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Nation states and nationality of MNEs

by
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This *Perspective* is dedicated to the memory of John Stopford who commented on early drafts a few days before his death.

The purpose of this *Perspective* is to explore the relationship between multinational enterprises (MNEs) and their home countries. I use the term "nationality" when discussing a home country, to stress the contrast with "multinationality" which refers to business enterprises. The question I seek to address is whether, *ceteris paribus*, nation states have an economic interest in becoming home countries to MNEs. This is not a trivial question, bearing in mind that in many countries -- especially those with emerging markets -- outward foreign direct investment (FDI) has been frowned upon long after incoming FDI was generally welcome by local governments and academic scholars.

My tentative answer to the questions posed above is "yes." The MNEs' value activities lower the barriers separating countries from their foreign sources of supply and their international markets. This enables home countries to increase the benefits they derive from the international division of labor, exploitation of economies of scale and the ownership advantages of their MNEs. Other things being equal, an extension of the global reach achieved through cross-border value activities is likely to compensate for the tax loss and the diminution of sovereignty implied by outward FDI.

The theoretical basis of the claim that home country status is generally superior to that of host country status is provided by the concept of the distance penalty (DP). DP is incurred whenever transactions are conducted across national borders. This penalty consists of costs generated by the existence of systematic differences among the cultural,

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legal and institutional characteristics of domestic and foreign business transactions. It constitutes a barrier to cross-border trade and investment. The tremendous advances of recent decades in transportation and communication have reduced the costs of international interactions dramatically, but have not eliminated them altogether.

In the absence of a cost of doing business abroad, the idea of "home country" would be indistinguishable from that of "host country." Home countries and host countries both increase the reaches of MNEs, and both pay a price in terms of tax losses and diminution of sovereignty. DP makes a difference because it has an asymmetric effect on home and host countries. Home countries benefit from an implicit first refusal when competing with host country counterparts for the establishment of new business ventures. This implies that home countries are able to "bid" on every new business project being considered. It goes without saying that, if a foreign location turns out to be more efficient or otherwise more profitable, the project will be located in that country. But, if the cost benefit calculation indicates equality between the two locations, the home country will be preferred. Similar reasoning applies to cases of relocation, closure and generally of gaining access to resources provided by top management. The absence of a distance penalty, due to proximity to the strategic decision makers, endows home country affiliates with advantages, over and above those available to affiliates located in host countries.

The above analysis suggests that, *ceteris paribus*, nation states will prefer being home countries to being host countries. Note, however, that firms rarely get to choose their home country. Their nationality is in most cases "an accident of birth." Consequently the public policy implications of home countries' preferences are not obvious.

Nationality can become an issue when an MNE is sold abroad. In my own country, Israel, several local MNEs have been sold to foreign companies in recent years, thus changing their nationalities. The latest example is Makhteshim Agan, a multinational producer of generic insecticides, herbicides and fungicides with 4,000 employees and 50 facilities worldwide. Makhteshim Agan was sold in 2011 to ChemChina, a state owned Chinese supplier of agricultural chemicals at a price of US$ 2.4 billion. The transaction undoubtedly made business sense to IDB Holdings, a conglomerate that had a controlling interest in the company. The question that should be considered is whether the transaction was consistent with the public interest. Regrettably, the issue of the public interest was never raised, despite the fact that numerous workers, suppliers and other stakeholders were affected, and that millions of dollars of taxpayers' money had been poured into Makhteshim Agan and similar companies over the years

I conclude this *Perspective* with a quote from J.M. Keynes who, in the early 1920s, opposed British financial investments abroad. His view of FDI was very different: "The hazarding of capital resources in foreign parts for trading, mining and exploitation is an immemorial practice, which has generally proved of immense benefit to nations with the courage, the temperament, and the wealth to follow it. For the English and the Scots it has been, beyond doubt, the foundation of their national fortunes. The risks are recognized to be great, but the profits are proportionate…. Nothing that I shall say here

must be interpreted as casting a doubt upon the national advantage of investments of this kind."[1]

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[1] J. M. Keynes, "Foreign investment and national advantage," reprinted in D. Moggridge, ed., *The Collected Writings of John Maynard Keynes*, vol. 19 (Cambridge: Cambridge University Press, 1981), p. 275.