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Transaction-Cost Theory and the Free-Standing Firm

Jean-François Hennart

Since the publication of Mira Wilkins's seminal *Economic History Review* article[1] where she described the free-standing firm as an important type of pre-1914 multinational enterprise, business historians have started to pay serious attention to this phenomenon. There is increasing evidence that this type of investment made up a substantial proportion of British foreign direct investment before 1914 and that there were a significant number of French, Belgian, and Dutch free-standing firms, and some US-based ones as well. While free-standing firms were overshadowed by the more traditional type of multinational enterprises after the First World War, they continued to be formed in both the UK and the USA, and some are still being floated in the 1990s.[2]

Free-standing firms share a number of characteristics. They were domiciled in the dominant equity markets of the time (in London, but also in Brussels, Paris, Boston, etc.) and raised equity there by selling shares directly to the public to finance investments that were located abroad. In their country of registration they had a head office, but no industrial activity, all their actual operations (plants, mines, plantations) being in foreign countries: in the least developed part of Europe (Spain, Italy, Russia), in the regions of recent settlement (Australia, Canada, the USA, Argentina), and in developing countries, both under colonial rule (India, Malaysia, the Dutch East Indies, Africa) and outside it (Russia, Persia, Siam, Latin America). While they were engaged in a wide variety of businesses, from services (hotels, utilities, docks, newspapers, banks) to manufacturing (breweries, jute mills, fish-canning, flour-milling), the majority of free-standing firms were in two sectors, ranches and plantations—natural rubber, tea, sugar cane, cincho-na—and mining and petroleum. In Christopher Schmitz's list of companies registered in Edinburgh between 1862 and 1914 to do

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business abroad, nearly half of the companies whose activity is known were in mining, quarrying, and oil, and nearly another quarter was in agriculture and ranching.[3] Forty per cent of the 2,544 British free-standing firms operating outside the USA and Canada listed in a 1916 US Federal Trade Commission report were in mining, and another 28 per cent were in agriculture.[4] Sixty-nine per cent of the Dutch free-standing companies identified by Ben Gales and Keetie Sluyterman as active in 1913 were in tropical agriculture and in mining and petroleum extraction.[5]

Another important aspect of these firms is that they were financed in large part by selling equity directly to the public. This mode of financing is only one among many ways in which foreign projects are financed, as we will see later.

Most free-standing firms were single project firms: they operated a single plantation, a single mine. Yet these seemingly independent free-standing firms were often linked in clusters.[6] A single promoter could spin off a number of firms. For example, the thirty-six separate companies engaged in the exploitation of Chilean nitrates in 1913 can be traced back to five groups of British capitalists.[7] Numerous Malayan rubber and Indian tea estates were promoted by British trading companies, such as Harrisons & Crosfield, and remained partly owned by them. Similarly, one finds a small number of mining engineering firms linked to many of the tin-mining companies in Malaya. For example, the partners in Osborne & Chappel, mining and consulting engineers based in Ipoh, Malaya, had by 1908 stakes in half a dozen Malayan tin-mining companies.[8] Bewick, Moreing & Co. and John Taylor & Sons, two London-based mining consultants, became part owners of a large number of mining free-standing enterprises at the turn of the century.

An explanation of free-standing firms would, therefore, seem to require a simultaneous understanding of two related phenomena: the phenomenon of the free-standing firm proper, a single project firm with no domestic operations, and that of their clustering around a firm that takes minority stakes. Both of these phenomena are hard to explain in terms of the eclectic theory of the multinational enterprise, although, as we will see, they can be explained by a suitable extension of transaction-cost theory.

How does one Explain Free-Standing Firms?

The eclectic theory, one of the best-known theories of the multinational enterprise, posits that multinational enterprises arise when firms have firm-specific advantages (for example, unique technologies), when these advantages can profitably be exploited abroad, and when the most

efficient way to exploit these advantages is through foreign direct investment.[9] Free-standing firms do not fit this model very well. Having no operations at home (besides their headquarters) and no cadre of professional domestic managers, it is difficult to see how they could have long-lasting firm-specific advantages to exploit abroad. Indeed, it is this lack of domestic firm-specific advantages, manifested by their lean governance structure, that Mira Wilkins saw as the cause of their allegedly short life and high failure rate.[10]

The minority investments of trading companies and mining consulting engineers that we have described above are also difficult to explain in terms of the eclectic model. That model posits that firms take equity in other firms (internalize) because the exploitation of their firm-specific advantages through arm's length or contractual sale is subject to high market transaction costs. It makes sense then to bypass the market and, instead of selling advantages at arm's-length to a foreign firm, to transfer those advantages to a wholly owned subsidiary, which will then sell to the public products or services that incorporate these advantages. In other words, internalization is efficient because it allows the owner of firm-specific advantages to bypass inefficient markets for these advantages in favour of more perfect markets for final products incorporating these advantages.

