

RECENT FOREIGN DIRECT MANUFACTURING INVEST- MENT IN THE UNITED STATES

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The study of direct investment movements has become increasingly important in recent years due to the impact that these movements have on development, balance of payments, and domestic control of the domestic economy. From 1954 through 1967, the value of foreign direct investment in the United States grew from \$4.6 billion to \$9.9 billion. Concomitant with this growth has been an increase in interest in the United States to attract foreign investment. At the national level the interest has evolved because of balance of payments problems; whereas, at the state and local level, interest is due to industrial development objectives.

The purposes of this study were to explain why investment has entered the United States (a net direct investment exporting country) and to profile the investor and his decision process. Most of the information was gathered in interviews with corporate managers of 40 firms (located in Canada, France, Germany, the Netherlands, and the United Kingdom). All of these companies made their first direct manufacturing investments in the United States between 1954 and 1968. The study also relied on published material and interviews with bank and government officials in the United States and abroad.

Investor Description

First of all, what did these companies look like? On the question of nationality, direct investment in the United States has come almost entirely from ten highly developed countries and nearly 60 per cent from Canada and the United Kingdom. This is understandable since firms from these countries are more apt to have available capital and

management to divert to external endeavors. Furthermore, these firms have experience in producing and selling goods in the economies which most closely resemble the economy of the United States.

Since at the time of the study there were only 316 foreign firms which were known to have manufacturing investments in the U.S., it was believed that these would be very large firms relative to other foreign firms. This was not true however. The participants' sales ranged from \$1.0 million to \$1.8 billion in 1967. Five had sales of over \$500 million and six had sales of less than \$10 million. Most of the companies were, nevertheless, large relative to other firms in their product lines.

Because of the size and scope of the American market, foreign industries have invested in a wide variety of American production. The 40 firms surveyed have investments in 19 of the 21 two digit SIC categories. There has been some recent concentration, however, in mineral processing, pulp and paper, and electronics. American production was usually in the same product line in which the investors had experience elsewhere. Some of the exceptions are noteworthy. One firm went from salt to machine tools, one from beer and cement to electronics, and one from steel pipes to gasoline pumps. Another had no production prior to that in the United States.

The Investment Decision Process

In order to understand why investment has entered the United States, one must understand the foreign investment decision process. A foreign investment decision is a culmination of intertwined decisions which fall as much within location theory as they do within investment theory. Before deciding to invest in the United States, foreign firms faced decisions of whether or not to serve foreign markets, which foreign markets to serve, and whether to serve them by exportation or by foreign production. Since an investment in the United States will take place only if the firms select the "right" alternative in each of these decisions, it is useful to analyze each sub-decision separately.

The first of these is the decision to do business outside the confines of one's own country. There were several impetuses for initial foreign involvement. The most important was a passive one—simply that consumers in foreign countries learned of the firm's capabilities and sought them out. This knowledge was gained through reports in scientific journals, through foreign spillover in advertising, and through selling to international firms in the home markets. American consumers are becoming more cognizant of foreign capabilities due to the upsurge in United States industrial, governmental, and tourist activity abroad. This

should have the effect of interesting more foreign firms in serving the American market.

Even the firms which actively sought foreign markets were reluctant to move abroad before their domestic positions were threatened. The subjective higher risk of operating in a foreign country normally overrode any early consideration for foreign sales. In nearly all cases, markets were developed nationally before any foreign sales were made. Once, however, that the national market was developed, the continuance of domestic expansion at the existing rate was threatened. At this point firms considered new alternatives including the alternative of selling abroad. The subjective higher risk of operating in a foreign country now was much lessened vis-a-vis the other alternatives available to them, such as moving into new product lines.

Some firms had to operate on more than a domestic scale in order to cover high fixed or high research and development costs. Because of rising R and D expenditures and shorter product cycles, this impetus is apt to become even more important.

The slowing of European and Canadian growth and profit rates, the competitiveness of American firms abroad, the shifts of certain industries to the United States, and the desire of big manufacturers to standardize products and purchases all have contributed to the threat of established position and have caused firms to consider foreign sales and most especially American sales. The size of the American market and the economic and political stability of the United States have been important attractions.

