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COMMENTS ON: MULTINATIONAL CORPORATIONS IN THE EASTERN EUROPEAN ECONOMIC TRANSITION

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1. Multinational Activity in Eastern Europe up to the Present

The most important single fact to be noted in discussing the present role of multinational corporations in Eastern Europe (in which I include the Soviet Union) is the insignificance of the activities of these corporations. Full acceptance of multinational activity has come only very recently in this region, of course. For example, the possibility of 100% ownership by foreign companies appeared only in the year of revolutions, 1989, and even then not by every country. Despite this possibility, there is enough equivocation in present legislation and ambivalence of attitude amongst Eastern European politicians that it might be many years before the officials of Western corporations come to believe that Eastern Europe welcomes and protects their investments as much as does, for example, Turkey, Portugal, or Greece.

The past negative attitudes toward foreign domestic investment imply that Eastern Europe is decades behind its potential economic rivals in securing the benefits from what is surely one of the most potent productive forces in the modern world -- the multinational corporation. To see how far Eastern Europe lags, it is best not to focus on how small is the level of foreign direct investment in Eastern Europe, for it is indeed insignificant. Rather, it is much more pertinent to remark upon the vast significance of the activities of multinational corporations in the European capitalist peers of Eastern Europe. Thus, according to the figures of *Dunning and Cantwell (1987)*, multinational corporations employed 21% of the manufacturing labor force in Greece in 1977, 26% in Austria in 1981, 35% in Ireland in 1981, and 13% in Portugal in 1978. (There is no doubt that these percentages will have risen since that time.) Hence, if the Eastern European economies are to catch up with their potential rivals, there would have to be a massive injection of foreign investment and a massive reallocation of the labor force.

Yet, these massive changes will not happen quickly. Present developments in the Soviet Union evidence this point quite clearly. (*See, for example, PlanEcon Reports VI.17 and V.10.*) Foreign domestic investment in the Soviet Union became possible in April 1987, in the form of participation in joint ventures. Given the previous isolation of the Soviet economy and the consequent potential for new investment opportunities, one might predict that there would be a flood of investments into this vast economic region. However, that potential is apparently outweighed by the tremendous uncertainties in the present political and economic climate. Thus, although interest was high -- measured by the fact that over 1500 joint ventures were registered within the first three years of operation of the joint-venture legislation -- activity is low. It is estimated that only 15% of these joint ventures are operational. Their total yearly sales currently amount to less than one dollar per Soviet citizen. Moreover, these joint ventures are focused on a rather narrow set of activities, in two senses. First, the sectoral interests of foreign partners are mainly in the area of services, while there is little activity in manufacturing. Second, the location of activity is highly skewed toward Moscow, which has received nearly half of the joint ventures. Evidently, these joint ventures are contributing little to the establishment of a decentralized manufacturing base, which is the necessary condition for foreign direct investment to reverse the effects of 60 years of planned autarky.

The foreign capital stock that does exist in Eastern Europe has, up to now, been installed as the result of joint venture-activity. This observation is crucial both in gaining an understanding of the effects of past foreign direct investment on future economic performance and in understanding why joint-venture legislation is not sufficient in the present context. Joint-venture operations lead to a very different structure of activity than in operations conducted under conditions of complete foreign ownership (*Murrell, 1982*). When a foreign company cannot completely control an overseas activity in which it participates, that company is much less willing to undertake certain types of operations. For example, companies often insist upon complete control of activities if they are to transfer the technology for making new products or to put at risk a reputation for quality that is embodied in their trademarks. Hence, compared to wholly foreign-owned subsidiaries, joint ventures are less likely to function in sectors in which new products are important and in areas where the use of brand names is crucial. This simple fact can be seen by comparing the structure of foreign direct investment in two countries that are similar in many respects -- Turkey and Yugoslavia -- but which have differed in their past attitude toward foreign direct investment. In Turkey, 100% ownership was allowed, while, until recently, foreign direct investment in Yugoslavia had to take place within joint ventures.

