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Localized clusters and the eclectic paradigm of FDI: film TNCs in Central London

Lilach Nachum and David Keeble*

This article examines the impact of the processes occurring in localized clusters of economic activity on investment by transnational corporations. Focusing on the cluster of film-related activities in Central London, the findings show that the interaction of transnational corporations with other members of the cluster, and its subsequent impact on their performance, varies considerably by type of investment and organizational structure. Localized processes also affect the ownership and internalization advantages of transnational corporations, as well as the location advantages of countries to varying degrees. The policy implications of these findings are examined in the conclusions.

Introduction

The location patterns of transnational corporations (TNCs) and the nature of their activities in these locations appear to exhibit characteristics that are not explicable fully by traditional foreign direct investment (FDI) theory, as developed by John H. Dunning (1958), Stephen Hymer (1960/1976), Richard Caves (1971), and elaborated by John H. Dunning (1977, 1980) and Peter Buckley and Mark Casson (1976). In some industries, notably knowledge-intensive industries characterized by rapid technological change, TNCs tend to cluster in small localities within countries, often in proximity to other indigenous firms.¹ Casual observation suggests that the activities of

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¹ See, for example, Dunning (1997, figure 1) for a description of the location of TNCs in selected industries in the United States and Nachum (2000, table 1 and figure 1) for a description of the location patterns of the leading TNCs in financial and professional service industries.

these TNCs are often linked closely with those of other members of their cluster. These phenomena suggest that TNCs derive some advantages from their proximity to other firms, and that the cluster of firms may form part of the attraction of particular locations. The relevant geographic area that affects their location decision may thus be far smaller than the country as a whole, being instead confined to a region or an urban centre, and often to a small district within it. These aspects of TNC activities cannot be addressed by the traditional formulation of FDI theory with its emphasis on countries as the unit of analysis and on advantages internal to individual firms.

The advantages gained by firms located in proximity to each other have been well recognized in the economic literature at least since the time of Alfred Marshall (1890, 1920). Marshall realised how “... great are the advantages which people following the same skilled trade get from near neighbouring to one another...” (1920, p. 271), a concentration that Marshall described as an “industrial district”. Such advantages result from an increase in the degree and specialization of skills, and from the benefits of large scale industrial production and of technical and organizational innovation that are beyond the scope of any individual firm. Marshall’s recognition of the collective advantages accruing to firms located in proximity has provided the foundation for a theory of geographical clustering of firms, which has inspired considerable research. Such research has illustrated the gains derived from the clustering of related activities in space and the dynamics of collective learning taking place in these localities. It has shown that links among firms, institutions and infrastructures within a limited geographic area can give rise to various forms of localized externalities that are external to individual firms, but internal to the cluster, and which are essential for the competitive performance of the firms taking part in them.²

The application of these ideas to the explanation of the location decisions of TNCs and their performance in these locations

² Recent examples of these studies include Storper (1997), Scott (1998a), Keeble and Wilkinson (1999), which address the most important current issues from the perspective of economic geography; You and Wilkinson (1994) which discuss them from the point of view of industrial economists; Krugman (1998) as the outstanding representative of an economic tradition that emphasises that “history matters”; Porter (1998) and Enright (1995, 1998) who demonstrate a similar approach by business strategy scholars.

is quite new. Until recently, intracountry location patterns, the forces that drive them and their consequences for the competitiveness of TNCs have gone largely unassessed by FDI theory. Scholars of international business have only recently begun to acknowledge the need to introduce ideas based on linkages among firms and the embeddedness of certain assets in particular localities into their models and paradigms. The most advanced and elaborated attempt has been made by Dunning (1995, 1997, 1998). Other developments in this direction are surveyed by Lilach Nachum (2000).

This article seeks to make a contribution in this direction by examining the ways in which the participation of TNCs in the processes taking place in localized clusters affect their operation and the nature of their investment. Using the eclectic paradigm as the theoretical framework, this article assesses the extent to which the economies arising from the proximity of TNCs to a cluster of firms in their own and in related industries affect the ownership advantages of the TNCs concerned, their choice of modality to serve a particular market and the location advantages of the location in which they operate. The article seeks to examine whether, and to what extent, these concepts, as traditionally conceptualized, need to be modified to acknowledge the geographic embeddedness of some aspects of the activities of TNCs. The next section examines these issues theoretically and seeks to construct a theoretical framework that acknowledges the processes occurring within localized clusters in the context of the eclectic paradigm. This framework is then used to study inward FDI in the film industry in London. The film industry represents an appropriate activity for investigating these issues, as it is characterised by high levels of international activity, while exhibiting a strong pattern of geographical clustering.

Geographic clusters and the eclectic paradigm: the theoretical framework

The participation of TNCs in various forms of local networking and cooperation with other firms located in geographical proximity, and the geographical embeddedness of some factors that shape their activities may affect the configuration of the variables comprising the eclectic paradigm. In what follows, the theoretical reasoning for a possible need to modify some of the assumptions

underlying the three tenets of the eclectic paradigm, as traditionally conceptualized (Dunning, 1993), is presented in order to take account of these influences and to reach a fuller understanding of TNC behaviour.

Several of the assumptions that underlie the concept of ownership advantages may need to be modified:

- The concept of firm-specific advantages is based on the conceptualization of firms having clear boundaries, defined by their ownership (hence, “ownership” advantages) (Hymer, 1960/1976). These advantages are assumed to be created and organized independently of other firms, and are assumed to be based on the unique capabilities and attributes of individual firms. Recently, there has been a growing realization that linkages with other firms are critical determinants of a firm’s ownership advantages and of its propensity to engage in cross-border activities. This realization has been developed particularly by scholars adopting the network approach, but also in research on the innovative capabilities of TNCs and the location of such activities (see Nachum, 2000, for a review of this and related work). However, these attempts do not fully acknowledge the spatial aspects of the linkages among firms. Notably in the network approach, such links are not confined geographically and may not necessarily occur in geographic proximity. When TNCs establish links of various kinds with other locally based firms, they often develop and maintain their ownership advantages through their interaction with these firms, and the behaviour of the latter might become an important determinant in shaping the ownership advantages of these TNCs.
- A critical tenet in the traditional conceptualization of ownership advantages is the assumption of the mobility of such advantages within the TNC across countries. This mobility allows TNCs to utilize their advantages in different locations, which is part of the rationale for international production (Lall, 1980). Firms can benefit from their ownership advantages everywhere, in line with their overall strategic plans, and they choose locations in which they can best utilize these advantages. There have

been a few attempts to examine the limitations of this assumption and to discuss the conditions under which firms' advantages are mobile (Lall, 1980; Hu, 1995). No explicit reference, however, has been made to economies that are embedded in a locality as one of the reasons for immobility. The economies arising from interaction among geographically clustered firms limit the mobility of the ownership advantages created through this interaction, as these become, to a certain extent, embedded in the locality and tied to the links with other firms.

- In its traditional formulation, the concept of ownership advantages implies that they are developed by the parent firm in the home country and then transferred to foreign affiliates (Dunning, 1958). In recent years, there has been a growing realization that this assumption is inadequate and underestimates the ability of foreign affiliates to develop ownership advantages on their own. The engine of affiliate growth has been acknowledged increasingly as being its distinctive capabilities, rather than the transfer of resources from the parent firm (e.g. Bartlett and Ghoshal, 1986; Hedlund, 1986; Nohria and Ghoshal, 1997).³ Research has also sought to identify the role of foreign affiliates in the generation of ownership advantages for their own benefit and for the benefit of a TNC system as a whole. However, the acknowledgement that linkages between foreign affiliates and the locality in the host country are an independent source of ownership advantage tied to the locality where it came into existence implies a different role for the advantages developed by foreign affiliates in affecting the competitive performance of TNCs as a whole. These advantages are, to a certain extent, unique attributes of foreign affiliates that distinguish them from the rest of a TNC and help form an independent identity for affiliates. The ties of these advantages to local clusters imply that they cannot be transferred from foreign affiliate to the rest of the TNC.

³ This development is explicitly acknowledged in the second edition of Dunning's seminal work (1958/1998), where there is a clear realization of the two-way flow of knowledge and innovation between foreign affiliates and the parent firm that was not recognized in the 1958 edition.

-
- Ownership advantages were perceived traditionally to take two forms, namely, the exclusive or privileged possession of specific intangible assets, such as technology, managerial and organizational skills (Oa), and the ability to coordinate the use of these and other assets in multiple product and geographic markets (Ot). The establishment and maintenance of formal and informal links with other firms have not been recognised as a potential source of ownership advantage.⁴ This ability, however, is what allows TNCs to take part in, and to benefit from, processes of collective learning and innovation occurring among geographically clustered firms, and should thus be recognized as a source of ownership advantage by itself.
 - In his pioneering theorizing of FDI, Hymer (1960/1976) assigned the propensity of firms to invest overseas to the intention to exploit their ownership advantages in foreign markets, thus increasing the return on these advantages. More recently, scholars have acknowledged that firms are also engaged in FDI in order to add to their existing portfolio of assets additional assets, which they perceive will either sustain or strengthen their overall competitive position. Dunning has named such investment “strategic asset seeking FDI” (Dunning, 1993, 1999). The need of firms to gain access to new technologies and organizational capabilities in order to make the best use of their own capabilities is particularly recognized with respect to firms from developing countries investing in developed countries. These conceptualizations, however, do not acknowledge the spatial aspects of such investments. Access to certain intangible assets in foreign countries often requires geographic proximity to the clusters of firms possessing these assets. These factors influence TNCs from both developed and developing countries, and are particularly common in industries in which technological advances are rapid and knowledge cannot be codified.

⁴ These aspects of the ownership advantages of firms have received much attention in the network approach (see, for example, Johanson and Mattsson, 1994); but until recently they have been dealt with mainly in the context of industrial marketing and have remained outside FDI theory (see Chen and Chen, 1998, for an outstanding attempt to incorporate this approach into FDI theory).

The conceptualization of countries as the relevant economic units that affect TNCs' location decisions, which underlies the notion of location advantages, the second tenet of the eclectic paradigm, seems to capture only part of the factors at work. Countries are defined by political boundaries, but the geographical, cultural and institutional proximity that creates the advantages of a particular location may not necessarily coincide with such boundaries. The location decisions of TNCs seem to suggest that often the advantages that attract them to invest in a particular locality characterize only a region or urban centre, and sometimes even a small district within it, rather than the country as a whole (Wheeler and Mody, 1992). Rather than being fully mobile within countries, as assumed traditionally, these immobile advantages are strongly embedded in particular geographic areas, often for decades or even centuries.

Furthermore, the typical location advantages to which the eclectic paradigm refers are the amount and quality of immobile resources and conditions in particular countries, such as the abundance of natural resources, the institutional framework, culture and government policies. The mere existence of clusters of economic excellence in a particular activity, and the economies arising from taking part in the dynamics within these clusters, have not been identified separately as potential sources of location advantages, nor have they been taken into account to modify the value of the traditional advantages considered by the eclectic paradigm. The acknowledgement of agglomeration economies suggests that the location of other firms may affect TNCs' investment decisions, and clusters of excellence in particular geographic areas may be part, and often a very important part, of the attraction of particular locations. It also changes the conceptualization of the causes of dynamic changes in location advantages of countries. Traditionally, these developments were assigned to changes in the abundance and/or quality of the assets providing the advantages relative to those of other countries. When economies of clusters are acknowledged, the reasons for changes in the advantages of a location are related to the amount of economic activity concentrated in a particular location and to the processes of collective learning and collaboration taking place there (Saxenian, 1994).

The third strand of the eclectic paradigm — internalization advantages — is based on the idea that, when the transaction costs of exploiting firm-specific assets through a market arrangement are high, the owner of the assets may choose to internalize the market transaction through FDI (Buckley and Casson, 1976). Firms engage in FDI when it is more beneficial for them to use their ownership advantages through an extension of their own value-adding activities rather than externalise them through licensing and similar contracts with other firms (Buckley and Casson, 1998).

More than other theories providing the basis for the eclectic paradigm, the internalization strand has been occupied with the external linkages of firms, as part of its focus on the boundaries of firms, but it has omitted spatial aspects. The participation of TNCs in geographic clusters changes the costs and benefits of alternative modalities to acquire, create and utilize created assets and intermediate goods. Clusters tend to increase the benefits of the market and diminish the incentives for internalizing. They help reduce information asymmetries and the likelihood of opportunism in imperfect markets, and make linkages with other firms more efficient, which in turn eases the selection of partners for various cooperative arrangements.