In this context, taking partial equity (internalizing through a joint venture) suffers from major defects. Since equity control means getting paid for one's firm-specific advantages not in the form of direct payment for these advantages, but through the sale of the products incorporating these advantages, a firm that exploits these advantages through a partially owned subsidiary must either charge the joint venture for those advantages, or give up part of the profits that result from the transfer gratis of these advantages to the venture. For example, a firm transferring proprietary technology free of charge to its 50 per cent owned joint venture will receive only 50 per cent of the contribution of its knowledge to the venture, with the other partner getting a 50 per cent free ride. Licensing the knowledge to the joint venture is a solution that is by definition less than optimal: if knowledge could be sold at a price acceptable to the innovator, it would have been licensed already. The very fact that the innovator has sought to internalize the transaction suggests that the knowledge is difficult to price. Hence, at least at first blush, the eclectic model does not provide obvious reasons why some firms would ever take small, minority stakes in other firms.

In the following pages I will show that the existence of both free-standing firms and of minority equity links to their sponsors can be explained by extending the eclectic model in three directions. First, we must reconsider the link between internalization and the exploitation of

advantages. The crucial point here is that, while equity links between two firms result from the internalization of markets, including markets for advantages, they do not require that one or the other firm possesses any type of advantage. Multinational firms exist to internalize markets, not to internalize advantages.[11] Secondly, the internalization model must be extended to financial capital if one is to make sense of free-standing firms, and, more generally, of the various types of institutions chosen to transfer financial capital across countries.[12] We will argue that free-standing firms are firms that internalize markets for international financial capital and that they will prosper as long as there is a pay-off to internalizing such markets, independently of whether they possess any type of firm-specific advantage or not. Lastly, the existence of minority stakes can be understood in terms of the transaction-cost theory of equity joint ventures.[13] Minority equity stakes are taken when full internalization is not necessary and would substantially increase management costs.

A Theory of Minority Equity Stakes

As a starting point, consider the reasons why firms decide to organize internally (as opposed to through an arm's-length market) the interaction between two stages of production linked by the exchange of inputs. The standard explanation is that the cost of organizing the transaction internally is lower than that of organizing it on markets.[14] Thus firms take equity into other firms when the interaction between these two firms is more efficiently organized through hierarchical than through price coordination.

The reason why interaction can, in some cases, be more efficiently organized within the firm has to do with differences in the incentive systems used in firms and in markets. Consider two firms (firms *A* and *B*), one of which generates knowledge while the other could profitably use it. When that knowledge is exchanged through the market (i.e. through licensing), the rewards to the knowledge seller are a function of the price he can charge for the knowledge. If the buyer has difficulty in cheaply assessing its value, the seller will be able to cheat (to sell the knowledge for more than it is worth). Given this expectation, the market may break down.[15]

The internalization solution consists in having the seller and the buyer of knowledge joined within a firm. Why does this improve the efficiency of the transfer? The answer is not that the firm organizes a better 'internal market', but instead that a shift to intra-firm exchange changes the incentives facing the parties to the exchange. The essence of the hierarchical mode of organization that is used in firms is that

individuals (employees) are rewarded not for their output, but for obeying managerial directives. Hence the knowledge seller no longer benefits from selling overpriced know-how, but instead is rewarded for facilitating the transfer to the buyer, now another member of the firm. By breaking the link between output and rewards, firms reduce the incentives that employees have to cheat in internal trades. Note, however, that an unintended consequence is that they now have greater latitude to slack in their effort (to shirk), since they are not directly rewarded for their output, but instead for their willingness to follow managerial directives.[16]

The problem with taking partial equity (through a joint venture or a partial acquisition) is that it re-creates the perverse incentives of the market. If the knowledge buyer is now only partly owned by the seller, then the seller still has incentives to overprice the knowledge. If the buyer was 100 per cent owned by the seller, each dollar by which the knowledge transferred to the buyer is overpriced would be offset by a dollar reduction in the profits of the (wholly owned) venture. When the buyer is only partly owned (say 50 per cent), then each dollar extracted through overcharging is only offset by a 50 cents reduction in the profits of the joint venture that accrue to the seller.