The following table shows the cross-sectoral structure of foreign direct investment in the two countries. The sectors are listed in the table roughly in the inverse order of the importance of new product technology and quality reputation in the activities of the sector (*Murrell 1990, Chapter IV*). Yugoslavia, which did not allow complete foreign ownership, has a much higher concentration of foreign direct investment in activities in which raw materials processing is most important and less in the sectors in which new products and quality are most important. Of course, this latter group of sectors is exactly the one in which the performance of the Eastern European economies has been poor relative to their capitalist peers (*Murrell 1990*).

Table A1: The Structure of Foreign Direct Investment in Manufacturing in Yugoslavia and Turkey

Sector:	Proportion of Foreign Domestic Investment in	
	in Yugoslavia	in Turkey
Basic metals	0.310	0.211
Chemicals	0.263	0.159
Wood, paper	0.046	0.054
Rubber	0.063	0.036
Food processing	0.058	0.160
Metal products	0.052	0.077
Transport equipment	0.184	0.202
Electrical machinery	0.025	0.102

Note: The data in the table is taken from Cory (1985) and OECD (1983). The figures for Yugoslavia are for 1980 and for Turkey in 1982. The data on the service sector and on manufacturing sectors not strictly comparable in the two data sources are not reported and are excluded from the totals on which the proportions are based. Hence, the proportions in each column sum to unity.

Hence the stock of foreign direct investment that has been inherited from the old economic regimes, and any accumulating now under joint venture arrangements, will not be relevant in addressing the most significant areas of failure evidenced by the Eastern European economies in the past.

Is the level of multinational activity likely to change dramatically in Eastern Europe in the near future? Of course, some small Eastern European country might be the fortunate beneficiary of a relatively large amount of multinational activity. For example, as *Andras Inotai (this volume)* shows, the situation might be somewhat hopeful for Hungary. But there is every reason to believe that Hungary's location, past economic history, and promise of tranquil politics make it special, rather than typical of Eastern Europe. The present flow of foreign direct investment into other countries in the region is certainly less than into Hungary. Moreover, the laws now being passed in Eastern Europe still evidence a large degree of ambivalence towards foreign corporations. For example, the relevant Polish legislation allows case-specific government intervention that can impede the setting up of the operations of a foreign company. Reflecting the old fears of capitalist monopolies, the laws presently awaiting the approval of the Soviet parliament restrict a foreign company to majority ownership in only one enterprise (*Moscow News, October 14, 1990*). In addition, the general economic instability of the region argues for great caution on the part of any potential foreign investor. Thus, only radical changes in the incentives facing multinational corporations are likely to change the foreign direct investment

developing its own technologies.

picture soon. I return to the subject of such incentives in section 4 of this paper, where I make some normative comments on policy relevant to the present situation.

2. The Effect of the Past Absence of Multinationals

The almost total absence of multinational corporation activity in Eastern Europe in the past has had notable effects on the nature and level of economic activity in that region of the world. First, there has been a significant effect on the level of trade. Modern economic theory *(for example, Helpman and Krugman 1985)* focuses on internalization of trade as the central characteristic of the operations of multinational corporations. Hence, transactions that would otherwise be too costly can occur when there are multinational corporations. Theory, then, predicts that countries shunning multinationals will have lower levels of trade. In a recent paper *(Murrell, 1989)*, I have shown that this effect is verified both for capitalist and Eastern European countries in the 1970-80 time period. Indeed, within a standard gravity model, a variable measuring multinational activity can explain all the differences in levels of trade between Eastern and Western Europe that cannot be explained by the usual measures of country size -- population and gross domestic product.