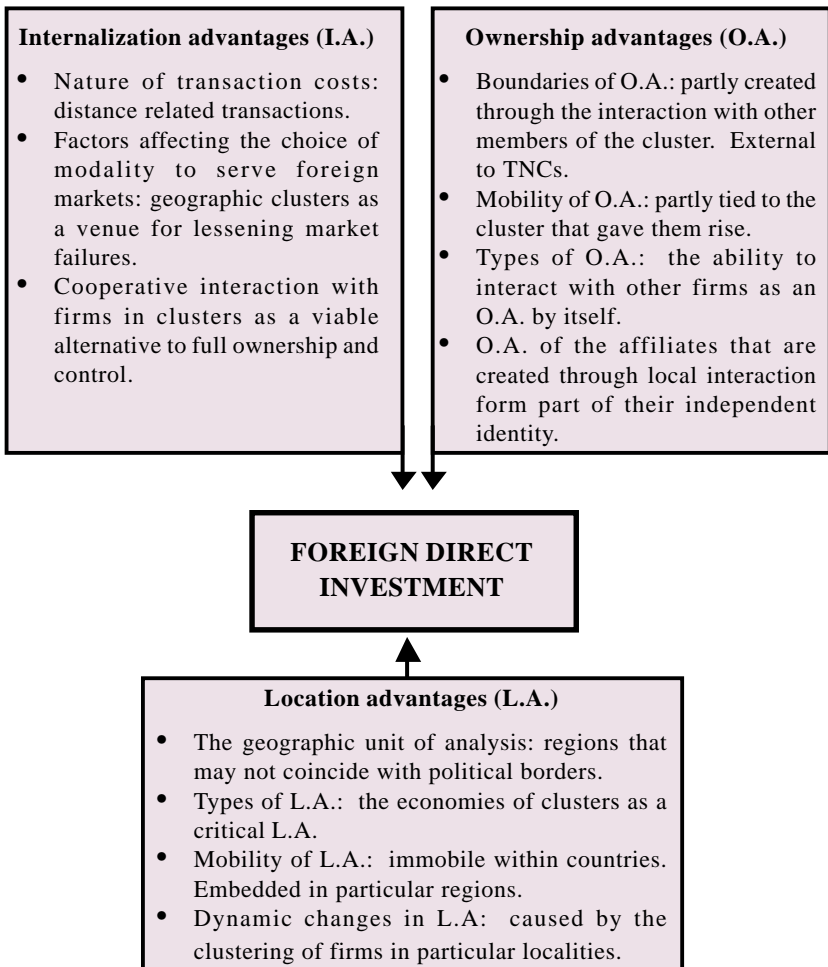
When economies of externalities are acknowledged, the idea that firms internalize intermediate markets primarily to reduce their transaction and coordination costs may need to be extended in two ways. The first way is the need to encompass the external benefits arising from the clustering of economic activities in particular geographic areas to the choice of modality in serving foreign countries. Such benefits may include external economies of scale, lower transaction costs, which often characterize transactions within these clusters (Scott, 1996), and diminishing risks and uncertainty arising from trust built within these networks of firms. The second way is to incorporate inter-firm transactions that are not concerned with control and ownership, but rather with the way in which tangible and intangible assets are managed and organized among the cluster of firms.

Figure 1 summarizes the main areas in which each tenet of the eclectic paradigm may need to be modified in order to take account

of the possible effect of the economies of geographic clusters and the embeddedness of certain types of economic activity.

In what follows, the framework summarized in figure 1 is used to examine to what extent and under what conditions there is a need to acknowledge the economies arising from the participation of TNCs in clusters in order to reach a fuller understanding of their FDI activities. It is argued that, if agglomeration economies affect these activities, the areas summarized in figure 1 are those in which their impact will be observed.

Figure 1. Economies of clusters and the eclectic paradigm of FDI



Some methodological issues

This article focuses on FDI in the film industry in the United Kingdom. About 95 per cent of foreign-owned film producers and distributors operating in the United Kingdom are concentrated in London, the great majority of whom (more than 65 per cent) are located in a tiny district of Central London, known as Soho.⁵ This location pattern makes the film industry a particularly interesting case for examination of the issues addressed here. In this type of industrial setting, theory predicts that networking and inter-firm linkages should play a strong role in affecting the economic performance of individual firms. Furthermore, the Soho area has also been the centre of film production and distribution, as well as a set of related activities, by United Kingdom-owned firms in London (Nachum and Keeble, 1999a).⁶ The participation of TNCs, whose activities spread over many countries and continents, in this cluster suggests that local processes linking together firms based in close geographic proximity may be important for their competitiveness. A recent study of the cluster of media activities in Central London (Nachum and Keeble, 1999b) has shown that the processes of mutual learning and cultural synergy, made possible by the presence of firms engaged in many interrelated activities in one place, are not confined to indigenous firms. Foreign firms investing in London, as well as United Kingdom-owned TNCs, take an active part in them, and the latter often play a vital role in their competitive performance.

⁵ Soho's borders are loosely defined by Oxford Street, Regent Street, Charing Cross Road and Leicester Square and the streets immediately adjacent to it (Tames, 1994).

⁶ Such location patterns are not unique to the film industry in London. Activities related to film production and distribution tend to display strong patterns of geographic concentration, typically in certain districts of large cities. The most well known example of such a concentration is Hollywood in Los Angeles (Scott, 1996, figure 1), but a number of other major metropolitan centres also possess clusters of such activities (see Llewelyn-Davies and UCL Bartlett School of Planning & Comedia, 1996, for a description of such location patterns in London, Paris, New York and Tokyo). These industries seem to favour such patterns as their production activities are reinforced by spatial agglomeration characterised by many different specialized functions and dense internal relationships, in which geographical proximity increases the efficiency of transaction and information exchange between firms (Scott, 1996, 1998b).

A descriptive, exploratory approach was adopted aimed at identifying the main areas that require additional research and at achieving a qualitative depth of understanding of the issues addressed. The case study method was judged to be the most suitable in this context because it provides rich data for theorizing and conducting a detailed analysis of the dynamics of inter-firm ties (even though the cases examined here may have moderate generalizability). This method was regarded to be appropriate for an exploratory study seeking to achieve qualitative depth of understanding of the issues addressed. The insights into local dynamics achieved would not have been afforded easily by a statistical approach, and the transformation of some of the concepts addressed into quantifiable, measurable variables required to conduct a statistical analysis would have been likely to raise serious difficulties in the subsequent interpretation of the findings.

The research is based on a variety of sources, including a number of detailed case studies of film TNCs operating in London, supplemented by a large variety of secondary sources, such as interviews with industry experts, various kinds of industry publications, company reports, industrial histories and published documents. Using this range of data, the article attempts to paint a picture of the nature of the links of film TNCs to their locality and the impact on their activities.

According to estimates by the London Film Commission, there are approximately 35 film TNCs established in the United Kingdom.⁷

⁷ This estimate refers only to foreign-based TNCs with established operations in the United Kingdom, and excludes TNCs whose activities are limited to shooting or using production facilities for the production of a single film (though the latter kind of investment often has a considerable magnitude). For the purpose of this study, it was judged that long-term investments are of main interest. The factors that attract short-term investments differ, and sometimes considerably so, from those that affect TNCs with long-term operations, and the theoretical framework developed here may be inadequate to examine these investments. For example, by its very nature, short-term investment is affected by considerations such as exchange rate fluctuations, a factor that does not affect TNCs that seek to establish a more permanent operation in the United Kingdom. The exclusion of this type of investment may introduce some bias into the analysis, as it is often the larger TNCs who establish long-term operations, while the smaller ones tend to favour temporary operations.

All these TNCs were approached, and 16 of them agreed to take part in this research. In-depth case studies of these TNCs, all of which are located in Central London, were conducted during the summer of 1998. Interviews lasted three hours on average. In most cases, the first interview was conducted with the chief executive or the managing director. When additional interviews were conducted, the directors of specific activities were approached (marketing, public relations, finance, production). Some characteristics of the TNCs studied are presented in the appendix, which reveals considerable variation among them in terms of specialization, age and size. Such variation minimizes the likelihood that the findings could be attributed to any one of these characteristics.

The research has taken a long-term view, starting in the early decades of the twentieth century, when film TNCs first invested in the United Kingdom, until the present day. Such a time span enables the examination of a great variety of circumstances in which investments have taken place and of variations over time in the issues of interest here. Another advantage of such an approach is that the investment activities of some of the major film TNCs operating in the United Kingdom today go back to the turn of the century, and an historical perspective is thus necessary to understand the changing nature of their activities over this period.

TNCs in the film industry in London

The activities of film TNCs (the overwhelming majority of whom are of United States origin) in the United Kingdom have taken three main forms: distribution, mostly of films produced in the TNC's home country; financing of films produced by local film producers, which have often then been distributed by the distribution arms of the TNCs; and complete local production, often in co-operation with local producers.⁸ In certain periods, these three forms of investment were undertaken in combination, sometimes by the same TNC, while other periods are dominated by one of them. The configuration of the ownership, location and internalization advantages that have

⁸ A detailed description of inward FDI in the film industry in the United Kingdom throughout the twentieth century is given in Nachum and Keeble, 1999a.

shaped these investments differ considerably, as do also the local links that the affiliates have developed and maintained in the United Kingdom. We begin by identifying the specific ownership, location and internalization advantages relevant for each kind of investment, using the framework summarized in figure 1, to examine under what circumstances and in which ways economies arising from the clustering of activity in a small locality have affected them. This examination is then used to generate some hypotheses regarding the effects of the economies of clusters on the three tenets of the eclectic paradigm.

Ownership advantages

The critical ownership advantage in the distribution of films is the organizational capability to direct films produced in one central location to consumers in multiple geographic locations in order to reach the widest possible geographic coverage.⁹ Economies of scale internal to individual firms, which help in acquiring the financial resources and developing the organizational capabilities needed for such operations, give considerable advantage to large firms. Because of the large size of their home country market, United States film distributors were already very large on arrival in the United Kingdom, and have enjoyed a considerable size advantage over their counterparts in the United Kingdom, where, around the turn of the century, film distribution was handled by a large number of small firms operating in small territories (Low, 1997). In consequence, United States TNCs have controlled virtually the entire distribution of films in the United Kingdom for most of the twentieth century. In 1997, five United States distributors (Buena Vista, Columbia, Fox, UIP and Warners) controlled 78 per cent of the distribution market in the United Kingdom, with another 15 per cent of the market controlled by TNCs of other origins (Entertainment and PolyGram) (The Film Policy Review Group, 1998).

⁹ The cost structure of film production, in which virtually the entire cost is incurred in making the first copy and duplicates require little additional investment, makes it critical to reach the widest audience possible as a way to hasten the flow of revenues to producers (Vogel, 1990). This characteristic favours international expansion of the distribution, and has been a major motivation for international activity in this industry (Nachum, 1994).

The nature of the activity of distribution affiliates requires limited, if any, links with other film production firms. United States distribution affiliates were set up to distribute films produced in Hollywood, and their orientation has been predominantly towards their headquarters. They are an extension of the parent company to provide a specific function — distribution — along the value-added chain. They are monitored by the parent company to such an extent that they do not have control over what films to distribute. All decisions (what films to distribute, when and on how many screens) are made by their parent companies in the United States.

Under such circumstances, distribution affiliates have no need to take part in the economies of agglomeration occurring among firms clustered in Soho, because such economies have limited, if any, impact on their ownership advantages. When asked to what extent they interact with other firms, and how important these linkages are for their activity, the managing director of a United States-owned distribution affiliate based in London described a common situation among these affiliates:

“We don’t have very much to do with them [other firms in film and closely related activities]. We get films for distribution from the headquarters in LA [Los Angeles]. Very seldom do we distribute films of local producers. So there is no reason for us to have any connection with them. ... Collaboration with other firms is irrelevant. We don’t work together, we compete.”

For TNCs providing finance to local film producers, the critical ownership advantages are those related to the financial strength of the investing firms, and their ability to establish and maintain links with local producers to be better able to select the best films for distribution. Throughout the twentieth century, United States film TNCs have enjoyed considerable financial strength due to their ability to generate funds both internally and external. The former is a consequence of their vertically integrated organization form, which incorporates film production, distribution and exhibition under the same ownership (Storper, 1989; Enright, 1995), thus enabling them to use the revenues from films to finance future productions. The latter is due to the ability of United States TNCs to

raise money externally (e.g. on the United States stock exchange). By comparison, for most of the twentieth century in the United Kingdom, production and distribution have been implemented under different ownership. Consequently, United Kingdom film producers have been dependent on external sources (most often of United States origin) to finance their films (Murphy, 1986; Low, 1997; The Film Policy Review Group, 1998). Furthermore, in the United Kingdom, film production has been regarded as a cultural rather than as an economic activity and, with few exceptions, United Kingdom investors have been reluctant to finance these activities (Chanan, 1983; Screen Finance, 1998).

This type of investment, in which United States TNCs finance local production, has facilitated close links between foreign affiliates and local film producers, established in order to reduce the costs and risks associated with the selection of local producers for support. The public relation manager of a United States affiliate strongly involved in this form of activity explained:

“We need to get to know them [local film producers] very well, to know how they work and what kind of films they are likely to produce, in order to be able to decide when it is worthy for us to support them financially and/or to distribute their films. It is easier to achieve this from Soho than from elsewhere. Here people get to know each other. ... We drink in the same pubs, eat in the same restaurants.”

Indeed, these affiliates maintain intricate networks of deals, projects and tie-ins with local and foreign firms based in Soho that link them together in ever-changing collaborative arrangements. However, these dynamics only affect certain aspects of the activities of the affiliates and have limited impact on others. These affiliates do not take part in the dynamics of collective upgrading of the advantages of the cluster that tie firms based there together, including affiliates with different functional focus (see below). They maintain strong linkages with the headquarters as the main source of finance, and are often monitored by the headquarters to an extent that excludes the possibility for their integration in the cluster.

The ownership advantages of the film production affiliates differ considerably from those of the distribution and finance affiliates. Like the latter, film production affiliates have also benefited from the enormous size, reputation and financial strength of the TNCs of which they are part relative to their United Kingdom counterparts, but several additional ownership advantages related to the organization of production are important only for this type of investment. First, taking advantage of developments in Hollywood, United States affiliates have been far ahead of local producers in technological innovation in film production. The film reviewer of the United Kingdom film industry publication *Sight and Sound* wrote in 1944: "... almost every technical and artistic improvement which has been made in the cinema in the last 30 years came from California. ... They [Hollywood firms] invented virtually the entire bag of movie tricks" (Curtiss, 1944, p. 28). This technological lead has persisted for most of the twentieth century. Second, unlike their United Kingdom counterparts and following their parent firms in Hollywood, United Kingdom affiliates have used advanced marketing techniques and have spent huge sums on marketing their films. In the late 1990s, the average marketing costs of the largest United States film producers were \$23.3 million per film — over twice the average total film production budget in the United Kingdom (Screen Digest, 1998). Third, United States TNCs came to regard the management of their corporations as an independent professional activity long before this practice became common in the United Kingdom, and thus benefited from advanced managerial practices that were adopted in the United Kingdom decades later, if at all.¹⁰ This tendency was further strengthened after many of these TNCs were taken over by conglomerates, some of which possessed limited, if any, interest in media and films.