Why would firms then ever take less than full equity stakes? Leaving aside the problem of government restrictions on full ownership, one can think of the following reasons:

- first, it may be possible to internalize the interaction between the two firms without owning all of the shares. If ownership of the shares is widely dispersed, control can be obtained with only a minority stake. It may also be possible to avoid fully sharing the profits of the venture with the majority (but dispersed) shareholders.
- second, the activity undertaken may require the combination of two or more inputs, each of them owned by a separate firm, and each subject to high transaction costs.[17]

Consider our previous example of firms *A* and *B*, and assume now that the buyer of knowledge (Firm *B*) possesses another type of know-how (perhaps a knowledge of local conditions) that is necessary to do business but is subject to high market transaction costs, and hence costly to transfer through licensing. Then the efficient solution is for both parties to take equity in the venture: this solution alleviates simultaneously the problem of transferring *B*'s knowledge to *A* and that of transferring *A*'s know-how to *B*.[18]

While the simultaneous failure of the markets for two or more inputs provides a necessary condition for the existence of less than full equity,

this condition is not sufficient. An additional condition is that the alternatives of replication or full acquisition must be more expensive than the sharing of existing assets through a joint venture or a partial acquisition. To return to the same example: one additional solution is for *A* to replicate the knowledge held by *B*; another is for *A* and *B* to merge.

One possible reason why a joint venture or a partial acquisition might be preferred to a full acquisition might be government or institutional barriers to acquisitions/mergers. Most countries put restrictions on acquisitions of domestic firms by foreigners in 'strategic' industries.

Another reason why replication and full acquisition may be undesirable arises from shirking, the unavoidable by-product of internalization. To reduce incentives that sellers have to cheat, internalization breaks the connection between price and rewards, but this encourages shirking by employees. When firm *A* buys all the shares of firm *B*, it reduces the incentives that the erstwhile independent owners/top managers of *B* had to perform by reducing the claim that they have on the profit stream for which they are responsible. They are now employees of *A*, and the relationship between their actions and their rewards is likely to be weaker. They will thus have greater incentives to shirk.

One way to control shirking is to monitor the behaviour of employees. This is made more difficult by geographic and cultural distance. When these factors create management problems, one solution is to leave some of the equity in the foreign venture to the existing owners/top managers of *B*. The result is a joint venture or a partial acquisition.

Similarly, replication means creating in-house the capability that is possessed by the potential joint venture partner. This necessarily means increasing the size of the firm, and often the range of activities undertaken, resulting in greater management problems. By contrast, a joint venture or a partial acquisition allows access to the needed inputs without having to manage their production.

To summarize, a firm will take a minority stake in another firm when some interactions between the two firms need to be organized through hierarchy, some of the capabilities of the other firm cannot be obtained in the market in disembodied form, yet a full acquisition of the firm owning these capabilities would unduly increase management costs.

Consider the case of sellers of heavy industrial equipment. They want to generate a stable market for their output. In emerging industries, there may be a significant information asymmetry between them and their potential customers. They typically have a more sanguine view of the prospects for investment in the industry than their customers, but may be unable to communicate it credibly. An equipment manufacturer eager to develop the market for its capital goods may then

be forced to integrate into the production of the goods using its equipment because of the failure of local entrepreneurs to enter the industry or to adopt the new technology.[19]

Such downstream integration is not without costs. First, it tends to tie up a considerable amount of capital. Secondly, it increases the size of the equipment seller, and extends the firm into activities with which it may not be familiar. This suggests that an ideal strategy is to foster the creation of new potential customers, but to sell most of the equity of the customer to other firms or to the public, keeping just enough equity to obtain contracts for the original equipment, for maintenance services, spare parts, and the replacement and upgrade of the equipment when the original equipment has worn out. As we will see, this process will result in the creation of free-standing firms if the capital of the customer firm is obtained in a country that is different from the country of operation and through equity directly subscribed by the public.