Perhaps more important than levels of trade, the absence of multinationals has led to a peculiar structure of international trade for the socialist countries. The need for internal organization (rather than arm's length transactions) varies greatly across sectors. That variation is evidenced in the cross-sectoral importance of the activities of multinational corporations. For example, *Blomstrom, Kravis, and Lipsey (1988)* find that nearly fifty percent of the exports of electrical machinery of less-developed countries is due to the operations of U.S., Japanese, and Swedish companies. (Such patterns of activity are, of course, also reflected in the table above, in Turkey and Yugoslavia.) The corresponding figure for metal products is only eight percent. Given this fact, it is not surprising that, when one compares the pattern of trade of the Eastern European countries with that of comparable capitalist countries, the former specialize in simple semi-processed materials and have a large comparative disadvantage in higher-quality high value-added products *(Murrell, 1990)*. Moreover, the high-technology imports of Eastern European countries are much less significant than those of capitalist countries, even though Eastern Europe has had well known difficulties in ~~implementing technological advances~~. The absence of cross-border internal organization -- multinational corporations -- means that the socialist countries have simply been unable to absorb new products as fast as those countries that embrace foreign direct investment.

developing its own technologies.

The above implies that the Eastern European countries lost two sources of technology because they refused to countenance the internal operations of multinational corporations. First, there was the technology embodied in new goods, which often cannot be easily exchanged on the market because of the uncertain value of new products. (Presently 75% of R&D activity in Western countries is directed at creating new products, as opposed to new processes). Second, there was the direct transfer of technology occurring within organizations. Three-quarters of direct technology transfer by U.S. corporations is deemed to flow to multinational corporation affiliates, rather than at arm's-length to licensees *(Vernon 1980, p. 737)*. *Mansfield et al. (1982, p. 36)* estimate that it takes six years to transfer a technology overseas to a multinational corporation subsidiary in a developed economy, but that the lag is thirteen years if licensing is the method of transfer. Moreover, there are likely to be spillover effects into domestically-owned industry from the presence of multinational corporations. *Blomstrom and Wolff (1989)* emphasize the effects of competition on domestic firms, the spread of labor trained by the multinational corporation, and the impact of the multinational corporations on the practices of their domestic suppliers. They show that these factors can help to explain differences in rates of productivity change across Mexican industries. All these facts underscore the conclusions of *Brada (1980)* and *Murrell (1990)* who emphasize the constraints on East-West technology transfer imposed by the absence of the operations of the multinational corporations.

3. The Spillover Effects from the Presence of Multinational Corporations

The discussion in the previous paragraphs leads directly to the most important issue in thinking about appropriate policy toward multinationals during the Eastern European transition. As emphasized in the first section of this paper, the prevailing attitude in Eastern Europe (and to be fair, in many other countries) toward multinational corporations is somewhat negative. There seems to be a suspicion in most Eastern European countries that capitalist corporations must be monitored very closely and restricted in their operations, or otherwise exploitation will occur -- to use a favorite term inherited from the old regimes. Here, I would like to argue that, in fact, the opposite might well be the case. It is likely that the multinational corporations will contribute more to the development of the Eastern Europe economies than these corporations are able to extract from the region. Because of the very nature of multinational corporations and the spheres of the economy in which they tend to be important, there are likely to be large positive spillover benefits for most Eastern European countries from foreign direct investment. In order to make this argument, I simply list the spillover benefits that are likely to occur from the operations of multinational corporations and show how these benefits directly address the problems that will be particularly important in Eastern Europe in the years of transition.