Along with these ownership advantages, which are an extension of knowledge generated by the parent company, United Kingdom affiliates have also developed ownership advantages of their own, mostly related to local co-operation in and co-ordination of film production. The production affiliates have largely relied on local

¹⁰ These differences between United Kingdom and United States firms are not confined to film production. See Chandler (1990) for an historical review of these developments in the two countries.

resources, such as talent (actors, directors), domestic studios and services provided locally (post production, design, photography etc.), and have been dependent entirely upon the local supply of these resources. In the words of the managing director of one of these affiliates:

“... what we get from Hollywood is very important. It gives us finance, reputation. But at the end of the day, it is the ability to put together the different parts, to hire the right people, to have the right connections, which makes a film. This has little to do with Hollywood ...”.

These affiliates repeatedly stressed the importance, along with marketing and managerial expertise, of their ability to establish and maintain links with local providers or owners of various inputs as one of the most critical factors for success in the United Kingdom. The fragmented nature of film production, in which many people with different skills are involved, requires cooperation and coordination of many different activities. Personal connections play an important part in the on-going process of selection of service providers and free-lance employees that are put together for the creation of a film. There is a need to become an insider to the cluster in order to acquire the knowledge and build the trust necessary for the successful establishment of these ties. As one interviewee put it: “... commercial and social relations are mixed, and it is not possible to establish them from [a] distance”.

The ownership advantages that the affiliates developed through their local linkages are often dependent on the dynamics of the cluster for their materialization, and they cannot be diffused to the rest of the TNC. The possession of such advantages provides the affiliates with an identity of their own, which is somewhat dissociated from that of the TNC as a whole. With respect to these advantages, United Kingdom affiliates expressed a strong sense of self-sufficiency and independence from their headquarters, and a perception that the strength of the headquarters is somewhat irrelevant for these aspects of their operations.

The dynamics of learning and economies of externalities taking place among the firms based in Soho are regarded by these

foreign affiliates as important determinants of their ownership advantages. The ability to interact and shape ideas with other film producers, as well as with firms engaged in a whole set of activities related to film production that are based in Soho, is seen as facilitating their own innovative and creative capabilities. The view expressed by the managing director of a United States affiliate, which engages in film production in London, was common among these affiliates:

“The whole business is about creating ideas, and other firms are often the source of new ideas. ... Sometimes you can get an idea just by having a few words with someone — and it has to be someone from the industry, so we speak the same language. Because we are involved in art — there isn’t really that kind of competition [as in other industries] — there is room for many movies as long as they are good. So we have nothing to hide from other companies — rather we see them as a source of inspiration.”

Location advantages

The location advantages that have affected film TNCs in the United Kingdom vary by the type of investment undertaken. Distribution oriented investment has been driven by TNCs’ desire to expand the market for their films in order to increase the returns for their investment. The location advantages that attract such investments are related to the size and growth prospects of the United Kingdom market. Its substantial size, combined with a common language that makes it accessible to United States-made films, have made the United Kingdom the most favoured destination for United States film distributors. Already by the early 1920s, the United Kingdom accounted for 10 per cent of total revenues (Low, 1997) and 35 per cent of foreign revenues (Jarvie, 1992) from film distribution by United States TNCs. In the 1990s, the United Kingdom remains the main foreign market of these TNCs, just as it has been during most of the twentieth century, with some of them obtaining as much as half of their foreign earnings from the United Kingdom (The Film Policy Review Group, 1998).

Indeed, the choice of location of distribution affiliates within the United Kingdom has been affected by considerations of proximity to the main distribution markets rather than to other firms. In the early decades of the twentieth century, when United States film TNC investment was predominantly distribution oriented, many of the affiliates operating in the United Kingdom listed in the telephone directory of the time were based away from the cluster of local film producers in the Soho area. The current location of some distribution affiliates in Soho is the result of historical heritage and of the purchase of their premises at a time when the nature of their operation was different (see below). The recent move of the affiliate of Warner Brothers, which deals predominantly with the distribution of films produced in Hollywood, to a bigger office outside Soho illustrates this situation. Another example is the location of the recently established Buena Vista International, the distribution affiliate of Disney, outside the Soho area.

Different location advantages have affected investment undertaken in order to use the United Kingdom as a production base.¹¹ Of importance here has been the intention to produce films with a “British identity” to reflect the specific characteristics of the immobile assets of the United Kingdom. A second location advantage that has been highly influential in certain periods throughout the twentieth century is the low cost of factors of production. The cost differences are such that on average three films and more could have been made in the United Kingdom for every two in Hollywood (Walker, 1986). The opportunity to produce films in the United Kingdom more cheaply, and sometimes considerably so, has been an important attraction. Third, well developed production facilities are abundant in London. The largest sound stages in the world are at London’s Pinewood and Shepperton studios. London boasts unrivalled post-production facilities, as well as major film labs (London Economics, 1994). Fourth, London is the international sales capital of the film industry, raising investment and assembling financing packages for Hollywood (London Economics, 1994). While the City of London has been reluctant to finance United Kingdom films for the most part

¹¹ Location factors have been less influential on investment involving the financing of local production, and therefore are not discussed in this context.

(Low, 1997; The Film Policy Review Group, 1998), it has financed, and sometimes very generously, United States films. Last, but in no way least, United Kingdom's creative talent is highly appreciated worldwide (Walker, 1986), and has been a major attraction for foreign film producers seeking to employ United Kingdom actors and directors in their films.¹²

Some of these location advantages are characteristics of London, and of Soho in particular, rather than of the United Kingdom as a whole. When asked what were the reasons for the choice of the United Kingdom as the location for their foreign activity, respondents referred to a combination of factors related both to the United Kingdom as a whole, and to those which are tied to London, and within it mostly to Soho. Language and low production costs were the most common advantages of the former mentioned by the firms studied, while the cluster of film producers and post-production services in Soho and other production facilities in London were regarded as the dominant advantages of the latter.

Production-oriented TNCs perceive geographic proximity to the cluster of indigenous film producers and service providers in Soho as essential to provide access to the latter's location advantages. These affiliates typically have intense interaction with production houses, design and post-production companies, which are all based in Soho. They regard the geographic proximity to these service providers as essential for successful collaboration in the production process. It is also seen as vital for the establishment of personal linkages that often form the basis for successful business co-operation. The chief executive of a United States affiliate explained:

“We could not afford not to be in Soho — that's where everybody is. ... We pay a high rent for it but we cannot do it without. ... It is an industry where you constantly change ideas and proximity helps doing it. ... This industry is about who you know — there are about 100

¹² The well recognized move of United Kingdom actors, directors and writers to Hollywood (see, for example, The Film Policy Review Group, 1998) raises some doubts as to the extent of immobility of this asset, and its inclusion as part of the attraction of the United Kingdom.

companies producing TV commercials — so why deal with strangers? Also when we need to hire people — for example, a director for a specific film — we take those we know from personal contacts.”

The location patterns of the overwhelming majority of foreign affiliates that have engaged in film production in the United Kingdom over the past century clearly reflect the value they assign to geographic proximity to the Soho cluster. For example, 20th Century Fox, Warner Brother in the 1930s and Columbia in 1940 all purchased premises in the heart of Soho and still own and occupy them today.

Internalization advantages

The reasons for the choice of modality to service the United Kingdom market, and for the preference to internalize particular value added activities rather than obtain them through the market, vary across the various types of investment and have changed over time. The main factors affecting these changes are the perception of the investing firms of the existence of market failures and the costs of transactions, and their appreciation of local firms as suitable licensees.

United States TNCs establishing distribution affiliates in the United Kingdom from the outset adopted a strategy of setting-up fully controlled affiliates rather than operating through local agents. There are four main reasons for this preference:

- It reduces the speculative element in film production. Film production is a highly risky activity because there are limited, if any, ways of anticipating the success of a film. Yet the entire costs of the production are incurred in the production of the first copy, without any guarantee of it finding a distribution outlet. This creates strong incentives to internalise the distribution to guarantee international distribution for the film produced.
- By setting up wholly owned distribution affiliates, film producers retain 100 per cent of the distribution rental, which is used as a source of revenues to finance future production, a

major obstacle in this highly capital-intensive industry. A licensing deal would entail loss of commission and costs to a third party and joint ventures involve revenue sharing and are therefore seldom used.

- The difficulty of finding a licensee with the necessary capabilities. United Kingdom distributors have been small and financially weak relative to their United States counterparts, a difference that has excluded largely the possibility of finding licensees with adequate capabilities.
- The internalization of distribution allowed United States TNCs to exploit in the United Kingdom the distribution expertise they had developed in their home market.

The stability of FDI as the dominant modality for distribution oriented investment over the past century suggests that increased market knowledge and greater interaction with local firms are not perceived by firms as changing the balance between the benefits of FDI versus licensing. Another possible interpretation of this situation is that, since distribution affiliates have not been closely involved with the local cluster, the perceived or actual costs and benefits of various modalities have not changed over time. The marketing manager of a well established United States distribution affiliate expressed the view that:

“[Licensing] is not an option we consider. ... To the best of my knowledge, it has never been considered in relation to the distribution in the UK. ... Distribution by an agent usually involves parting with an agency commission as well as a distributor commission and is used only in countries where very few options are available, such as in less developed markets or in ones that need a high degree of local knowledge, but not in the UK.”

The dominant form of operation of the affiliates involved in various forms of co-operation with local producers, such as the provision of finance for locally produced films, or participation in

the actual production of the films, has also been one involving FDI. The reasons for preferring fully owned affiliates over licensing or other forms of contracting of these production affiliates differ considerably from those which affected the choice of the distribution affiliates. First, and most important, as the previous discussion highlights, a predominant source of advantage of United States TNCs has been their privileged possession of intangible assets, such as reputation and specific knowledge of film production. The motivation to internalize the market for these advantages is substantial, as full ownership and control enable better to appropriate the economic rents of their firm-specific capabilities and protect more effectively their proprietary rights and product quality. As the managing director of a production affiliate expressed it: "... we have worked for decades to build up a reputation — we want to get the full profits from it." Second, FDI has often qualified United States TNCs to receive incentives offered for local film production by Governments of the United Kingdom (Dickinson and Street, 1985; Low, 1997; British Film Commission, 1996).

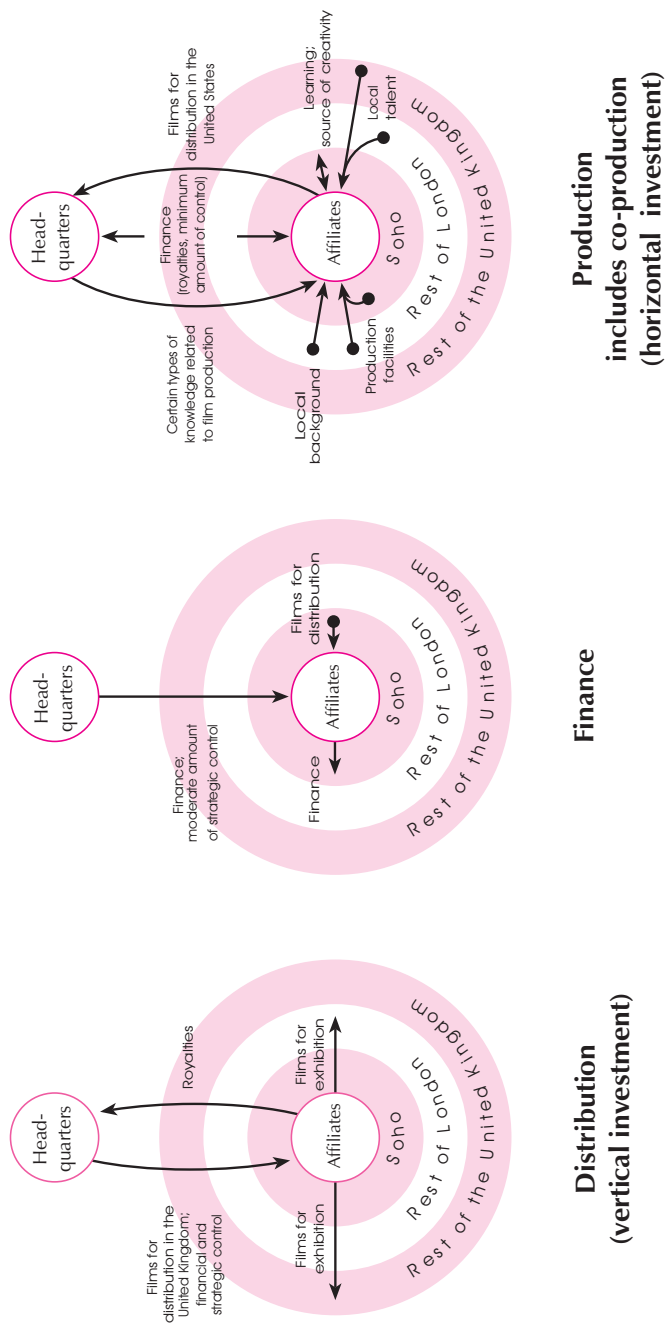
This said, one major component of film TNCs activity in the United Kingdom, which does often involve contracting rather than internalization, is the actual production of films. Over the years, there has been a growing tendency for TNCs to acquire films through the market rather than producing them internally, because films from independent United Kingdom film producers are often cheaper and of higher quality. Nonetheless, most of these TNCs have retained a local presence in the United Kingdom in the form of fully owned affiliates. Such a presence has allowed them to establish relations with, and to acquire knowledge on, local producers, which is necessary for this form of operation. The choice to source out film production has been affected by the overall strategic organisation of the TNCs concerned, notably, the trend towards vertical disintegration of the parent companies, which took place in Hollywood from the 1950s onwards. In this process, studios in the United States redefined themselves as profit centres, financing films produced by independent film producers (Storper, 1989). This form of organization has affected considerably the nature of the activities of the affiliates in a manner that is not related to their links with the locality that hosts them.

