explore the main characteristics of the multinational enterprise.

Key words: Multinational enterprise, foreign markets, market imperfection

The growth of international companies has been a marked feature of the twentieth century. The world's largest 200 private sector companies, defined by sales, today enjoy a combined turnover approaching one third of the world's gross domestic product [1]. Most of these firms operate on an international scale. In the 1920s, 1950s and 1960s, foreign direct investment was dominated by US firms. In the 1980s, Japanese firms have made much of the running, most often in the forms of new plats in foreign countries rather than foreign acquisitions. Large parts of US business are now owned by Japanese, British, Canadians, Germans and Arab countries concerns. Foreign ownership is still more marked in Australia, Canada, and Latin America, but much less so in Japan.

Most large Europeans countries have tended to confine production to their home base or to other continents, but since 2000s we have seen a big step forward to the East European countries. Cross-border mergers and acquisitions were comparatively rare in Europe a decade ago. The Anglo-Dutch giants, Shell and Unilever, the Volkwagen-Seat link, and the strong Swiss presence in food products and pharmaceuticals are not typical. It seems likely that this may change with the European countries. But at present most large foreign subsidiaries operating in Europe are American owned. France, the UK and Germany are countries where foreign direct investment by domestic companies roughly balances inward investment by foreign firms. The USA and Japan, and now Arab countries, have been major net exporters of capital in this sense, with Japan increasingly overhauling the USA. Many developing countries have hosted inward direct investment by foreign firms, but several have recently started to spawn international companies of their own. This phenomenon is explored by Lal (1983) [2].

Yet international companies are not new. By the end of the nineteenth century, many of Britain's leading firms had spread tentacles over large parts of her overseas empire, particularly in the fields of banking, confectionary, engineering, insurance, mining, shipping and tobacco. The sixteenth and seventeenth centuries saw the emergence of great Portuguese, Dutch and English trading companies, with vast networks of offices, trading posts, and factories spread around the globe. They were preceded on a smaller scale by Genoa, Venice and the Baltic Hansestaedte, and long before that, the Carthaginians, the Phoenicians and the Greeks. The phenomenon usually begins with trade. But the trading companies moves swiftly to establish a strong physical presence in the host country to preempt supplies from competitors. The host country's residents have always had varied reactions to foreign companies. Some welcome them as a channel to technological know-how and wealth. Others see them as latter-day Vikings bent on pillage. These complex attitudes persist. The hope of lucre is tinged with fear of sovereignty. Opinions in the capital exporting country, whose companies internationalize their operations, are simply mixed. The prospects of higher and steadier profits, and considerations of national prestige are qualified by apprehension for exports, wages, jobs and dissemination of advanced domestic technology. Governments everywhere are as excited by the thought of attracting foreign capital as they are fearful that tax revenues will be lost if the prices of intra-firm international transactions are warped with the aim of minimizing global tax payments. In the USA, the traditional home base for most of the world's largest multinational enterprises, there have been growing worries about the scale of recent inward direct investment and

acquisitions by foreign firms. Some are concerned at the thought that foreign companies are buying up US businesses to drain off superior US technology. Researchers suggests, however that such fears may be unjustified.

Multinationals tend to fall into one of three categories. Horizontally integrated multinationals are firms with national branches of an enterprise producing largely the same product. American car companies and fast food chains are examples.

In vertically integrated multinationals, the output from one national plant provides an intermediate input to another national plant, all under common ownership and control. Until recently, multinationals in the oil industry were an instance of this: crude oil is extracted in one country, refined in another and marketed in a third. In Romania, in recent years we saw a big number of vertically integrated multinationals, especially in automotive and car producing industry.

Diversified multinationals are firms with national plants the outputs of which are neither vertically nor horizontally integrated. The Nestle Corporation in Swiss owned but 95% of its production is outside the country: it is involved in foods, restaurants, wine and cosmetics. The number of diversified multinationals is growing rapidly.