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a. Technological spillovers can occur in myriad ways -- for example, through the three routes emphasized by *Blomstrom and Wolff (1989)* and discussed above and through the copying and imitation of products and processes that are inadequately covered by patents. Given the technological lag between Eastern Europe and the rest of the world in many sectors of activity, these spillover benefits are likely to be very significant in the earliest years of reform.

b. More important perhaps than the high-technology which is often the obsession of economic policy, there are the elements of business and organizational culture that are so intrinsic in the operations of modern capitalism, but which are missing from the operations of the Eastern European enterprises. Thus, the operations of multinationals are bound to spread modern techniques of accounting, Western business practices, the use of international standards in the manufacture of products, and simple ideas about organization (e.g., franchising operations). Here, it must be emphasized that these basic elements of modern business culture will inevitably spread from the operations of Western corporations to the rest of the economy because they are not the types of ideas that are protected by patents or by secrecy. It is only the previous isolation of Eastern Europe that has stopped the spread of such ideas in the past. Moreover, these ideas often cannot be spread by textbooks or by the counsel of consultants. They are ideas that often can only be transmitted by practice and personal contact -- learning by doing. Therefore, the participation of multinational corporations is absolutely essential for the quick diffusion of such ideas within Eastern European countries.

c. When the quality of a product can vary greatly as a result of variations in the manufacturing process, it is often in the interest of companies to gain a reputation for quality. As I have argued elsewhere (*Murrell, 1982*), until foreign companies have clearly established their reputations, there will be a tendency for buyers to use country-of-origin as a signal of quality. This tendency has been important in Eastern Europe in the past where individual company trademarks have been little used. Needless to say, the quality reputations of the Eastern European countries are not high. Hence, anything that changes customers' perceptions of quality might have enormous significance in increasing the selling price of a country's products. Sales of products made using the technology of multinationals might do exactly this. To the extent that such sales change foreign customers' perceptions of a country's products, they provide a beneficial externality for the country in question.

d. It is an unavoidable fact that economic activities are highly dependent upon the processes of politics. Even if an economic activity cannot gain much from the solicitousness of politicians, it might lose much from the enmity of the body politic. Hence, multinational corporation activity -- indeed private sector activity in general -- requires political support that protects it and defends it from political encroachment. This support could be most reliably generated by the workers and managers of the foreign-owned enterprises that are operating in an economy and the suppliers and customers of these companies. Hence, there is an inevitable political-economy externality in the setting up of a multinational enterprise during the early stages of the Eastern European reforms. The creation of such an enterprise will be instrumental in creating the political conditions favorable for multinationals.

e. The presence of multinational corporations tends to be greater in industries that pollute less per unit of value-added. (The reason for this is simply that multinationals operate in industries where transaction costs are high -- where organizational and technological skills are at a premium. For natural reasons, these industries are ones where value-added is high and raw materials processing is less important. Raw materials processing industries are the high-polluting ones.) Hence, the addition of substantial multinational production capability might well be a significant second-best anti-pollution policy for a nation suffering the after-effects of the laxness that the communist regimes showed on matters of environment policy.

4. Conclusion: What Policy for Multinationals in Eastern Europe?

The three preceding sections constitute a single strand of reasoning that proceeds in three steps. Once the threads of this argument are clearly seen, there inevitably follows a simple conclusion concerning the nature of the appropriate Eastern European policy toward multinationals. The first step in the argument is to recognize the drastic limits that have been placed in the past on the operations of multinational corporations in Eastern Europe. Second, the absence of multinationals (compared to their important role in capitalist economies) is one of the most important factors explaining the relatively poor economic performance of the Eastern European economies over the past two decades. Third, in the activities of multinational corporations, there are a very large number of beneficial externalities that will be crucial in changing the Eastern European landscape.

The conclusion that stems from this argument is straightforward and contains the only major disagreement between this paper and the one by *Andras Inotai (1991)* contained in this volume. A passive policy towards multinationals is not sufficient in the present situation. Instead, the Eastern European countries must undertake a very active effort to encourage foreign direct investment activities. If such encouragement requires tax concessions and subsidies, then what is necessary must be done. Inevitably, such policies will involve unequal treatment between domestic and foreign enterprises, favoring the latter. This must be accepted because it is either this choice or stagnation. For the Eastern European countries must acknowledge that policies favoring multinational corporations are the inevitable consequence of their past economic mistakes, especially the retreat into autarky that was such an essential part of their planned past.

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