Discussion

While many of the factors at work are idiosyncratic, a number of common points are discernible from this study of film TNCs in London. First, and most important, is the great variation in the effect of externalities within a cluster on various types of investment. Such economies modify the tenets of the eclectic paradigm to different degrees in different investments. When investment is oriented towards selling and distributing films, it is driven by demand rather than supply factors, and the attraction of the market is determined primarily by its size. The orientation of the foreign affiliates tends to be towards the parent company. Foreign affiliates develop limited links with the locality in which they operate, which in turn affects them in a limited way. In finance-oriented FDI, whose main purpose is the finance of films produced by local producers (often followed by distribution by the same TNC), affiliates tend to establish close links with the locality, but the nature of this interaction is such that the latter affect them only to a limited degree. Proximity to the cluster of local activity minimizes the costs of coordination and selection of films, but usually has limited impact on the TNCs concerned. When investment is undertaken in order to use a particular location as a production site, the affiliates tend to become closely involved with firms in their own or related industries and to take an active part in accessing the economies of externalities available locally. These then become a vital part of their ownership advantages and of the location advantages which attract them. Some of this variation is illustrated in figure 2, which presents the nature and contents of the links of the affiliates with the locality, more distant areas and the headquarters in these different types of investment.

Generalization of this pattern beyond the film industry suggests that the linkages of foreign affiliates with the local cluster that hosts them vary in line with their overall position within the TNCs, and the nature of the organization of value added activity globally. When international production is organized so that foreign affiliates implement large parts or the whole value-added activities in the foreign countries (horizontal investment), they typically enjoy considerable autonomy. These affiliates would tend to develop strong local linkages with other members of the cluster, which are likely to become essential for their successful performance. In other types of

Figure 2. The links of foreign film affiliates in London with the locality and headquarters, by type of investment



investments, when the affiliates are responsible only for part of the value-added chain, they tend to have strong links with other parts of the TNCs (vertical investment), and are usually closely controlled by headquarters. Under such circumstances, the interaction of the affiliates with the locality is limited and tends to be of little value for their competitive performance (see Morsink, 1998, for a similar conclusion).

Second, not all ownership advantages are affected by the interaction of TNCs with other members of clusters, and not all of them to the same degree. Some advantages, notably those related to internal working processes and organizational routines and those emerging from the proprietary rights of brand ownership or financial strength, are characteristics of individual TNCs. The boundaries of these TNCs, as defined by their ownership, are valid for the understanding of the nature of such advantages. In contrast, the advantages emerging from a foreign affiliate's ability to innovate, to establish productive linkages with suppliers and customers, to benefit from access to a common labour market, a cluster of specialized intermediate inputs and to be embedded knowledge of other members of the cluster, are influenced, and sometimes considerably so, by the close interaction of the affiliates with the local cluster of firms in their own and closely related industries. The conceptualization of ownership advantages as defined by the ownership of the firm may be too narrow with reference to these advantages, as the links among firms in the geographical cluster play a vital role in their development. The ability to develop and maintain these advantages requires the participation of foreign affiliates in the processes occurring within their localities. These advantages give the affiliates some identity of their own, which is independent of the parent firm and the TNC as a whole. It is with regard to these advantages that the competitive success of TNCs in clusters is often strongly dependent upon the performance of the cluster as a whole, irrespective of the individual capabilities of the TNCs concerned. While some of the advantages that foreign affiliates develop locally may be transferred from the affiliate to the rest of the TNCs, their mobility might be limited and their exploitation might only be possible in the cluster that gave them the initial rise.

Third, the benefits from being part of a cluster are not confined to situations in which the investing firms are weaker than the cluster

of firms in terms of their technological and managerial knowledge, or the scope of their activity, nor are they related to the size of the investing TNC. For most of the twentieth century, film TNCs investing in the United Kingdom (notably those of United States origin) have been more advanced than indigenous Soho firms whose proximity they have sought. The proximity to this cluster has provided them with benefits other than those related to getting access to various kinds of knowledge embedded in a locality. This point signifies a considerable change from the reasons commonly identified as driving firms to take part in a cluster, notably those related to investment undertaken as a way of acquiring new knowledge and getting access to sources of learning, which are cited particularly with reference to TNCs from developing countries investing in developed countries (see Chen and Chen, 1998, for FDI into Taiwan Province of China). Furthermore, while theories of geographic clusters emphasize the advantages of agglomeration accruing to small firms, this article suggests that small and large TNCs alike have sought to take part in the dynamics of the Soho cluster, with size by itself seeming to lack any significant impact on this need.

Fourth, the location advantages that attract film TNCs to the United Kingdom, particularly when such investment is production oriented, are a combination of factors that characterize the United Kingdom as a whole (such as language, or government policies) and those that are specific to London or Soho. The latter are embedded within the locality and immobile within the country. They may not be related to the availability of resources of any kind, but rather be created by the mere existence of a cluster of economic activity, possibly the result of a historical accident. TNCs perceive the benefits of these advantages to be confined to investment taking place in the particular locality providing them. It appears that the more TNCs cluster in a particular locality, the less adequate is the country as a whole as the unit of analysis for the explanation of their location activities and the more important are the location advantages embedded in that locality.

Fifth, the economies arising from clustering of economic activity affect various location advantages to different degrees. They seem to have no impact on some location advantages, notably those related to resources that are mobile within countries and to certain

characteristics of the country as a whole. By contrast, agglomeration economies may change, and sometimes considerably so, the value of other location advantages. For example, one of the major location advantages of the United Kingdom in the film industry lies in its advanced post-production services. These advantages appear to be powerfully enhanced by the concentration of these activities in a distinct locality within the country. The former type of advantages are likely to lead to a sporadic distribution of TNCs within countries, while the latter would result in their concentration in the particular localities that possess the advantage.

Sixth, of the three tenets of the eclectic paradigm, internalization advantages seem to be the least affected by the dynamics of geographic clusters. The processes taking place within the cluster of film related activities in Soho have affected the modality chosen by these TNCs to serve the United Kingdom only to a limited degree. Notably, when the advantages of FDI over licensing are considerable, diminishing costs of transactions resulting from greater interaction with other firms based in the locality do not affect the choice of modality.

To conclude, the discussion thus far suggests that the economies associated with geographic clusters are indeed a powerful factor affecting the investment activities of film TNCs in the United Kingdom. This impact, however, is by no mean invariable. Rather it varies considerably by the type of investment and the specific advantages concerned. These findings indicate a need for extending and elaborating the eclectic paradigm to incorporate the impact of locally specific agglomeration economies on the location decisions of TNCs, and on their performance in these locations. Such an extension is likely to enhance the explanatory power of the eclectic paradigm to explain the uneven distribution of TNC activities within countries and to provide insights into the nature of the factors attracting them to cluster in proximity to other firms.

Given the exploratory nature of this article and its narrow empirical basis limited to observations drawn from a single industry, its findings should be interpreted as hypotheses for future research rather than as conclusions. A far more systematic empirical investigation is necessary in order to establish general conclusions

about the impact of the economies arising from the geographic clustering of firms on the investment activity of TNCs. The nature of film production, in which there are high levels of fragmentation and specialization, is likely to make such economies more important than in other industries. Future research may examine the issues raised here in the context of industries in which the whole or large parts of the production process are carried out under a single owner and there is less tendency towards vertical disintegration.

Policy implications

This article has suggested that the proximity to localized clusters is an important factor affecting the location decisions of TNCs and their performance in these locations. These findings have several policy implications for national and local governments seeking to attract FDI, many of whom signify a considerable departure from the policy implications of the traditional FDI model.

First, the findings suggest that clusters of economic activity themselves act as magnets for attracting FDI and form an important part of a country's location advantages. Facilitating the creation and development of such clusters and enabling TNCs to take part in their dynamics are thus essential parts of efforts to attract and keep FDI. Growing attention has to be given to the interaction between TNCs seeking to take part in these dynamics and the local host context in the host country.

Second, the attraction of clusters to FDI changes to some extent the balance between a country as a whole and regions within the country in affecting the location decisions of TNCs. The traditional approach towards FDI attraction was based on a TNC's location decision process which evolves gradually from the level of countries to the level of regions within them. In this view, TNCs were assumed to select a country for investment in the first place, and then to select a particular location within the country. This approach underlies the organization of investment promotion activities in most countries at the national and regional levels, with regional authorities often having power to act only within the boundaries of the country. The attraction of clusters implies that TNCs may invest

in order to locate themselves in proximity to a particular cluster, and the rest of the country might be irrelevant to their location decision. Clusters may compete with other clusters elsewhere in the world rather than with other regions within the country. For example, film TNCs are more likely to compare London as an investment location with other film production clusters (such as Paris) than with Manchester or Birmingham. In a similar manner, the City of London is competing with Frankfurt and Paris rather than Leeds to attract financial service TNCs. This should be acknowledged explicitly in the organization of investment promotion activities, and more autonomy should be given to regional agencies to have the power to act outside the borders of the country.

Third, the findings also imply that a combination of the location advantages that emerge from the abundance and quality of certain factors of production and the advantages gained by proximity to clusters critical for work in attracting TNCs to particular locations. Government policies thus should be designed under the recognition of these different, and often complementary, types of advantages. This combination is often associated with advantages at two different geographic levels. The location advantages that derive from the abundance of certain factors of production can be either characteristics of a country as a whole, or of a particular location within it, depending on the mobility of the assets providing the advantage within the country. The advantages emerging from the clustering of economic activity are, by definition, confined to the geographic area that hosts the cluster and tend to be immobile within countries. One implication of this is that there might be an asymmetry between the political boundaries and the geographic areas that affect the location choices of TNCs. Policy instruments related to the attraction of FDI should be applied at the level of the relevant economic unit (such as a particular region or urban centre) rather than of the political unit (i.e. the country as a whole).

Fourth, as agglomeration economies tend to give rise to virtuous circles, FDI is likely to create a cumulative mechanism, in which past inflows engender current and future flows. This implies that countries that already attract FDI are those most likely to continue to do so. The key policy issue for governments seeking to attract

FDI thus becomes what needs to be done to create the virtuous circle in the first place. Any benefits received from attracting a single investment will be magnified by an increased probability of attracting subsequent similar investments. This means that the impact of a single investment project can be substantially greater than the value of the investment itself, as it may sow the seeds for the creation of a cluster under the appropriate conditions. This is a different approach from the policy recommendation drawn from the traditional FDI model, in which each investment is treated on an individual basis and links between them are not acknowledged.¹³

Fifth, the variation suggested by the present study in terms of the attraction of clusters to various types of FDI suggests that the economies of clusters, and the balance between them and the more traditional location advantages are considerably different for various types of investment. A useful distinction in this context was shown to be between vertical and horizontal FDI, with the attraction of clusters particularly notable for the latter type. Efforts to use clusters as a mean to attract FDI should acknowledge this variation and should be directed primarily to this type of investment.

Finally, the participation of TNCs in geographic clusters is particularly common in some industries, but may not exist in others. Consequently, the balance between the traditional location advantages and those gained from taking part in geographic clusters in affecting the investment decisions of TNCs vary considerably across industries. Typically, industries characterised by high levels of vertical disintegration and rapid technological change favour such clustering as a means to increase the efficiency of transactions and to facilitate the diffusion of knowledge and new ideas. These differences should be reflected in policies designed to affect the investment decisions of TNCs in specific industries. ■

¹³ The literature on the “signaling effect” of FDI expresses a somewhat similar idea, where the presence of other foreign firms in a particular location acts as a signal to other foreign TNCs (see Liu, 1998, for a recent discussion).

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Appendix. Some characteristics of the TNCs studied for this research

	Nationality ^a	Nature of activity in the United Kingdom	Size ^b	Age ^c	London location ^d	Interviews ^e
1	United Kingdom/ Netherlands	Production and distribution of films, mostly for television	350	1986	W1	3
2	Netherlands/ Canadian	Production and distribution of films; limited finance	120	1991	W1	2
3	United States	Production of films and advertisements	7	1994	W1	1
4	United States	Finance and distribution of films	40	1992	W14	2
5	United States	Finance and distribution of films; limited production	n.a.	1930s	EC1 ^f	1
6	United States	Finance and distribution of films	60	1933	W1	2
7	United States	Finance and distribution of film and television	80	1940	W1	1
8	United States	Distribution and production of film and television	300	1985	W1	2
9	French	Production and distribution of films	50	1910	W1	3
10	United States	Production of films	20	1990	W1	2
11	German	Distribution of films	30	1990	W1	3
12	Canadian	Distribution of animation films	3	1992	W1	1
13	United States	Finance and distribution of films	35	1981	W1	1
14	United States	Finance and distribution of film	20	1993	W1	2
15	French	Production of films	15	1990	NW1	1
16	United States	Finance and distribution of film and television	25	1985	NW1	2

^a Defined by the location of the headquarters.

^b Measured by number of permanent employees. In the case of film production, this measure provides only a partial picture of the size of firms, as these firms employ large numbers of free-lance employees. However, the number of the latter changes considerably in line with the needs of specific films, and it cannot be used as a measure for the size of firms.

^c Year of establishment of the United Kingdom affiliates.

^d By postal code area. Soho is part of the W1 postal code area. Most TNCs based in W1 are concentrated in Soho.

^e Number of people interviewed in each affiliate.

^f Based in W1 until 1998.