A company can be multinational in at least three senses. It can sell in more than one country; it ca run plants or own subsidiaries in two or more countries; and it can be owned internationally, with quotations on more than one national stock exchange, for example. Many large companies are multinational by all these definitions. But for our purposes the most important test of multi-nationality is production. Let us define an enterprise as multinational if it owns or runs production facilities in two or more countries. Multinational enterprises on this definition are responsible for much of the foreign direct investment undertaken throughout the world. We know why countries should trade with each other. Still, these explanations take a very limited local view of companies' production behaviour. But just because a theory does not explain every real world phenomenon does not mean that it should be discarded. The principle of comparative advantages is extremely important, whether or not there are multinational enterprises. If the theories are found to be deficient because they do not explain an important phenomenon, the assumptions made in the model must be examined: this is usually the source of the deficiency. When discussing the notion of comparative advantage we could assume that all firms are perfectly competitive and had equal access to the international markets, independent of their country of origin. We have to relax these assumptions if we wish to identify and explain the economic attributes of the multinational enterprise. In fact, we shall see that multinationals do not undermine the concept of comparative advantage. They underline it. For comparative advantage plays a vital role in the multinational's location and trading decisions. A multinational enterprise exists precisely because these assumptions (perfect competition and equal access) may not hold. One can explain the existence of the multinational by acknowledging the existence of certain types of market imperfection in the international economy.

We can note two points that increase the reason for establishment of overseas plants. First, multinationals are typically oligopolists, that is, the output and pricing decisions of firms in a particular industry are interdependent. We can observe that multinationals enjoy market power. The market form in which they operate is usually one of international oligopoly, with elements of monopolistic competition. One possible reason for this is the sizeable setup costs that are involved in establishing an overseas plant. Only larger firms will be willing to incur these costs. Firm size obviously correlates with market power. The establishment of overseas subsidiaries is hardly comparable with the strict conditions of perfect competition. In a perfect competitive industry there are many independent small firms enjoying common access to knowledge. The element of oligopoly power provides some insight as to why certain firms choose to establish cross-border plants. Entry barriers are crucial in maintaining a high profit. If these come to be eroded in the domestic market, then the firm may find it best to set up plants overseas. This argument is false in a world of full information: firms will go overseas anyway, regardless of domestic developments, if there are profits to be had by doing so. But it becomes appealing when information and decision-making costs are taken into account. The expected adverse trends in home profits, due perhaps to increased competition from rivals, will shake a firm into scrutinizing its options carefully, something it would be less likely to do had conditions been tranquil. The outcome could be the discovery that costs are low enough abroad. Foreign direct investments will follow. We can discuss now the case of Nokia, who had relocated a production plant form Bochum, Germany to Jucu, Romania. The movement of the factory became more cost effective in Romania, because of the low work costs here. Nokia announced the cut back of number of

jobs (form around 6000 in Germany to around 3000 in Romania) and then calculates that the work related costs here were smaller. Since the ultimate goal of a company is profit, the movement is truly correct. Of course, the social impact on German work force is strong, but we could predict (on a long scale term) that the same thing could happen in Romania. If Nokia will find a lower cost of labour somewhere else, the company will probably relocated there its plant, regardless of social distress produced in Jucu region.

It is assumed that in the decision to set up a plant overseas, locational efficiency conditions have been met. Considerations of locational efficiency, that is comparative production and distribution cost considerations, obviously help to explain where production occurs. But it cannot be only factor at work. If it were, one would have to ask why a host country firm is not producing and exporting the goods. The multinational firm has to have some specific advantage that gives it an edge over potential indigenous producers. There are some reasons for setting up overseas plants. Prominent among them are the importance of gaining access to a particular market, the desire to spread risks, and adverse trends in home-market. There is obviously no single factor at work.

