BOOK REVIEWS

Foreign Direct Investment in Japan

Masaru Yoshitomi and Edward M. Graham, eds.

(Edward Elgar, Aldershot, 1996) 231 pages

This book contains the proceedings of the conference on "Foreign direct investment in Japan: why so small and how to encourage?" held at the Wharton School in October 1994. The conference was initiated because of the recognition of the small amounts of inward foreign direct investment (FDI) that have been flowing to Japan. The conference's objective was to explore the reasons for this phenomenon and to suggest whether and by what means it should be corrected.

The volume is divided into three parts. The papers and commentaries in the first part analyse the extent to which theories of the determinants of FDI shed light on the small size of FDI in Japan. Lawrence R. Klein compares the historical macroeconomic conditions in the United States, Europe and Japan, particularly during recession periods, and illustrates that historically Japan faced the worst macroeconomic circumstances.

John H. Dunning explores whether the present-day extent and structure of FDI stock in Japan, as well as recent flows of inbound investment, are consistent with the tenets of received theory and, if not, in what respects does the theory need to be modified. Dunning argues that the propensity of a country to host foreign firms is not only a function of the OLI configuration facing firms, as this configuration is itself strongly influenced by country-, sectoral- and firm-specific factors, the kind of FDI under consideration, and the position of the country in its investment development path. Therefore, an attempt to explain the low propensity of foreign firms to invest in Japan should introduce Japanese-specific variables into the analysis. The general empirical findings suggest that, while foreign firms possess significant competitive advantages over Japanese firms, these were more likely to be exploited through other modalities than FDI. High costs of acquiring and operating foreign affiliates in Japan, as well as legal, institutional and other barriers, induce foreign firms to prefer joint ventures and market-related cooperative arrangements.

Edward M. Graham argues that the theory of FDI tells something about the low levels of FDI in Japan when considered in the context of the history and culture of Japan. He does not believe that level of FDI flows to Japan will rise in the foreseeable future due to the barriers to entry posed by the way in which Japanese business activity is organized. However, it might be that the large amounts of outward Japanese FDI will induce rival firms to mount new efforts to invest in Japan, particularly in sectors where Western firms possess advantages relative to Japanese firms.

Stephen Kobrin, in a commentary, claims that FDI theory cannot explain why flows of FDI to Japan are so low relative to other advanced industrial countries. He argues that explanations for this phenomenon are likely to be found in the unique characteristics of the Japanese market that relate to cultural factors, infrastructure and business structure, rather than ownership or internalization advantages.

Part II includes two essays on Japan's distinctive business practices and trade structure and how they affect FDI inflows to Japan. Ryuhei Wakasugi's search for explanations for the low levels of FDI inflows to Japan is based on the theory of comparative advantage and on institutional factors. Different practices of government regulations of business activities and anti-competitive business practices (like those seen in *keiretsu*), common among Japanese firms, negatively influence foreign firms' entry to the Japanese markets. The Government of Japan should remove those obstacles and liberalize the Japanese market for both foreign and domestic firms.

David Weinstein offers a historical analysis of the structural impediments to investment in Japan over the last 450 years and shows that difficulties in entering the Japanese market are not recent phenomena. Weinstein suggests a number of factors to explain these difficulties, among them government regulations which have created barriers to entry (for both domestic and foreign entry), and labour-training practices. Bruce Kogut shows that the industrial breakdown of outward FDI from Japan is concentrated in a few industries. In these industries, the low penetration by foreign firms can largely be explained by the rigour of competition in the Japanese market, along with the large investment requirements in distribution.

Part III of the book describes the actual experience of transnational corporations in Japan. Thomas F. Jordan adds other difficulties for investment in Japan, such as high costs of land, office rents, wages and social costs; the highest taxes in the world, difficulty of hiring qualified personnel and of penetrating the controlled distribution channels; lack of market opportunities because of the *keiretsu* relationship set up by Japanese companies; and lack of transparency and of opportunities for mergers and acquisitions.