Privatization and FDI in Central and Eastern Europe

Kálmán Kalotay and Gábor Hunya*

Since economic transition started, a close relationship has developed between privatization and foreign direct investment. It has nevertheless been an unequal relationship: while privatization has undoubtedly dominated foreign-direct-investment inflows, in most Central and Eastern European countries, foreign direct investment has not been the dominant form of privatization, although, according to the findings of a number of previous studies and a recent survey carried out by UNCTAD, foreign direct investment seems to have made a positive contribution to the improvement of efficiency and corporate governance in the framework of economic transition. These findings are particularly important in the light of the expectations that, in the near future, privatization remains the mainstay for an important part of the potential investment inflows of several (but not all) Central and Eastern European countries. At the end of the 1990s, policy makers in the region seem to recognize that not only is privatization important, but also the way it is carried out matters, as restructuring and the establishment of strong corporate governance may be more

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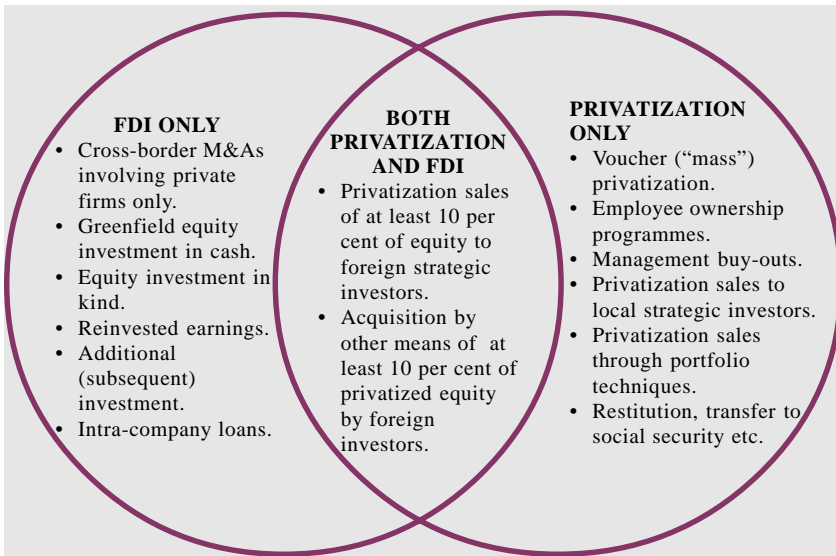
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important than the disposal of former State-owned assets. A strong presence of foreign-owned firms allows a fast restructuring, on condition that, at the same time, host Governments follow sound, efficiency-oriented and internationally competitive economic policies. The impact of privatization-related foreign direct investment depends largely on the follow-up investments and on the restructuring efforts of the new owner. The role of government policies in the future can be seen in maximizing the positive effects and stimulating spillovers to the rest of the economy.

The relationship between FDI and privatization

Both foreign direct investment (FDI) and privatization are complex phenomena. This article does not intend to look at FDI and privatization individually, but to analyze the field in which these two subject areas overlap, namely, the privatization-related part of FDI (i.e. the part of privatization carried out by foreign investors; see figure 1). The scope of this article is also confined in a geographical sense: we analyze the relationship between FDI and privatization in Central and Eastern Europe under the specific conditions of the

Figure 1. The relationship between privatization and FDI



transition from centrally planned to market economy. Consequently, while some of the findings may offer lessons to other countries, other lessons may be applicable only to the specific conditions of economic transition.

A close relationship has developed between privatization and FDI in Central and Eastern Europe since the beginning of the transition process. Tables 1 and 2 and figure 2 highlight that FDI has been an

Table 1. Distribution of enterprise assets between privatization methods in selected Central and Eastern European countries, up to 1998
(Per cent)

Country	Sales to foreign investors ^a	Sales to domestic Investors ^a	Equal access Voucher	Insider ^b	Other ^c	Still State Property
Bulgaria	1	...	39 ^g	6	...	54
Czech Republic	15	15	40	5	5	20
Hungary	48	13	-	3	21	15
Lithuania ^d	12	2	43	9 ^e	-	43
TFYR Macedonia	1	1	-	62	12	24
Rep. Moldova ^f	1	..	21 ^g	23	..	55
Poland ^d	20	5	6	..	29	40
Romania	3	2	25	10	-	60
Russian Federation ^f	3	..	18 ^g	49	..	30
Slovakia	7	3	25	30	5	30
Slovenia ^d	1	8	18	27	21	25
Ukraine ^f	1	..	14 ^g	40	..	45
Memorandum: <i>Central Asia</i>						
Georgia ^f	2	..	8 ^g	50	..	40
Kazakhstan ^f	4	..	26 ^g	25	..	45
Kyrgyzstan ^f	1	..	14 ^g	45	..	40

Sources: UNCTAD; Djankov, 1998, adjusted with data drawn from EBRD, 1998; and estimates adapted from Hunya, 1998.

^a Includes both direct and portfolio sales.

^b Management buy-out and employee share ownership programme.

^c Leasing, debt-equity swaps, restitution, transfer to social security funds and local organizations and liquidation.

^d Data available from the privatization agencies, up to end-1998.

^e This share of employee participation is also included under the voucher data as employees acquired voucher shares in their companies.

^f Up to end-1997, based on unweighted averages.

^g Data on equal access vouchers include also sales to domestic investors.

Notes: Two dots (..) indicates unavailability of data; a dash (-) indicates data are zero or negligible.

Table 2. Privatization-related FDI inflows in selected Central and Eastern European countries, 1991-1999

(Million dollars and per cent)

Country	Indicator	1991	1992	1993	1994	1995	1996	1997	1998	1999	Total
Bulgaria	Total FDI ^a	..	..	40	105	90	109	492	505	476	1 817
	Privatization-related	..	..	3	28	63	36	340	216	227	912
	Privatization-related as share of total (per cent)	..	..	8	26	70	33	69	43	48	50
Croatia	Total FDI ^a	..	..	88	105	83	437	320	591	1 146	2 769
	Privatization-related	..	..	53	92	79	4	169	449	951	1 798
	Privatization-related as share of total (per cent)	..	..	61	88	95	1	53	76	83	65
Czech Republic	Total FDI ^a	..	..	654	869	2 562	1 428	1 300	2 540	4 877	14 230
	Privatization-related ^b	..	..	568	862	2 559	1 317	1 038	..	..	6 344
	Privatization-related as share of total (per cent)	..	..	87	99	100	92	80	..	..	45
Hungary	Total FDI ^a	1 459	1 471	2 339	1 146	4 453	1 788	1 811	1 410	1 675	17 552
	Privatization-related	325	488	651	99	3 025	577	272	12	0	5 449
	Privatization-related as share of total (per cent)	22	33	28	9	68	32	15	1	0	31
Macedonia, FYR	Total FDI ^a	..	..	..	20	1	5	9	103	10	148
	Privatization-related	5	26	3	34
	Privatization-related as share of total (per cent)	57	25	35	23

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Table 2. Privatization-related FDI inflows in selected Central and Eastern European countries, 1991-1999 (concluded)
(Million dollars and per cent)

Country	Indicator	1991	1992	1993	1994	1995	1996	1997	1998	1999	Total
Republic of Moldova	Total FDI ^a	..	..	14	28	65	21	70	57	37	292
	Privatization-related	..	..	14	28	64	17	39	..	..	161
	Privatization-related as share of total (per cent)	..	..	100	100	97	82	55	..	..	55
Poland	Total FDI ^a	892	298	892	884	1 807	2 845	2 663	4 323	..	14 604
	Privatization-related ^c	127	213	176	104	480	423	464	300	..	2 287
	Privatization-related as share of total (per cent)	14	72	20	12	27	15	17	7	..	16
Romania	Total FDI ^a	..	..	37	188	207	151	655	1 346	656	3 240
	Privatization-related	..	..	6	33	82	16	335	1 131	..	1 604
	Privatization-related as share of total (per cent)	..	..	17	17	40	11	51	84	..	49
Russian Federation	Total FDI ^a	..	..	1 211	640	1 451	1 822	5 014	1 378	1 240	12 756
	Privatization-related	..	..	..	..	..	..	2 155	1	0	2 156
	Privatization-related as share of total (per cent)	..	..	..	..	..	..	43	0	0	17

Source: UNCTAD FDI/TNC database.

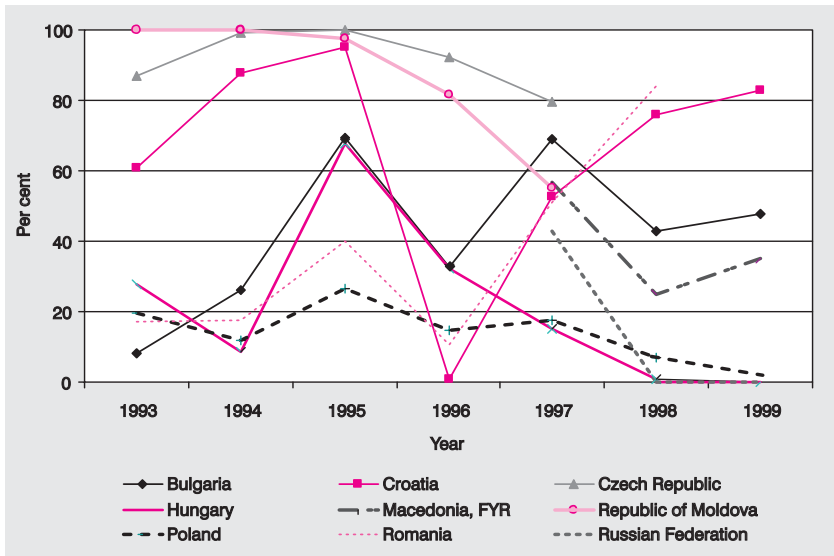
^a FDI equity inflows paid in cash only.

^b Including reinvestments and additional investments.

^c Capital (indirect) privatization only.

Note: The data presented in this table are not strictly comparable because the definition of "privatization-related inflows" varies from country to country.

Figure 2. Share of privatization in FDI inflows, 1993-1999
(Per cent)



Source: UNCTAD, FDI/TNC database.

important form of privatization, and privatization has been a major conduit for FDI. It has nevertheless been an unequal relationship: while privatization has undoubtedly dominated FDI inflows, FDI has not been — with the exception of Hungary — the dominant form of privatization. Hungary has almost completed its privatization programme.¹ This is reflected in the increasing role of non-privatization FDI in that country: in 1998, non-privatization investment accounted already for 87 per cent of inflows, compared to 32 per cent only in 1995 (UNCTAD, FDI/TNC database).

The dynamics of FDI inflows in individual countries can be seriously influenced by the acceleration or slowdown in privatization and the mode of privatization chosen (Hunya, 1997a, pp. 285-286; EBRD, 1998, p 80). Privatization is understood as one of the basic pillars of transformation into a market economy (World Bank, 1996), together with liberalization, stabilization and institutional reforms. As for the role of FDI in privatization, there has been a *recent shift* of privatization methods from the distribution of property rights to local owners to direct sales and international tenders. The motivation of

privatization shifted from social and distributional considerations to improving corporate governance (EBRD, 1998, p 31). This is especially true for latecomer countries (e.g. Bulgaria, Romania) that try to speed up privatization and attract FDI simultaneously under the pressure of mounting external and internal deficits, but also in countries in which privatization in the 1990s had been relatively slow (Poland), or geared almost exclusively to local ownership (the Czech Republic).

Most of the studies on privatization have found that, from the point of view of efficiency and corporate governance, FDI is one of the best performing modes of privatization.² But in the early phase of transformation, non-economic considerations (social equality and the speed of ownership change) seemed to be more important, prompting some Governments (the Czech Republic, Romania, Bulgaria, Russian Federation) to opt for voucher schemes, which allowed a fast distribution of shares (Boycko, et al., 1994; Lieberman, et al., 1997). It seems that sales to foreign (and domestic) investors became a major avenue of privatization only when the wish for maximum efficiency improvement was reinforced by other economic and financial impetuses. Governments under the financial strain of debt servicing and budget deficits were pressed to increase revenues from privatization. This was the case in Hungary in 1995-1996 and in the Czech Republic and Romania more recently, and for South-East European countries in 1999 (as a result of the Kosovo crisis).³

There are two competing explanations why distributive methods, such as vouchers and insider privatizations, dominated the privatization policy in most countries at the beginning of

¹ See Mihályi, 1998, p. 461: “By and large it is ready ... already 85 to 90 per cent of the task has been accomplished. What is left is only minor work, tidying up, checking up and settlement...” [translated from the Hungarian original].

² One of the exceptional studies that did not find evidence for foreign-owned firms sold to domestic owners was carried out by Frydman, et al. (1997), covering the Czech Republic, Hungary and Poland. But even they found that “outsider-owned” firms (as they call the firms sold to domestic or foreign investors) outperformed insider-owned (management, workers) and non-privatized firms.

³ Although a part of the new privatization wave had already been underway before the Kosovo crisis started, it accelerated the actions of host countries aimed at the finalization of such deals.

transformation. On the one hand, it was argued that FDI was not available as foreign investors were only interested in a small part of the privatized companies (Hare, 1999). On the other hand, it was highlighted that, even where potential interest by foreign investors was apparently in place, there were influential political forces opposing and blocking such sales. These political forces argued that the assets at stake were all key assets that had to be kept in the hand of the Government. They also expected major benefits arising from the empowerment of the local population by involving them in the privatization process. In some cases, these forces built on resentments against some badly conceived or executed privatization deals. In many instances, it was the rent-seeking attitude of the incumbent management and trade unions that effectively prevented sales to outsiders.

The problem of the mass distribution of shares through voucher privatization lay in the fact that apparently no efficient corporate governance could be established in the voucher privatized firms. Ownership proved to be too dispersed, and ownership control over the firms in question remained almost non-existent. This lack of real and efficient ownership led to delays in restructuring, especially as voucher privatization was accompanied by an acute lack of new financial resources for investment. In the case of insider privatization, the employee-owners of the companies paid for shares from the profits of the company, which prevented investments. As a result, most of the voucher privatized firms lost competitiveness (EBRD, 1997; Claessens, et al., 1997; Hunya, 1997a, 1997b).⁴

This meant that the original plans for fast ownership change could not be met in substance. There have been also growing doubts whether these schemes met their original goals in terms of empowerment, job security and social equality. With the growing recognition of the benefits of FDI-related privatization, this became the main method of privatization after new political forces came into power (1996 in Romania, 1997 in Bulgaria the Czech Republic and Slovakia). The Government of the Czech Republic introduced an

⁴ With dispersing ownership, in some countries this method could also be (mis)used for maintaining political control over enterprises after privatization.