Pressures to Locate in the United States

Given the desire to sell in the U.S., firms were faced with the decision of where to locate the facilities to manufacture goods for the American market. Most companies reported that they prefer to export than to set up foreign production facilities, and invest abroad only when there are clear cut advantages over exportation.

When tariffs were added to the cost of selling in the American market, fifteen of the firms found it cheaper to produce in the United States than to export. Although tariffs were the major cost savings, firms also found it advantageous to save on transportation, and to have an easier access to the cheaper American capital market. This comparative cost situation at first seems paradoxical when one considers that direct investment is both entering and leaving the United States at the same time. There are a number of explanations for this however.

To begin with, much of the two-way flow of investment is not

duplicative, especially when product differentiation is considered. Legal or competitive barriers sometimes make it easier to expand abroad than at home. Where there are very few worldwide producers, consumers—especially industrial consumers—often want to buy from several companies and have them located close at hand in order to assure supplies in case of strikes. Another reason for the two way flow is that some investment takes place through an exchange of stock by companies in more than one country. This creates an automatic two -way capital movement which can show up as a direct investment in the accounts of both countries as a result.

Aside from tariffs which basically raise the prices of imported goods to the United States, other government restrictions (primarily “buy American” policies) prevented 17 companies from exporting at least part of their product line. These firms found that they had to produce in the United States or not be able to sell their goods in the American market.

Consumers exerted considerable pressure on the foreign firm to locate in the United States. This was particularly true when technically advanced products were concerned. Changes needed to be made often in order to fit the customer’s specification, thus there was an advantage in producing near the market because of the need to make alterations quickly. Several firms which did not initially enter the United States because of advanced American consumer acceptance, nevertheless, have found it useful to try out new products and packaging on the American market before introducing them abroad. One company just could not convince American industrial consumers that Canada could produce high quality electronic equipment. As soon as the parts were stamped “made in U.S.A.,” the quality image improved.

The Evolvement of Policies

While this discussion has summarized the major reasons for moving abroad and for establishing investments in the United States as a means of serving the American market, it is necessary to digress in the explanation of the decision process. Companies naturally have limited resources and must limit the area and methods of their expansion. It is useful, therefore, to understand the development of their investment policies and the effects which these have on the attractiveness of an American investment.

There was a marked difference between the initial and later foreign activities of companies. In both exportation and investment, firms tended to go first to the countries which seemed simplest and least risky

rather than most profitable for them to operate. This was usually due to the proximity of geography, language, and customs. Fourteen of 16 Canadian firms made their first foreign investments in the United States, whereas only two of 24 European firms made their first foreign investments in the United States. Policies became much more developed as firms gained foreign experience.

Although firms made investments in response to a number of outside stimuli, investment ideas were generally generated internally. New foreign investment ideas usually originated from top management within the very small firms and from sales and operating groups within the very large firms. Although considerable delegation was given to operating groups for the reinvestment of earnings and even for expansion, the decision to make initial investments in foreign country was always made at a top management level.

Only three of the companies, which were among the four largest participants, have ever been faced with "backlogs" of proposed investments. Decisions involve whether or not to make an investment rather than of which investment to make. Besides constraints due to limited resources, some firms further restricted investment possibilities because of their policies concerning the nationality of personnel, the amount of equity to take in an enterprise, and the countries which they refused to serve. Since decisions were made on one investment at a time, an investment was made if it met minimum criteria. The criteria were highly qualitative, and were based more on sales forecasts than on profit rate calculations. Fear of losing a market (due mainly to government restrictions on imports) was often a more potent motivator to invest than opportunities. Furthermore, firms sometimes invested where there were fewer firms competing even though their forecasts indicated that their sales would be higher elsewhere. In the usage of profit rate calculations, there was a tendency to consider the effect that an investment would have on the overall earnings of the company.

Only 16 of the companies felt that risk and uncertainty differences warranted the setting of different criteria for investments in different countries. Most of the companies took a very long run perspective that country by country differences are too fluid to evaluate. Many felt that they could successfully overcome some of the problems such as political risk and currency blockages for which other firms differentiate their investment criteria. The companies which did view countries differently reacted primarily by rationing capital to or by expecting higher rates of return in the higher risk areas. Two firms take an opposing view. They feel that they decrease risk by taking a smaller return in underdeveloped

countries. Only two investors considered any part of the U.S. to be a high risk area as compared to other countries.