Reinhard Neumann discusses some of the causes and effects of the low levels of European FDI in Japan. The author focuses on the importance of joint ventures between non-Japanese and Japanese firms, many of which are based on the willingness of the Japanese partner to cooperate in sectors where European firms have technological advantages. Neumann argues that some steps such as lower tax, better loan facilities, a more favourable environment for mergers and acquisitions, lower office costs and an acceleration of the movements deregulating the economy, are necessary to increase flows of FDI to Japan. Masaru Yoshitomi concludes the book observing that the Government of Japan must take action to reduce the costs of doing business in Japan, and foreign firms must strive to develop the ownership advantages that are the key to overcoming these costs.

It is certain that researchers and practitioners of the subject will find this book valuable. One of the most important contributions of this book is in establishing links between various approaches—macroeconomics, multinational management and business strategy—often using radically different languages, to extend our understanding of the low level of FDI inflows to Japan. ■

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The Effects of Taxation on Multinational Corporations

Martin Feldstein, James R. Hines Jr. and R. Glenn Hubbard (eds.)

(National Bureau of Economic Research,
The University of Chicago Press, 1995) 332 pages

This book attempts to measure by way of econometric techniques the extent to which decisions by and within transnational corporations (TNCs) are shaped by tax provisions. This question is applied to the complex field of international taxation, where fiscal laws of both the home and the host country interact.

The first three chapters provide general background. Robert Lipsey, probably the most respected scholar on the interrelations between international trade and foreign direct investment (FDI), shows that FDI has allowed United States firms to maintain market shares abroad. He finds no support for the argument that outward FDI destroys employment in the United States. Much of the concern about such negative consequences derives from the wrong assumption that, without outward FDI, the activities of firms would remain at the same level. Martin Feldstein explores the relationship between domestic and foreign investment and finds that investment abroad reduces domestic investment between 20 per cent to 40 per cent, since a sizeable portion of investments abroad is financed by borrowings and mobilizing equity capital in the host countries. Roger Gordon and Jeffrey MacKie-Mason address the paradoxical situation which results from lack of corporate taxes. According to optimal taxation theory, small, open economies should not feature a tax on capital income and on corporate profits, but the latter are none the less needed, in order to prevent TNCs from avoiding income tax.

Two other articles explore the overall set of international tax rules and their impact on TNCs. Joosung Jun concludes that the cost of capital for United States firms is higher than that faced by United States firms abroad. The reasons for that are (*a*) the absence in the United States of a mechanism that imputes the tax paid by firms to the tax due by shareholders; and (*b*) relatively stringent rules on exemption or deferral of income earned abroad. The paper by Jason G. Cummins and R. Glenn Hubbard is particulary interesting because it uses firm-level data. The authors find that, contrary to prevailing opinions, tax parameters are considered by TNCs when making investment decisions. The message is that taxes matter.

Other papers in this book examine particular aspects of the tax system, such as the alternative minimum tax introduced in 1986 (Andrew B. Lyon and Gerald Silverstein); the impact of tax on repatriation of profits, which states that the anticipations about the future level of taxes in host and home countries affect the flow of such repatriation; and the impact of the limits to the deductibility of interest payments—also introduced in 1986—to the extent that the funds borrowed finance investments abroad (Kenneth A. Froot and James R. Hines). The general conclusion of these papers is that United States TNCs that are in an excess foreign credit position (i.e. whose taxes paid in the host countries cannot fully be deducted from the taxes due in the United States) indeed reduce their borrowing and investment activities.

A paper by Jason G. Cummins, Trevor S. Harris and Kevin A. Hassett examines whether the existence of two somewhat divergent sets of accountancy standards, one for tax assessment purposes and the other for report to shareholders (as typical to the Anglo-Saxon countries), has an impact on investment by TNCs. This article presents a useful summary of the rules in a large number of countries and finds that one-book companies are less sensitive to tax incentives.