FDI friendly policy in 1998, and the privatization of companies and banks was re-launched by inviting foreign investors.

The change in privatization policy and the faster inflow of FDI can be demonstrated with some data, for example, for Bulgaria, Poland and Romania (see table 3, comparing their privatization and FDI results with those of Hungary). In Poland, privatization has been slow, but sales to foreign investors accelerated after 1997, when the current account turned into deficit. In Romania and Bulgaria, privatization had been delayed for years, and has picked up only lately. In both countries, external financial pressure (default in Bulgaria in 1997 and high current account deficit in Romania in 1996-1998) contributed to the political will to put an end to absolute preference for local owners in the privatization policy.

Regarding the benefits of privatization through FDI, there is a growing agreement that, particularly at the micro level, foreign investors, using their distributional, financial, technological and

Table 3. The relative importance of FDI in privatization and privatization in FDI in selected Central and Eastern European countries, 1990-1999

(Per cent and dollars)

Country	1990-1996			1997-1999		
	Share of foreign exchange in total privatization revenue (per cent)	Share of FDI-related privatization revenue in total FDI (per cent)	Per capita FDI ^a (dollar)	Share of foreign exchange in total privatization revenue (per cent)	Share of FDI-related privatization revenue in total FDI (per cent)	Per capita FDI ^a (dollar)
Bulgaria	low ^b	25	8	high ^b	56	73
Hungary	63	47	188	40	20	203
Poland	low ^b	20	48	medium ^b	40	162
Romania	low ^b	20	8	medium ^b	47	62

Source: estimated by the authors based on national statistics and UNCTAD FDI/TNC database.

^a Arithmetic average of years, partially estimated.

^b The exact share of foreign exchange in total privatization revenue could not be calculated for Bulgaria and Poland as non-cash privatization could not be measured. Based on the relative role of various privatisation modes, a very rough estimation could be made: "low" means less than one third, medium means between one third and one half, and high means above one half.

managerial advantages, tend to carry out transformation deeper and faster than local investors. And although this transformation, just as economic transition in general, is not exempt from difficulties in terms of keeping existing capacities, employment levels and supplier networks, most authors seem to share the view that the turnaround of local companies sold to foreign investors will continue to produce tangible benefits that will compensate for the temporary losses of capacities and employment.

It is to be noted, however, that just like privatization in general, acquisitions by foreign investors themselves cannot save most of the redundant capacities in oversized industries. For example, the steel industry is lagging behind both in terms of privatization and FDI due to the expected high social costs. Current attempts to privatize by selling Polish or Romanian steel companies to foreign investors have not attracted the expected foreign interest, and a Hungarian steel mill (Ózd) had to be re-nationalized after the failure of the foreign investor who acquired it.

The case study evidence on FDI and privatization⁵

The results of company surveys and case studies amend and complement the findings of the general literature on FDI as part of the privatization process (for an early comprehensive summary of issues, see, for example, Odle, 1993). Although these studies focus more often on manufacturing than on services, this focus is not exclusive, and most of the findings seem to be applicable to all FDI-related privatization. These surveys and studies highlight some typical characteristics of foreign-owned enterprises created through privatization. They also document a wide range of circumstances and impacts. In terms of enterprise strategies, most studies, including the one prepared by Andrea Éltető and Magdolna Sass (1997), highlight the relative market-seeking nature of privatization-related FDI. They have shown that in Hungary privatization acquisitions were less export-oriented, smaller and less import intensive than greenfield investments. This phenomenon may be linked both to the

⁵ This section is based on information compiled by Gábor Hunya, and based on Szanyi (2000).

relatively high level of protection of Central and Eastern European economies in the early phases of transition and to the advantages offered by the existing local marketing links for privatized enterprises. Differences in entry modes appear at the industry level and on a case-by-case basis (see Mikelka, 1996, for Slovakia; Kosta and Konstantinov, 1993, for the Czech Republic; Legeza, 1997, for Hungary). While privatization was not a mode of entry in the Hungarian car industry, it was dominant in the Czech Republic and Romania. The Polish foreign-owned car industry has companies originating both from privatization and greenfield investment.

Even when privatization is the dominant form of entry, there are huge differences in motives and strategies. In the Hungarian pharmaceutical industry, for example, young and rapidly expanding transnational corporations (TNCs) purchased companies because they saw merits in their market positions, products and perhaps even research and development (R&D) personnel. Others bought privately established companies because they wished to increase sales by becoming a local firm (Antalóczy, 1997).

Privatization acquisitions bring about important changes in decision-making, competence and streamlining of the product line. Sometimes, the acquired firms are “flattened” to a sub-delivery base, or to an assembly unit (Naujoks and Schmidt, 1995). Peter Farkas (1997) and Alena Zemplínerová and Vladimír Benáček (1997) also provide some empirical evidence of such a “downgrading” of activities in FDI projects in Hungary and the Czech Republic seeking factor cost advantages. In many cases, a general overhaul of corporate activities was necessary after privatization (Lakatos and Papanek, 1994; Mike, 1996). But it is less clear from the literature whether this streamlining is a natural consequence of a transition from oversized State-owned conglomerates to smaller, more specialized firms better adapted to a market economy, or it is typical for foreign-owned firms only.

Most, but not all, case studies report significant investments as a means of financing restructuring. In almost all cases, investments were combined with technology transfer and rapid improvements in quality. In many cases, further investments by foreign investors were

fuelled by a quick absorption of the latest technology (Hunya, 1997b; Estrin, et al., 1995; Carlin, et al., 1994; Rojec, 1997). Zemplínerová (1998) found that, in the Czech Republic (in terms of improvements in organization, marketing and management, quality control, and training and innovation), 94 per cent of the privatized firms sold to foreign owners fared better than the average firm in the country did. In Hungary, foreign-owned firms were ahead of others in introducing new technologies (Szanyi, 1997), although State-owned ones were also well represented. In Poland, Władysław Jermakowicz (1994) concluded that large privatization transactions involving foreign investors had made a major contribution to restructuring: while 90 per cent of the foreign investors made changes in the profile and the organizational structure of the acquired Polish enterprises, only 20 per cent of the investors reduced employment.

A comparative survey of Czech, Hungarian, Polish and Slovenian enterprises purchased by foreign investors (Rojec, 1995) found that, frequently, restructuring meant the introduction of new production programmes and the improvement of marketing activities. In the Czech Republic, new owners often reduced the staff and sold non-core businesses. They did it less frequently in Poland, and rarely in Hungary. In newly acquired facilities, organizational build-up and management changes usually preceded other restructuring activities (Aal, 1997). But organizational and management changes did not mean major changes in management personnel (Filip, Spurry and Zigic, 1997; Rojec, 1997). Foreign owners also gave particular emphasis to continuous training and education of the workforce (Lakatos and Papanek, 1994; Mike, 1996; Weiszbürg, 1997).

The survey results confirmed the importance of building regional and global networks as a motivation for FDI through privatization. Local companies sold to foreign investors can in fact increasingly become part of modern production networks, which help them to meet global requirements (Kurtz and Wittke, 1998). As integration into a global network is a difficult process, it is not surprising that, according to one study on the Czech Republic, Hungary, Poland and Slovenia, in the mid-1990s, only one third of the foreign-owned firms studied were integrated into the investing company's network (Rojec, 1995). The larger and the more

internationalized the foreign partner and the acquired company are, the higher is the propensity to be integrated into the investor's network.

Some case studies have also found that foreign ownership puts an additional discipline on company strategies (Csermely, 1995). Incorporation into global sourcing may narrow the product range (although it is unclear whether this is a negative or positive development) and stimulate competition for higher-standard products inside the TNC network; this may be a new challenge for the local company.

In the same vein, becoming part of a TNC network may result in a redefinition of R&D activities. If an R&D activity loses justification in the new network, the local company may end up with reduced R&D expenditures. In some cases, even the retention of old brand-names and corporate names becomes impossible (Csermely, 1995). But the strategic position of the privatized firm may change with time. One of the best-known and first examples of privatization is the take-over of Hungary's Tungram by General Electric. The early outcomes of the deal were rationalization, layoffs and a radical streamlining of production. But this pain resulted in a completely transformed company that became the main business centre of General Electric for its lighting activities throughout the world (Weiszburg, 1997). New products (compact lighting) and technology were transferred to Budapest. Even the main R&D facility of the company's lighting branch was set up in Tungram. General Electric is estimated to have invested an amount 3-4 times higher than the original purchase price it paid for Tungram (Weiszburg, 1997).

A cross-country comparison of post-privatization performances (Hunya, 1997b) confirmed the potential for turnaround in these companies. It found that the sales of foreign privatized firms often decreased after privatization. But employment remained stable, while a very intensive investment activity took place. Investments per sales in firms sold to foreign owners were higher than in either greenfield FDI, or in locally owned firms. This is a sign of ongoing restructuring and follow-up FDI in the wake of privatization. The lead of foreign privatized firms over other firms is most salient in terms of expenditures on machinery and equipment. In the course of

restructuring, foreign firms preferred upgrading and expanding existing capacities over introducing totally new activities, which shows that the privatization was triggered by the local firm having products (and markets) with good sales prospects.

The undertaking of major improvements in efficiency after sale to foreign owners is further confirmed by a recent survey carried out in Slovenia. In that study, Stephen Smith, et al. (1997) found that a one percentage point increase in foreign ownership was associated with a 3.9 per cent increase in value added, as compared with a 1.4 per cent increase in value added attributed to a 1 per cent increase in local (employee) ownership. Other surveys came to the conclusion that downsizing occurred in all firms, whether locally or foreign owned (Carlin, et al., 1994). But Rojec (1997) depicted a different experience: foreign-owned enterprises operating in Slovenia did not do much downsizing, did not sell many facilities in non-core businesses and did not dismiss employees.⁶

In sum, most of the knowledge on FDI and privatization gathered in surveys of the mid-1990s indicates that FDI is generally beneficial for privatization. As a follow-up to these surveys, UNCTAD undertook a survey in 1999 to obtain information on the latest developments in the major foreign privatized enterprises.

The UNCTAD survey of FDI and privatization

The advantages of privatization through FDI are confirmed by a questionnaire survey carried out for UNCTAD in 1999.⁷ Although the period of observation was relatively short (in most

⁶ These findings, as well as most case studies outlined above, belie the frequent rumours in the region that the original aim of many investors was to buy a competitor in order to shut it.

⁷ The survey, conducted in January to June 1999, reviewed the pre- and post-privatization performance of 23 major companies, selected from seven Central and Eastern European countries (Croatia, Czech Republic, Hungary, Latvia, Poland, Romania and Slovenia). For 22 of these companies, their performance during the two or three years following their privatization could be followed with detailed data. Data availability for the two years preceding privatization was more limited, but still satisfactory: 16 firms provided data in this respect. The combined asset value of these large enterprises at the moment of their privatization exceeded \$5 billion, i.e. 8 per cent of the inward FDI stock of the seven countries (table 4).

Central and Eastern European countries, privatizations and FDI are quite recent), and the potential population was relatively small (the number of completed major privatization deals via FDI is small), the UNCTAD survey, conducted in 1999, offers useful insights into the analysis of these phenomena.

The basic findings of the survey are as follows (table 4; note that all data given in local currency were converted into dollars; hence, these findings refer to results expressed in current dollars):

- For almost all indicators, there was a generalized improvement of performance both in the pre- and post-privatization periods. This indicates that, in various instances, the restructuring and reshaping of enterprises already had started during the

Table 4. Results of the UNCTAD survey on FDI and privatization, 1999
(Per cent)

	Average growth	
	Pre-privatization	Post-privatization
Total paid-in capital	4.4	-0.9
Paid-in capital owned by foreign investor	-5.1	
Total assets	6.0	3.3
Number of employees	-4.6	-3.3
Total output	7.1	30.2
Capital investment	27.9	36.6
Research and development expenses	22.8	13.6
Personnel cost	14.1	34.6
Revenue from sales	11.1	42.8
Domestic market share for lead products	-4.3	6.2
Total exports	39.5	33.8
Total imports	14.2	39.9
Total assets at privatization (<i>million dollars</i>)		5 063
Productivity indicators:		
Sales/Assets	4.9	38.2
Sales/Employee	16.4	47.6
Output/Employee	12.3	34.6
Sales/Personnel cost	-2.6	6.1
Sales/Output (capacity utilization)	3.7	9.7
Number of companies surveyed		23
Number of companies bound by performance requirements		4

Source: UNCTAD survey on FDI and privatization, 1999.

preparatory phase of the privatization. In principle, this may also indicate that, in line with the expectations on the importance of cutting start-up costs, foreign investors preferred to take over companies in good condition, with considerable domestic market shares and good prospects. But the findings on massive capital outlays after privatization (to be highlighted below) seem to indicate that even if this had been the original aim of the investors, they could not avoid subsequent investments to make the acquired firms efficient and profitable.

- Notable exceptions to the rule of improvement are the number of employees in both periods, paid-in capital in the post-privatization phase, and the domestic market share for the lead product in the pre-privatization period.
- In most cases, firms improved their performance in terms of output, sales etc. after privatization, as compared with the pre-privatization period. This finding is largely in accordance with common explanations and with the findings of previous surveys.
- Most of the positive developments in the surveyed enterprises occurred as a normal result of privatization and restructuring. Of the 23 enterprises surveyed, only four were bound by performance requirements in the privatization contract. Interestingly, the eight performance requirements mentioned by these firms (some of them had more than one) were quite dispersed. Only performance commitments concerning the volume of output were mentioned twice. It is also notable that even the enterprise (Volkswagen-Skoda) that in the early 1990s had been mentioned as a case where performance requirements were imposed (Odle, 1993, p. 29), but the company had failed to meet the original performance target, at the end had a largely positive performance — at its own speed.
- The number of employees decreased both in the pre- and the post-privatization periods. This is broadly in line with the patterns of transformation from soft to hard budget constraint, resulting in the disposal of excess work force. It is notable, however, that the decrease in the surveyed enterprises was small

compared with a generalized decline in employment,⁸ and was more felt in the period preceding privatization. This means that the rest of employers, including the firms kept in public hands, were even less successful in preserving jobs than the firms privatized to foreign investors. A further, more indirect, conclusion one can draw from these findings is that, contrary to widespread belief, it is not privatization *per se* that leads to a major reduction in employment, but the failure of the centrally planned economy, which had relied typically on overstuffed economic activities. With its collapse, the workplace of redundant employees suddenly disappeared.