There are many explanations for why firms may choose to establish an overseas plant, all of them essentially related to some form of market imperfection. Such imperfections in turn cause the firm to internalize the market, a concept that we try to explain below. The market imperfections include the following:

- Barriers to international trade due to the tariffs and other barriers to trade mean that not all firms have equal access to the same market. Provided locational efficiency conditions are met, the establishment of the plant in the protected country is one way of overcoming these barriers.
- Market imperfections in the supply market arise from imperfect competition or imperfect information. Suppose that the supplier of a crucial factor input in a firm's production process has some monopoly power. Then the purchasing firm may confront problems such as price discrimination and it will certainly pay a higher price for the input than it would have done under condition of perfect competition. In these conditions it may pay the firm to internalize the supply network by buying up the supply source: making the supplier the part of the buying firm's production process. If the supply firm happens to be located in another country, then the purchasing firm becomes a multinational.
- Product differentiation may also lead to internalization. Suppose that some crucial factor input is supplied by a number of firms, but the products of each of these firms are slightly differentiated. Then the buyer of the product will face a large fixed cost in switching from one supplier to another because of the costs of testing or adapting to new varieties and/ or differences in the organizational structure of the selling firms. In the presence of switching costs, it is in the interest of buyer and seller to enter into a long term "arm's length" contract, which is a contract formed between separately owned firms. With terms specified in advance to take account of every possible contingency. But negotiating such a contract will prove very costly. The alternative is internalization of the intermediate product market.
- Less than perfect information regarding supply is a problem if the supplier of the factor input is external to the production process. Suppose that buyer had less than perfect information on the price and future availability of the input and the supplying firm does not provide all the information (for example, on future price development). If such behaviour is potentially very costly for the buyer, then internalization will ensure that the firm has the most information available. It may be especially important for firms relying on raw materials in the production process, where prices are highly volatile and accurate information on price is very important.
- Presence of increasing returns for the multinational, which transcend any scale economies at the level of individual plants. There could be monopsony power in the market for raw materials and cost savings for coordinating inventories and research and development activity, or economy in the transportation network when the shipment of goods extends beyond the output needs for a single plant. Finally, there may be scale economies from the pooling of the capacities of the different national plants to meet local demand fluctuations. All these are examples of positive externalities between plants, which only an integrated firm, as multinational is in position to exploit.

- Difficulties in trading a firm's intangible assets may explain the establishment of plants across national boundaries. Knowledge is one example of an intangible asset. The firm may possess knowledge of how to produce a cheaper or better product at given input prices which permits production at lower costs. It may take the form of a patented process or design or it may be less formal, involving the know-how shared among the employees of the firm. Marketing skills permit a firm to differentiate its product from those offered by competitors. Managerial skills lead to more cost-effective production. Why is a firm unable to trade some of its intangible assets? The answer is that the traditional market concept may break down in this case. The market fails because there is an important characteristic of intangible assets, which prevents them from being traded in the usual way: the one-sided or asymmetric information aspect of intangible assets prevents there being an efficient market in them. Intangible assets have some attributes of a public good because knowledge or informational advantages are important features. If a piece of information can be used to the firm's advantage at one location, it can be deployed profitably at another without a reduction in knowledge at the original location. The marginal cost of using the knowledge in the production process is zero. Attempts to trade the intangible asset on the open market are likely to fail. For example, suppose a firm tries to sell its intangible asset to another firm. The intangible nature of the asset will mean that the potential buyer is unable to assess the true value of the proposed purchase. If the selling firm reveals the details of why the asset is valuable, the buyer obtains knowledge that has not been paid for. A further problem is the fact that the commercial value of the information, even if it could be established, depends on how many firms are to purchase it, and when. So a firm may be endowed with an intangible asset it might like to sell some off, but cannot. It may have, for example, an excess capacity in managerial skills. It may be profitable to "internalize" the market for intangible assets by selling up other plants, if they meet the test of location efficiency. If conditions point to an overseas location, then the firm becomes a multinational.