James R. Hines tackles the difficult issue of the link between taxation and research-and-development activities. He addresses two main questions: (*a*) whether tax conditions in the host country (mainly, the withholding tax on outward licensing fees) impinge upon research and development by TNCs; and (*b*) whether imported technology (from the parent company) or locally-performed research and development (by affiliates) are complements or substitutes. If the host country tax has an impact, the substitution relations should prevail, as indeed was found in his research.

This volume demonstrates a high level of scholarship, by many of the best tax specialists in the United States. Their ability to use critically available data, to construct carefully and imaginatively sophisticated models and to operate them is impressive. As the above survey shows, they also do not hesitate to tackle rather subtle issues related to the fiscal position of United States TNCs. Thus, they suggest paths for further enquiries and progress in measuring and understanding the impact of given tax provisions on the activities of TNCs and, subsequently, for more informed policy decisions.

Yet, despite the indisputable progress made by this book, it would be premature to give excessive faith to the findings, particularly those based on the coefficients of the regression analyses. The econometric devices available for researchers may shape the outcomes and econometricians often do not agree on the techniques that should be used to address particular issues. Models must abstract from a number of variables, which, in real life, are probably interrelated. Thus, focusing on fiscal variables may assign too much weight to them and overlook those that are not included, quite often because they are not documented by reliable data sets.

Finally, one may mention two objections, expressed by discussants of the papers in this volume. Joel Slemrod, in commenting on the Jun paper, reminds us that the model that the author has built overlooks income-shifting manoeuvres, such as transfer-pricing modulations. Those may be resorted to in order to minimize the overall tax burden on TNCs. David H. Hartman—who himself had been an outstanding contributor to the academic debate about taxation and TNCs before embarking upon a business career—stresses the fact that the neoclassical, profit-maximizing models tend to derive optimum situations by adjustments at the margin, whereas in real life, TNC investments are rather "a lumpy process of one-time strategic decisions on how to serve an emerging market or change the locus of production" (p. 148). ■

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Regional Integration and the Asia-Pacific

Bijit Bora and Christopher Findlay, eds.

(Melbourne: Oxford University Press, 1996, 260 pages)

This book takes up a topic that many economists and policy makers alike believe to be of special importance, i.e. the role played by regional integration in the Asia-Pacific region. It is one of the more comprehensive pieces of research with which I am familiar on this topic. The editors have done an admirable job in assembling and organizing contributions by some of the leading experts on the topic. The rigorous and well-thought analysis is useful to professional economists and at the same time it is also understandable to non-economists. As such, the book makes an important contribution to the literature and will be of interest to a wide range of readers.

The book is organized in three parts. The first part is devoted to general analysis of regional arrangements. This part includes a good overview of the book by the editors (chap. 1). It also includes two very informative chapters on regional arrangements and how they have evolved over time (chap. 2 by Richard Pomfret and chap. 3 by Peter Lloyd). These are two of the best chapters in the book because they clearly and simply set out the major issues of concern from an economic point of view, while showing how these issues have been dealt with in the Asia-Pacific. In the following paper (chap. 4), Richard Snape discusses the consequences of different types of regional arrangements and emphasizes the negative aspects of "explicitly preferential arrangements" (p. 62), especially those of the hub-and-spoke variety. This chapter is followed by an analysis of the special problems faced by federalized countries such as Canada and the United States when they become involved in regional integration (chap. 5 by Kenneth Holland).

The first paper in the second part of the book (chap. 6 by Bijit Bora) deals with the growth of foreign direct investment (FDI) in the region, its causes and related policy issues. Perhaps since I work on this area in my own research, I have more criticism on this chapter than on others. My major concern is that the exclusive reliance on FDI data as a measure of the growth of transnational corporations (TNCs) in the region is misleading because the production of TNCs grew more slowly than did FDI flows or stocks (see Ramstetter, 1996). By relying on FDI data the author overemphasizes the role of TNCs in the development of the region as reflected in the conclusion that "the region owes much of its economic success to the presence of transnational corporations and FDI'' (p. 96). This statement is misleading because it does not consider the role of transnationals in the context of the numerous other factors that determine economic success.