- Both total paid-in capital and a foreign investor's part in it declined somewhat in the post-privatization period. This is basically due to, among other factors, the devaluation of local currencies. Once the capital base was consolidated through privatization, its value expressed in dollars started to erode. But this is within the expectation that as privatization itself usually involves a heavy capital investment, the capital base does not increase immediately after privatization.
- The domestic market share for the lead products eroded in the pre-privatization period, mainly as a result of the end of previous monopolies or oligopolies. But after privatization, market share usually recovered. This result confirms the expectation that foreign investors wish to, and are generally able to, gain market share with the privatized enterprises.
- There were two more areas in which the performance of the pre-privatization period was better than that of the post-privatization period: R&D and exports. But despite a slowdown, the growth of both areas remained positive. In R&D, the fast growth of the pre-privatization period mainly reflected the temporary continuation of previous non-market-oriented, sometimes overstuffed programmes. Once a foreign takeover

⁸ In 1990-1996, the number of employees excluding the self-employed decreased by more than 4 per cent per annum in Hungary (Hungary, National Bank of Hungary, 1997) and more than 1 per cent per annum in the Czech Republic (Czech Republic, Statistical Office, 1998).

was realized, some of the redundant programmes were stopped and/or replaced by imported technology.

- In foreign trade, the survey results confirmed import surplus as a general feature of local market-oriented TNCs in Central and Eastern Europe. The main reasons for a growing import propensity are the increasing use of local affiliates as distribution channels for imports, the substitution of earlier local sourcing by suppliers from a TNC's own network, and a generalized increase in capital investment, particularly in imported capital goods.
- In general, foreign affiliates have higher export intensity than local firms (Hunya, 2000), and the difference increases with time. The sample result deviates only in part from this trend, mainly because local market-oriented firms are over-represented in the sample. Even so, the growth of exports after privatization remains high, and its lag behind the growth of total sales is not too high.
- The performance of sales is the key to most of the improvement occurring in the firms surveyed. Already in the period before privatization, they grew by 11 per cent per year. These findings confirm that companies that already previously had better than average results had better chances to undergo fast privatization. The rate of increase in sales accelerated to more than 40 per cent in the period after privatization.
- With the exception of sales per personnel costs in the pre-privatization period, all the performance indicators containing sales in the numerator had a positive growth rate in both periods. And without exceptions, the performance during the post-privatization period was better than that during the pre-privatization period. In sales per personnel cost, improvement after privatization stood at 6 per cent per year, as compared with a decline of 3 per cent before privatization. It seems that, indeed, cost saving, financial restructuring and output growth are the first post privatization targets of the foreign investor. Only after profitable operations are established, can new capacities and new products be introduced.

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- Improved performance seems to be the consequence of capital investment activities. In line with expectations for a lagged impact, capital expenses grew faster than sales in the pre-privatization period, while sales outperformed capital expenses in the post-privatization period. But this reversal of order did, by no means, result from a slowdown of investment activities; in the contrary, their growth rate increased from 28 per cent to 37 per cent.

The UNCTAD survey findings are, by and large, in line with the results of previous mainstream studies on FDI and privatization. As for social considerations, the impact of FDI-related privatization on employment is neutral, or at least not as negative as its alternatives, and positive on wages. It should also be taken into consideration that, by contributing to budget revenues available to social expenditures, this form of privatization indirectly may enhance the social policies of host countries. This indirect impact is to be weighed against other forms of privatization (e.g. equal access vouchers, management buy-outs, employee share ownership programmes), which do not have such an impact on budget revenues.

Policy implications of privatization-related inward FDI

In many Central and Eastern European countries, after a decade of economic transition, privatization is still far from being completed. Consequently, the impetus for fast privatization is still there. But, as a new element, there is a growing consensus that the method of privatization also matters. In fact, restructuring and the establishment of strong corporate governance may be more important than the disposal of former State-owned assets. This policy conclusion is supported by the fact that, in the past two years, some countries with strong foreign presence in privatization (e.g. Hungary and Poland) have grown faster than others. It is also underpinned by an international context in which arguments for restricting foreign presence in any given industry are weakening.

A strong presence of foreign affiliates contributes to a fast restructuring, on condition that at the same time host Governments follow sound, efficiency-oriented and internationally competitive

economic policies (e.g. tax policies, trade policies, competition policy), which reduce the eventuality of a precipitous exit of these foreign investors. In the current stage, the economic difficulties of some Central and Eastern European countries (e.g. the Czech Republic, Bulgaria and Romania) seem to be best surmounted with a radical restructuring of the enterprise sector that inevitably involves an active role for foreign investors. A large part of local enterprises have based their international competitiveness on the non-sustainable grounds of low wages and low capital expenditure. They need foreign investors in order to realize massive capital expenditures and to assure a better access to international networking and international knowledge flows, particularly in technology intensive industries.

The benefits of foreign privatization on restructuring are independent of the other pressures that may have prompted a Government to accept dominant foreign ownership in certain segments of the economy. As already highlighted, Hungary (in the mid-1990s), the Czech Republic and Romania (more recently) have sold assets to foreign investors under budgetary and balance-of-payments pressures. It needs to be stressed that, except for special circumstances, these sales are not and should not be “fire sales” (Krugman, 1998). In most cases, disagreements about the fair price offered by an investor into former State-owned assets arose from the fact that previous accounting practices, based on costs instead of market value, tended to overestimate the real value of those assets. It is also to be stressed here that the findings of the UNCTAD survey on declining local market shares before privatization indicate that, the more privatization is delayed, the more market value State-owned assets lose, and the Government may be obliged to accept a lower price offered by investors.

This does not necessarily mean an unlimited role for FDI in privatization. There may be industries and firms in which it is not realistic to expect significant levels of FDI. In such cases, restructuring should be locally driven. In the same vein, FDI policies are one element of economic policy that by no means can replace, or substitute for, other policy imperfections.

The impact of privatization-related FDI depends largely on the follow-up investments and on the restructuring efforts of the new

owner. In this respect, the government agency responsible for privatization and/or FDI is in the best position to judge the potential costs and benefits of a given deal. Except for monopoly industries, these evaluations may prove to be more important than formal performance requirements in guiding a privatization transaction towards a maximum benefit for the host country. It is also the task of that agency to make it sure that the amount spent by the foreign investor on a privatization acquisition is not just a revenue for the government budget, but it is also used to improve the financial standing of the company. The retention of a part of the company's price offered by the investor may improve the chances of a fast and successful financial restructuring. As for the part of the revenues available to a Government, it is usually recommended to use it for the reduction of public debt and the financial restructuring of State-owned enterprises in the pre-privatization stage, and to limit its use for current budget expenditures.

In monopoly industries, competition policies, too, play a key role in guiding inward investment, and making sure that the host country draws the maximum benefit from such investment (UNCTAD, 1997). In this respect, competition authorities should use the same techniques and mechanism as in their regulation of domestic monopolies: pre-entry competition (auctioning), circumscribing exclusivity in terms of time and scope, circumscribing exclusivity through alternative sources of competition, ensuring fair and non-discriminatory access to essential facilities, the breaking up of national monopolists into regional firms, a periodic reviewing of behaviour, and the use of price regulations whenever necessary (UNCTAD, 1997, pp. 186-189). These considerations can be best taken into account and enforced if competition authorities are involved in the evaluation of the privatization of monopolies from the outset. The application of competition policy is particularly needed when the exclusivity of the foreign investor is person-made or has major implications for the national budget, such as in the case of tax incentives, tariff protection or other market inducements (UNCTAD, 1997).

The results of most of the studies so far, and of the UNCTAD survey, underline the overall positive effects of privatization-related FDI in Central and Eastern Europe. The role of government policies

in the future, particularly in the newcomer countries, can be seen in stabilizing the positive effects and stimulating spillovers to the rest of the economy. In this respect, predictable and sound policies may contribute to a maximization of FDI and privatization revenues.

Governments pursue various goals with privatization. Beyond the great variety of the forms of privatization, the conditions set for the privatization sales reflect a Government's concern about the impact of a particular deal on the labour market, regional development and the environment. Although the price may be the central criterion in the evaluation of bids, authorities try to get further commitments from the buyer concerning future investments and employment. These commitments prove to be necessary when there is an evident lack or weakness of proper policies in the given field (e.g. employment policy, R&D policy).

What makes the transition economies specific in this respect is that they inherited weak policies (or sometimes none) from the previous economic and social system. Furthermore, the very first policy advice on economic transition tended to focus on macroeconomic stabilization. As a result, employment policies and institution building, in general, were neglected. But with a growing awareness about these aspects of transition, the chances that they are being covered by general regulations in the given field, rather than putting the burden on individual enterprise in a case by case manner, may improve in the future. In general, this means a shift from so-called "active" FDI policies (Samonis, 1995) (whereby a wide range of performance commitments is negotiated) towards "integrative national treatment" of FDI (*ibid.*) (whereby the Government tries to influence indirectly the positive spin-offs of given investments).

Other commitments are meant to ensure the good future prospect of the company. In this respect it is certainly important to select a reputable investor and evaluate its business plan. But the actual investment and output growth will depend on many unforeseeable business conditions. The price offered by an investor is usually indicative for the future intentions: the higher the amount the investor is willing to pay for an investment, the more the investor will care for ensuring the company's profitable operation. It does

not seem to be a sound industrial policy to block efficiency increase in a specific company by too specific regulations beyond the limits of general labour, environmental etc. regulations and competition policy.

The experience of Hungary shows that strict performance requirement can be ineffective. The privatization law stipulated the value of the price offers as the main criterion to select between privatization bids. In the course of the judgment of the tenders and/or the individual bids, the obligations undertaken by the bidder in respect of reorganization, capital increase, technical development, restructuring and employment policy, social security of employees and environmental clean-up can be taken into consideration as additional major criteria. An in-depth appraisal of the experience with such criteria has found that (Csáki and Macher, 1998):

- the enforcement of the “soft” — environmental, employment etc. — conditions stipulated in privatization contracts can not be carried out successfully;
- unfulfilled contractual commitments have not been penalized always, particularly because some of these conditions are difficult to quantify by nature (e.g. to estimate the cost of environmental clean-up is extremely difficult);
- the incorporation of such conditions in the contract resulted in the reduction of the purchase price; and as the fulfillment of the commitments proved to be uncertain and unpenalizable, the country turned out to be a net loser in this respect.

Hence the question arises under what condition can a Government afford the trade-off between revenues and commitments, especially when privatization takes place under budgetary pressures and a need to maximize revenues. In this respect, a comparative study of privatization sales to foreign investors in the Czech Republic, Hungary and Poland and Slovenia (Rojec, 1995) suggested the following policies:

- ensure competition among potential buyers;

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- a realistic maximum price should be determined through bidding and negotiating with potential buyers, as the proper valuation of assets before sales is not really possible;
 - a premium can be required for the purchase of a controlling share in an enterprise, as compared with the purchase of minority stakes;
 - in most cases, the national, non-discriminatory treatment of investors is enough; special treatment is to be limited to a minimum.

In sum, an optimum policy on privatization sales to foreign investors should focus on two basic criteria: on the price offered by an investor and on the reputation and business plan of the investor. Other “softer” criteria may also be part of the evaluation of a potential investor’s bid for a privatized company. They should, nevertheless, enjoy less priority, as their enforcement seems to be uncertain, and may result in net losses for countries. As for monopolies, the above criteria need to be complemented by competition policy considerations. In fact, it is desirable to involve the competition authority into the evaluation of privatization bids from the outset.

Over the past decade, the countries of Central and Eastern Europe have undergone an important learning process in terms of FDI and privatization. They have attracted significant amounts of FDI and carried out large privatization projects over a historically short period. Despite their constraints in terms of knowledge and historical precedents, transition economies have proved to be relatively successful in both areas. In the meantime, in some countries, related policies improved significantly. This development may raise the chances that, by learning from each other’s experiences, the countries of the Central and Eastern Europe region maximize the benefits derived from FDI and from privatization and minimize the chances of negative impacts. If these things happen through their gradually maturing market economies and a mutually advantageous involvement of foreign investors, the countries in that region may finally reap significant benefits from their transition from a command to a market economy. ■

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BOOK REVIEW

In the Hurricane's Eye: The Troubled Prospects of Multinational Enterprises

Raymond Vernon

(Cambridge, Harvard University Press, 1998)
262 and x pages)

Besides an apparent infatuation with meteorology (evident from the titles of his books) the late Raymond Vernon exhibited prophetic tendencies as well. He had the uncanny ability to capture the mood of the times in his titles. At the Harvard Multinational Enterprise Project, which he launched, Vernon initiated the study and measurement of foreign direct investment (FDI) and transnational corporations (TNCs), and began theorizing about them. This pioneering effort, which began in the 1960s, spawned many books, articles and doctoral dissertations. Vernon continued to monitor the TNC-host country relations, as they evolved during the 1970s and into the late 1990s. In his last book, he made bold and somewhat unsettling predictions about the future.

In 1971, Vernon summed up the relationship between TNCs and nation States with his *Sovereignty at Bay* (Vernon, 1971). This book captured the mood of the late 1960s and early 1970s, a time when national sovereignty was being challenged by TNCs (called “multinational enterprises” by Vernon and several others). By spreading goods, capital and technology across the globe, they were presumed to threaten national sovereignty. This threat was seen not only in developing countries that were beginning to struggle with nation building and independence, but even in countries such as France (Servan-Schreiber, 1968) and Canada (Levitt, 1970). Everywhere, sovereignty was “at bay”. This, he said, was a “period of great pain for multinational enterprises” (Vernon, 1971, p. 5).