The United States Operating Experience

With these investment policies and preferences established what was the actual nature of their American investments?

First let us consider the question of equity. Twenty-one firms had a strong preference for 100 per cent ownership in the U.S. subsidiary because (1) they did not want to share profits and (2) they did not want to have minority stockholder problems. Nine firms had a preference for less than 100 per cent equity because of a belief that it would enable them to expand faster and because they wanted local owners to help manage the enterprise. The remaining firms had no strong preference.

In actuality, 27 firms took a 100 per cent interest. Most firms contributed management, technical knowledge, or good will to the American operations and often considered these to be more important than their capital contributions. In fact, six companies raised all of their capital in the United States and transferred only non-capital resources.

When joint ventures were formed, there was a desire to find a U.S. firm of approximately the same size as the foreign investor and one which was in a complementary product line.

It has often been contended that American firms begin foreign operations by buying existing companies; whereas the foreign firm builds its own facilities. The study did not bear this contention out. Twenty-five of the participants entered by buying into an existing American operation. The reason was the desire to acquire assets which the investors did not have. This method also saved time in beginning operations, gave an immediate cash flow, and reduced the risk of failure. The firms which started new facilities did so primarily because of the uniqueness of their own product. They simply could not find a company where they would like to locate which would be willing to sell.

What determined the location of the American operations? Eighteen companies did not consciously make a location decision. They accepted the location of the company which they wanted to buy or they let a U.S. partner decide for them. Input costs, nearness to markets, and non-economic factors were important in the decision of the other firms just as these factors are important for a domestic company. Differences in prior familiarity with regions, and a desire to integrate the American activities with those at home caused a location to differ sometimes between that of the international and what one would expect of the

domestic firm. Having once selected a region, the companies found a considerable variation in costs within the region. Although there was an effort to find and locate in the least cost area, community acceptance was an important non-economic factor.

How did firms view the ease of American entry? Most companies had some experience in operating in the United States prior to establishing an investment here. This was by virtue of exporting, licensing, raising money in the U.S., or having close business affiliations with American companies. Through this experience, the firms usually acquired most of the knowledge on which to base a decision to make an investment.

By this time, the decision was not so much whether or not to invest, but rather where and how to invest. At this level, most of the companies felt that they needed additional information and contacted a wide variety of public and private agencies for assistance. The opinion of nearly all companies was that the cost and difficulty of getting information in the U.S. was no greater than in other countries in which they had operated including their home countries. The major complaints concerned accuracy of financial data on American firms and, the inability to get advance rulings on taxation and antitrust implications of proposed moves. The experience of British Petroleum since this study was made is consistent with these findings.

None of the investors felt that regulations to enter and operate in the U.S. were discriminatory to foreign firms. They were impressed by the lack of government offices which became involved in their own entry.

The very large size of the United States was itself a problem. Because of the largeness, 37 firms entered the U.S. on a restricted basis by limiting their equity, product line, value added to production in the U.S., or the geographic area of market coverage. Thirty-two firms assured themselves of sales for their U.S. production prior to investing. The methods used were advance contracts, buying a firm with established sales, and substitution of U.S. production for exports.

What have been some of the other experiences? Twelve firms found that they needed more technically advanced and sophisticated products for the American market. Only six firms found that they could effectively substitute U.S. production for exports to the U.S. Instead they acquired new markets through U.S. manufacturing. In fact ten firms found that they could increase exports to the U.S. by having U.S. manufacturing facilities. This was due to the avoidance of some duties through partial U.S. manufacture, through the added U.S. sales force,

and through vertical integration which gave them a captive U.S. market for foreign raw materials.

In very few instances were the foreign investors innovative in operational methods. Instead they followed those operating methods which they felt were most prevalent in their lines in the U.S. Some of the additional advantages given of operating in the United States were earning dollars in a dollar world and the better transference of knowledge from the United States to their home operations.

Conclusion

In conclusion I would like to say that when I first conceived the idea for this research, many people were skeptical as to the willingness of foreign managers to cooperate in giving information. Not only was there no problem, but these managers often went out of their way by researching for data and by granting me time on weekends and at their homes when their work schedules did not allow for my seeing them during regular work hours. In all, I found the foreign based international firm to be much more similar to the American based international firm than I expected.