Another minor point I found incredulous was the statement that ''the rise in importance of the NIEs as a host for Japanese investment, and the rise in the ASEAN countries as hosts for NIE investment, have very little to do with the objective of servicing domestic markets'' (p. 86). This statement is simply not correct because market seeking is a major motive for FDI in these economies. As of October 1993, selling to local markets was identified as an investment motive by 52 per cent of Japanese affiliates in the NIEs (with the following motive selected by only 23 per cent of the firms surveyed) (Keizai, 1994).

The other chapters in part two stand on somewhat more solid analytical grounds. One of the most striking things about the paper on financial services (chap. 7 by Mervyn Lewis) is its very strong conclusion that ''national treatment . . . is an inadequate principle [for market access] . . . when there are substantially different regulatory regimes and market practices—such as those in evidence amongst the NAFTA countries'' (p. 126). Chapter 8, by Christopher Findlay, Peter Forsyth and Bijit Bora, deals with transport and compares the bilateral arrangements that dominate the industry at present with the potential benefits of regional arrangements. Chapter 9, by Peter Crowley and Christopher Findlay presents the familiar economic argument regarding environmental issues and maintains that the primary policy tool for solving environmental problems should be by affecting the prices of environmental assets and not by trade policies. The authors also argue that regional groups are important venues for discussing the relatively few environmental issues that do require international cooperation.

The third and final part of the book deals more specifically with the Asia-Pacific region. In the first paper (chap. 10) Philippa Dee, Patrick Jomini and Robert McDougall look at alternatives to regionalism and argue that regional arrangements tend to be inferior to unilateral or multilateral liberalization. Chapter 11 on NAFTA, by Bijit Bora, emphasizes the potential danger that NAFTA poses for other Asia-Pacific economies, if it turns out to impede the progress towards greater multilateralism: . . . ''that [NAFTA is] a political animal developed by its members for its members'' (p. 181). The conclusion of the following chapter, on the Australia-New Zealand Closer Economic Relations Agreement by Robert Scollay, was also particularly resonant to me, namely that ''the crucial breakthrough was the acceptance in each member country of a commitment to non-discriminatory liberalization, through their respective unilateral trade liberalization programmes'' (p. 195). In the same vein, the chapter on AFTA (the Asian Free Trade Area) (chap. 13 by Linda Low) also emphasizes that the formation of AFTA was a result of development strategies in ASEAN, as well as a reaction to changes in the world trading environment. This chapter is one of the few in the book summarizing the quantitative effects of regional groupings, and illustrating that AFTA is net trade creating, albeit its effects are rather small.

The next chapter, by Richard Pomfret, deals with subregional economic zones that have proliferated in the Asia-Pacific, and emphasizes the need to consider those in addition to national considerations. The final chapter, by Andrew Elek, refers to APEC. It is highly descriptive, very general, and like APEC itself, vague and lacking in economic substance. Of course, APEC may prove itself to be more than a venue for talking in the future, but this chapter does little more than describe the APEC-related rhetoric that abounds these days.

Overall, I found this book to be one of the more interesting books I have read on the topic at hand. Having said that, it is my impression that this book, like the vast majority of the literature on the topic, often overemphasizes the importance of economic integration, both in general and in the Asia-Pacific in particular.

In addition, I felt that the volume was not sufficiently explicit in distinguishing between integration that is the result of unilateral liberalization (AFTA is an example I have in mind) and integration that does not have this effect or indeed leads to greater protection in many of the member countries (like several integration schemes in Europe and Latin America). It is crucial to emphasize the differences between regional integration where relatively open economies are taken as the benchmark for levels of protection applied to the whole region (e.g. Australia, Canada, Hong Kong, Japan, New Zealand, Singapore and the United States), and regional integration where relatively closed economies are the benchmark (e.g. China, Indonesia, Philippines, Thailand). The former type of integration is likely to promote growth, though the contribution would probably be rather small given the liberalization of the economies involved; the latter type of integration would almost certainly retard growth.