His next major work, *Storm over the Multinationals* (Vernon, 1977), chronicled the waves of nationalization and expropriation and numerous other hostile acts against TNCs, which seemed threatened by the “storm” that swept across the TNCs-host country landscape in the 1970s.

Vernon’s last book, *In the Hurricane’s Eye* (Vernon, 1998), another meteorological metaphor, captures his apprehension over the next phase. Vernon sees TNCs in the eye of the hurricane, hence a rather gloomy prediction (p. 29):

“... if my projection proves right, the pressures from aggrieved constituents can be expected to break out at times, often in ways that are destructive both to their national interests and to those of the multinational enterprises”.

Vernon bases his apprehension and prediction on many disturbing signals. He detects signs of trouble everywhere, from corruption and fragile democracies to cash strapped governments and the heavy-handed role of some international organizations. In Latin America, he sees several troubling signs (p. 77):

“Is the new-found tolerance for multinational enterprises simply a passing phase in a half century or more punctuated with hostile gestures? Can the region live comfortably with a condition in which the economy is increasingly open to the influence of multinational enterprises marching to their own distant music?”

Vernon notes troublesome indicators elsewhere as well. In Asia, he sees erstwhile stars fading under the weight of debt, corruption and cronyism. From Thailand’s “orgy of borrowing” and the “profligacy of Korea’s *chaebols*” (p. 83) to the undercapitalization of banks and the mercurial political balance in Asia’s emerging markets, Vernon sees uncertainty ahead. That includes the global institutional architecture and the home countries of traditional TNCs. On the one hand, he sees the potential for demagogic reaction in hitherto beneficiaries of these institutions (p. 79):

“The resurgence of multinational enterprises in the 1990s has taken place with the urging and support of the IMF, the World Bank and the U.S. government, a fact that renders the movement especially vulnerable to future demagoguery intent on preserving national autonomy”.

On the other hand, there are the host countries and their ambivalence towards open markets, with contending and amorphous power bases vying for influence, occasionally head to head. How prophetic indeed, in light of the anti-WTO demonstrations in Seattle in November 1999 and similar ones in Washington against the World Bank and the IMF in April of 2000. Vernon wrote before either of these events had erupted. Could we see in these two events proof of the accuracy of his predictions? Or is it that, completing the book in the midst of the Asian financial crisis, Vernon was overtaken by the excessive gloom that prevailed at the time?

Other themes highlighted by Vernon include the underlying mistrust between TNCs and governments,¹ the off and on attempts at regulation (including codes of conduct) and the emergence of non-traditional TNCs. Indeed Vernon’s warning on mistrust is one of the danger signs he sees ahead (p. 176):

“Indeed, the lingering mistrust of many developing countries in the multinational enterprises as a business institution stems partly from the political influence that enterprises like Unilever, Alcan, and Standard Oil once exercise over governments in the countries where they operated”.

Vernon’s advice on how to prepare for the incoming hurricane is consistent with his life-long message, namely increased transparency and openness, harmonization of laws and treatments (including a regional application of the “unitary tax” idea), better enforcement of competition rules and sorting out conflicting

¹ This mistrust is an oft-repeated theme in the relationship between TNCs and host countries. For an empirical proof and elaboration of this mistrust, see Sagafi-nejad and Perlmutter, 2000.

jurisdictional issues. In short, like any good weatherperson, Vernon has given us the warning signs. But he has done them one better. Unlike the weather, where “everyone talks about it but no one does anything about it”, Vernon’s grand tour does include suggestions on how the hurricane can be avoided. Let us hope we are all prepared for the possible hurricane, and not sitting peacefully, quietly and complacently in its eye. ■

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JUST PUBLISHED

Investment Policy Review Uganda

(Sales No. E.99.II.D.24) (\$ 19)

The *UNCTAD Investment Policy Reviews* are intended to familiarize Governments and the international private sector with an individual country's investment environment and policies. The reviews are considered at the UNCTAD Commission on Investment, Technology and Related Financial Issues. The *Investment Policy Review* of Uganda was initiated at the request of the Government of Uganda. The Uganda Investment Authority was the implementing agency, and the Ministry of Finance and Planning the cooperating agency. It is hoped that the analysis and the recommendations of this review will promote awareness of the investment environment, contribute to improved policies and catalyze increased investment in Uganda.

**UNCTAD series on issues in international
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Employment**

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This paper points out that employment promotion is a major goal pursued by Governments and that transnational corporations (TNCs) have an employment-generating potential that can be harnessed. At the same time, TNCs are called upon to promote equality of opportunity and therefore to base their employment policies on qualifications and skills. In this regard, they are also encouraged to invest in human resources development, especially in developing countries, so as to upgrade the human-capital base. While recognizing that TNCs are generally progressive in terms of pay and conditions of work, international investment agreements (IIAs) can exhort them

to maintain high standards, considering that the record of some foreign affiliates raises some concerns. Another important employment issue is that of industrial relations practices. The paper illustrates how such related issues as the right of association, collective bargaining and consultation can be dealt with in an IIA. Finally, the paper examines certain emerging issues, including expanding TNC specific IIA provisions to cover all core labour standards and efforts to ensure observance of such provisions through a social clause.

Taking of Property

(Sales No. E.00.II.D.4) (\$12)

The taking of private assets by public authorities raises significant issues of international law, where such takings involve the assets of foreign private investors. This paper examines the concept of “takings” in the context of international law and international investment agreements. The focus of the analysis is twofold. First, different categories of takings are distinguished, addressing in particular the problem of the distinction between governmental measures that involve interference with the assets of foreign investors, yet do not require compensation, and those that do require compensation. Second, the requirements for a taking to be lawful are discussed, in particular the issue of the standard for compensation. The paper highlights the challenges that remain when considering the takings clause in international investment agreements, and discusses policy options relative to defining a “taking” when drafting the clause. It also illustrates some drafting models.

Taxation

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The paramount issue underlying all international tax considerations is how the revenue from taxes imposed on income earned by the entities of a transnational corporate system is allocated among countries. The resolution of this issue is the main purpose of international taxation agreements, which seek, among other things,

to set out detailed allocation rules for different categories of income. While international tax agreements deal foremost with the elimination of double taxation, they also serve other purposes such as the provision of non-discrimination rules, the prevention of tax evasion, arbitration and conflict resolution. Tax provisions do not typically form a principal part of international investment agreements (IIAs), partly owing to the existence of the tax-specific double tax treaties (DTTs).

One reason for the limited role of taxation provisions in IIAs is that the inclusion of taxation matters can sometimes unduly complicate and draw out IIA negotiations and decrease the chances of successful conclusion. There nonetheless exists a wide range of models of tax provisions in IIAs, ranging from an exclusion of such issues from a treaty to the inclusion of very specific tax issues, notably the use of taxation as a means of administrative expropriation; as an incentive for investors from other countries that are members of a regional economic integration organization formed among developing countries; as a general statement of the responsibility of transnational corporations (TNCs) in the area of taxation; and as the basis for a taxation regime for regional multinational enterprises or supranational business associations.

Books received on foreign direct investment and transnational corporations since December 1999

Blomström, Magnus, Ari Kokko and Mario Zejan, *Foreign Direct Investment: Firm and Host Country Strategies*. (Houndmills and London: MacMillan, 2000), 253 pages.

Helleiner, G.K., ed., *Capital Account Regimes and developing Countries* (Houndmills and London: MacMillan, 1998), 232 pages.

Luo Yadong, *Multinational Corporations in China: Benefiting from Structural Transformation* (Copenhagen: Copenhagen Business School Press, 2000), 381 pages.

Prakash, Aseem, *Greening the Firm: The Politics of Corporate Environmentalism* (Cambridge: Cambridge University Press, 2000), 181 pages.

Rangan, Subramanian and Robert Z. Lawrence, *A Prism on Globalization: Corporate Responses to the Dollar* (Washington DC: Brookings Institution Press, 1999), 198 pages.

Rugman, Alan M. and Joseph R. D'Cruz, *Multinationals as Flagship Firms: Regional Business Networks* (Oxford: Oxford University Press, 2000), 219 pages.

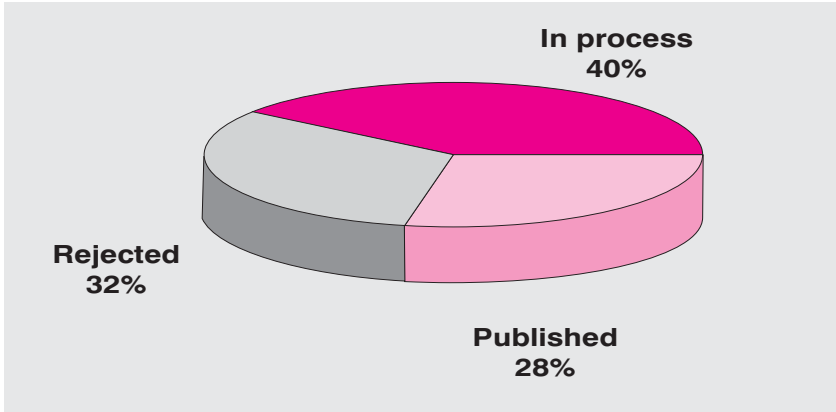
Rugman, Alan M., *The End of Globalization* (London: Random House Business Books, 2000), 237 pages.

Sauvé, Pierre and Robert M. Stern, eds., *GATS 2000: New Directions in Services trade Liberalization* (Washington DC: Brookings Institution Press, 2000), 544 pages.

Welfens, Paul J.J., *Globalization of the Economy, Unemployment and Innovation: Structural Change, Schumpeterian Adjustment and New Policy Challenges* (Berlin and Heidelberg: Springer, 2000), 256 pages.

Submission statistics

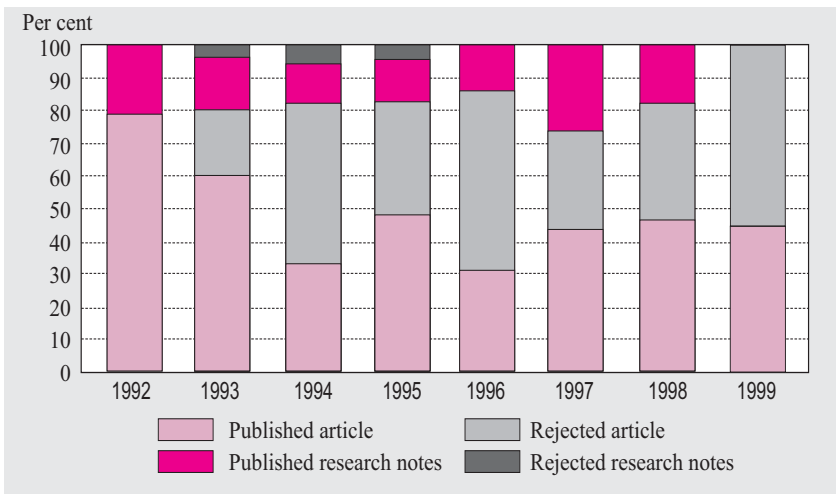
Figure 1. *Transnational Corporations*: breakdown of manuscripts as of 31 December 1999



Notes: None of the following is included.

- Six articles published during 1999 were submitted in 1998.
- Six articles that were still under the review process, three of which were submitted in 1997 and the other three in 1998.

Figure 2. *Transnational Corporations*: breakdown of manuscripts since inception



GUIDELINES FOR CONTRIBUTORS

I. Manuscript preparation

Authors are requested to submit three (3) copies of their manuscript in English (British spelling), with a signed statement that the text (or parts thereof) has not been published or submitted for publication elsewhere, to:

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Articles should, normally, not exceed 30 double-spaced pages (12,000 words). All articles should have an abstract not exceeding 150 words. Research notes should be between 10 and 15 double-spaced pages. Book reviews should be around 1,500 words, unless they are review essays, in which case they may be the length of an article. Footnotes should be placed at the bottom of the page they refer to. An alphabetical list of references should appear at the end of the manuscript. Appendices, tables and figures should be on separate sheets of paper and placed at the end of the manuscript.

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II. Style guide

A. **Quotations** should be double-spaced. Long quotations should also be indented. A copy of the page(s) of the original source of the quotation, as well as a copy of the cover page of that source, should be provided.

B. **Footnotes** should be numbered consecutively throughout the text with Arabic-numeral superscripts. Footnotes should not be used for citing references; these should be placed in the text. Important substantive comments should be integrated in the text itself rather than placed in footnotes.

C. **Figures** (charts, graphs, illustrations, etc.) should have headers, subheaders, labels and full sources. Footnotes to figures should be preceded by lowercase letters and should appear after the sources. Figures should be numbered consecutively. The position of figures in the text should be indicated as follows:

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E. **Abbreviations** should be avoided whenever possible, except for FDI (foreign direct investment) and TNCs (transnational corporations).

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Cantwell, John (1991). “A survey of theories of international production”, in Christos N. Pitelis and Roger Sugden, eds., *The Nature of the Transnational Firm* (London: Routledge), pp. 16–63.

Dunning, John H. (1979). “Explaining changing patterns of international production: in defence of the eclectic theory”, *Oxford Bulletin of Economics and Statistics*, 41 (November), pp. 269–295.

United Nations Centre on Transnational Corporations (1991). *World Investment Report 1991: The Triad in Foreign Direct Investment*. Sales No. E.91.II.A.12.

All manuscripts accepted for publication will be edited to ensure conformity with United Nations practice.



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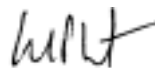
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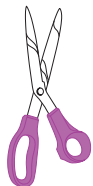
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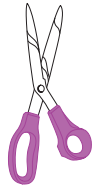
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