The firm has three choices: it can serve a foreign market by exports from its domestic production base; it can license other firms to produce abroad; or it can set-up production facilities of its own overseas. Asset intangibility does not always give rise to the third option of foreign direct investment. If the intangible asset can be embodied in the product without adaptation and if plant level returns are strongly increasing and international trade barriers weak, then exporting is the best method for penetrating the international market. It is worth stressing that multinational production is not necessarily a substitute for exports from the home base. If the intangible asset takes the form of knowledge of a specific process or product technologies that can be written down and transmitted, then foreign expansion is likely to take the form of a licensing: a local firm is licensed to manufacture the company's product in return for royalties and other form of payment. But the firm may find that such a strategy eventually leads to the growing of competitors.

If the intangible asset is inseparable form the firm itself because of the strong public good element in it, then the market fails and the firm finds it is unable to unbundled these skills: the answer is foreign direct investment. The choice between the licensing and foreign direct investment also depends on other considerations, above all the "market solution" bedeviled, as we have seen by the difficulties in drawing up appropriate contracts. The non-market solution for foreign direct investment can suffer from other disadvantages. How is the foreign subsidiary to be monitored and controlled? How much latitude should its managers be given? Should their rewards be related to results, or should the parent company offer them some form of implicit income insurance against risks?

One advantage of foreign direct investment is the reduction of risk through international diversification. Popular saying " do not put all your eggs in one basket" applies at its best here. Much of the systematic or general market risk affecting the corporation is related to the business cycles in a firm's national economy. By diversifying across countries the economic cycles of which are not perfectly phased with the home country, the variance I the firm's overall earnings and cash flows can be reduced. However, many of the political and economic risks specific to the multinational enterprise are unsystematic. Diversification cannot help here. More important, various market imperfections may deny individual investors full access to the international capital markets. Information barriers and legal economic considerations (tax regulations, currency controls) may prevent individuals from fully diversifying their portfolios. Investment in the stock of a multinational is a means by which these imperfections can be overcome. By setting up foreign subsidiaries, the multinational gives investors a geographical spread of risks on their assets more

cheaply than they could obtain on their own. Asymmetric information is also relevant here: the multinational can be thought of as an institution rather like a bank, which specializes in exporting private unmarketable information about the particular set of products and markets with which it is involved.

To summarize, the multinational enterprise, or the predominant form of foreign direct investment, is the response of the oligopolistic firm to:

- Market or international capital markets, or imperfections which can arise in the intermediate products market; because of market failure associated with intangible assets.
- The need to achieve economies of scale that extend beyond national plants;
- Government barriers to international trade that deny equal access to markets.

Companies have become multinational for many reasons. Transport costs favour international dispersion of production facilities. Although increasing returns at the plant level make for geographical concentration, there are numerous reasons why they may relate to the firm and not just to its individual plants. If they do, the international company will be admirably placed to exploit them. Tariffs set by individual governments pay a key role too. Also, individual investors will often find that stocks in multinational enterprises give a better risk-return trade-off in their portfolios that an assortment of shares in the different national firms in different countries. Asymmetric information issues are one aspect of this. They also explain why companies often choose to set up overseas subsidiaries rather than license production by foreign firms, and at the same time, why such firms structure their worldwide operations in the different ways that they do. Asymmetric information considerations, and associated game-theoretic concepts, lie at the heart of every facet of the multinational enterprise: its internal operations and transactions; its external dealings with customers, suppliers, rival firms, and national governments; even the reason for its existence. It is also to be regretted that the existing literature on multinational companies by and large ignores them.

Like the great international trading monopolies of earlier centuries, today's multinational enterprises are almost states in themselves. Some generate turnover far in excess for the GDP of smaller countries. This is an appropriate point, therefore, to turn from the microeconomic analysis of international activity to the macroeconomic.

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