The volume as a whole seems to put the cart before the horse by implying that regional integration drives unilateral liberalization and thus affects growth. I would argue that, especially in the Asia-Pacific region in recent years, dramatic unilateral liberalization (e.g. Australia, Indonesia, Korea, Malaysia, Mexico, New Zealand, the Philippines, Taiwan, Thailand) has been the driving force, with growth and increased regional integration being the results of this process. To be sure, after a certain gestation period, regional and international agreements can become driving forces (as in Europe), but for the major existing arrangements in the Asia-Pacific (AFTA, the Australia-New Zealand Closer Relations Agreement and NAFTA), this has not been true to date and it is not likely to become true during the next few decades. The failure to clearly delineate the relationship between unilateral liberalization and regional arrangements has led many policy makers to overestimate the economic significance of both AFTA and NAFTA.

A final point of importance is the role of politics in regional arrangements. Regional arrangements may be best viewed as political games with economic consequences. Subsequently, the most important effects of integration are directly political and only indirectly economic. For example, I think it is abundantly clear that a primary benefit of integration in ASEAN (and Europe, for that matter) has been the creation of a forum for discussing grievances, finding common ground, and thereby reducing the risk of war. It would be very interesting to measure the peace dividend of ASEAN in economic terms. I know economists are not fond of such topics, but the economic effects of war or the lack of it will undoubtedly dwarf the effects of any economic measures taken in the context of regional integration in the Asia-Pacific. ■

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Trade, Investment and Pacific Economic Integration

Selected Essays of Kiyoshi Kojima

(Tokyo, Bunshindo, 1996, 248 pages)

As indicated by its subtitle, this book is a collection of selected journal articles and book chapters written over the past five decades (in English) by Kiyoshi Kojima, a well-respected Japanese economist. The essays cover the issues of international trade, finance, foreign direct investment (FDI) and regional economic integration. The book was published in May 1996, on the occasion of Kojima's retirement from the Surugadai University, Japan. This was his third retirement—the first was from the Hitotsubashi University in 1984 after 40 years of research and teaching, and the second was from the International Christian University in 1991.

The collection includes eleven essays, grouped into three parts, presenting the major writings that Kojima considers as the milestones for his evolving intellectual thoughts throughout his professional career as a political economist. Part I is concerned with trade, part II with FDI and economic development and part III with the Asia-Pacific economic community.

The trade section explores David Ricardo's theory of international balance-of-payments equilibrium within the context of a gold standard (essay 1); the two phases of structural change associated with foreign trade (from agriculture to light industries and to heavy industries) and capital shortage (essay 2); "horizontal trade" instead of "vertical trade" in manufacturing among advanced countries (essay 3); and a theory of agreed specialization (designed to exploit scale economies) as a facilitator of economic integration (essay 4).

One major concern embedded in these four essays is the examination of a continuous process of *tâtonnement* or tentative equilibration, instead of mathematically manipulative static equilibrium analysis of the neoclassical genre. Through such analysis, economic forces produce a dynamic temporary equilibrium. In this respect, essay 2 is perhaps the most interesting one. It analyses a sequential structural change away from agriculture, to light industries and later to heavy industries: "With given factor proportions, in shifting labour resources from a less capital-intensive industry to a more capital-intensive industry, or, in other words, in carrying out diversification of production . . ., the economy as a whole encounters a capital shortage and will have to derationalize each industry . . . in the direction of greater shortage or weak accumulation into which an economy falls during a structural change'' (p. 24). Kojima names this process ''a curse of industrialization.'' How did Japan escape from this trap? He observes: ''Besides foreign investment, liberated factor-price differentials among industries also played an important role in fostering rapid structural changes in Japan . . . in transferring resources during periods of structural change and in making stronger the international competitive power of the industries which are intended for expansion'' (pp. 29, 31). This analysis is particularly pertinent for developing countries, since it is rich in policy implications which are relevant for these countries.

Part II focuses on FDI and transnational corporations (TNCs). It discusses the idea of international complementarity of production factors against the background of the ''New International Economic Order (NIEO)'', an ideological movement that gained short-lived attention in the 1970s (essay 5); the twin concepts of trade-oriented vs. anti-trade-oriented FDI (essay 6); internalization vs. externalization of TNCs' business operations as determined by their needs of optimal scale in production and marketing (essay 7); and the dynamics of Japanese FDI and official development assistance in East Asia (essay 8).

From this reviewer's perspective, part II contains the most exciting original ideas of Kojima, ideas that are of significant interest to the readers of this journal. The notion of international complementarity between the North and the South is one of them. It is even more important nowadays—and will continue to be so in the future—than in the 1970s, when the NIEO was propagated, because TNCs today, more than ever before, are acting as the key instrument of cross-border complementarity in economic activities. Kojima's differentiation between anti- vs. pro-trade investment, framed in terms of a distinction between United States- vs. Japanese-type FDI, invites criticism, but his idea of the trade-promoting type of investment has gained acceptance and its theoretical significance is widely acknowledged.[1] Kojima presents strong evidence for the pro-trade orientation of Japanese investment in East Asia and illustrates how this investment has acted to facilitate convergence in patterns of trade and FDI at both country and industry levels.

[1] For a theoretical elaboration and a discussion of the conceptual significance of this idea, see Ozawa (1996).

Finally, part III includes three selected essays on Pacific economic integration: a hypothetical enquiry about the benefits of a Pacific Free Trade Area (PAFTA) involving Australia, Canada, Japan, New Zealand and the United States for the Asian developing economies (essay 9); the problems of economic cooperation, institutional integration, regional multilateral development aid, reorganization of North-South trade and resource security in the Asia-Pacific (essay 10); and policy suggestions for the peace and prosperity of the Asia-Pacific region (essay 11).

Kojima is widely recognized as the conceptual founder of an Asian-Pacific economic community and as the intellectual father of such regional economic integration. As early as 1965, Kojima proposed a plan for PAFTA, which led to the first Pacific Trade and Development (PAFTAD) Conference in 1968 and eventually to the Asia-Pacific Economic Cooperation (APEC) with its first forum meeting in 1989. As Hugh Patrick (1996) put it, "The seeds for Asia-Pacific economic integration, cooperation, and trade liberalization that Professor Kiyoshi Kojima planted in the mid-1960s have grown and flourished beyond all expectations" (p. 207).

In recognition of Kojima's intellectual leadership in setting the present movement towards freer trade and greater economic cooperation in the Asia-Pacific, in 1996, the Government of Japan awarded him a medal of honour. Some of Kojima's theoretical, empirical and policy research works which set the foundations for these achievements are included in part III.

The eleven essays comprising this volume clearly demonstrate Kojima's highly innovative and original analyses and his often bold policy proposals, both of which have had—and will continue to have—a significant impact on the thinking of academic economists and policy makers alike, especially in Asia. Many of the ideas gathered in this collection provide the vital building blocks for constructing a theory of integrative regional growth which involves trade, FDI, official aid, as well as a host of conscious complementation efforts at the government level, a theory that is needed to explain the current dynamism of the Asia-Pacific economies. Kojima refers, although briefly, to the flying-geese pattern of industrial development as a general frame of analysis (pp. 152-154) and attempts to incorporate his ideas into this broad conceptual framework, originally constructed by Kaname Akamatsu in the 1930s. The flying-geese model is essentially a regional growth paradigm.

Many of Kojima's original ideas—such as an industrial dualism as a solution for capital shortage in the early phase of industrialization, the trade-augmentation principle of FDI, the principle of inter-economy complementation, a theory of specialization and complementarity between internationalization and externalization—need be brought together, along with ideas of other economists, to formulate a theory which will explain continuous industrial expansion on a regional level. Such a theory is particularly needed in the context of the current phenomenon of the Asia-Pacific as the fastest growing and competitive region in the global economy. ■

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