A good example of this process is the system of *Unternehmergeschäft* used by German manufacturers of heavy electrical equipment. Peter Hertner notes that the large German manufacturers of electrical equipment

> created their own market by founding local and regional electric power, tramway and lighting companies or by taking over and 'electrifying' existing firms in those countries (for example Spain, Italy, Russia, the Latin American states) and for those customers (particularly local and regional public authorities) which suffered from a chronic lack of capital or which were too reluctant to adopt this new technology. The newly-founded or transformed companies were then obliged by statute or by more flexible means to buy all or most of their electromechanical material from their big industrial founders.[20]

The German firms created financial holding companies, which held the shares and bonds of the newly created utility companies and sold them to the public as soon as the companies had yielded profits, keeping only a minority holding. To insure their own liquidity during the construction period, the holding companies floated shares, and, if possible, issued long-term bonds in their own name.[21] Whether this process resulted in free-standing companies or not depends on where the utility companies were domiciled. If they were domiciled in Belgium and sold their shares to the public there, while operating in other countries, then they became Belgian free-standing firms. If the companies were registered locally, they became indigenous companies with minority foreign ownership. In all cases the common link between these companies was the limited control exercised by the German makers of electrotechnical equipment through their financial holding companies.

There are many other examples of this type of investment. Hence the French equipment-maker Schneider took minority stakes in foreign enterprises to secure orders for its French plants.[22] The Belgian Empain group followed a similar strategy to sell its equipment to foreign electric tramway companies, thus creating a large number of Belgian free-standing firms.[23]

The investments of mining finance houses follow a similar pattern. Mining finance houses emerged in the 1890s in South Africa. They were created by diamond merchants who raised money in their own name in Europe to finance the development of deep-level gold mines. When the development of these mines was advanced enough to interest the investing public, their shares were sold to the public in European stock markets. The mining finance houses kept a controlling minority interest which allowed them to keep selling managerial, secretarial, technical, and administrative services to the members of the group.[24] The result was the system of 'Group Administration' which was eventually adopted throughout the South African mining industry, consisting of a large number of European-based free-standing mining firms grouped in clusters around mining finance houses.

The behaviour of trading companies is very similar to that of equipment sellers and of mining finance houses. Trading companies make money through commissions on the sale of commodities, or, when they take title to the goods, through temporal or geographic arbitrage. Their profits are thus directly linked to the volume of business which they have a contract to handle. Trading companies are always looking for new business for which they can have trading rights. In the case of new and risky business, however, a trading company may have difficulty convincing entrepreneurs to enter the field, and may be forced to put up the capital for such ventures. The idea then is to develop the enterprise to the point where it can be floated as a public company, and to sell the shares to the public or to other firms so as to recoup the initial investment and make profits from the flotation.

In most cases, it does not make sense for the trading company to take full ownership of the new firms it has helped establish. First, the commissions earned on the business of the new firms provide a much higher (and much quicker) return on invested capital than the profits that will eventually be generated by the venture. Secondly, a public flotation makes it possible to offload the risks inherent in the enterprise. Thirdly, it keeps the trading firm small and nimble. Trading firms will therefore take a share that is just large enough to guarantee that they will retain the trading rights in their offsprings.[25] As a result, traders typically own a large number of minority participations.

Whether these minority ownerships will be in free-standing firms or not will depend on the form taken by the financing of their progeny.

The history of British trading firms in the East provides a good example. British traders (such as Harrisons & Crosfield and Guthrie & Co.) played an important part in the early development of rubber-planting in Malaya, when there was still considerable uncertainty as to the future of the industry. British trading firms had a clear interest in developing the industry. Rubber plantations could offer them a profitable business as they required supplies, both capital goods for the estates and consumer goods for the imported labour force, and assistance with the selling of rubber in consuming countries. The trading companies had experience in import/export, and their good names in London helped convince the British public to subscribe the capital needed for the development of what was still a speculative business.[26] British trading companies sponsored the London flotation of a large number of rubber estates. They sold most of the shares to the public, keeping only a minority stake. This minority stake allowed them to guarantee that they would get the commission business of the estate (usually 2.5 per cent on the sales of produce and on the purchases of inputs).[27] In this process the trading companies became involved in giving commercial and technical advice to the rubber estates; they slowly evolved from trading companies to agency houses. There is some evidence that they saw their agency role as accessory to their main trading business. Because these companies were financed through the sale of shares directly to the British public, this process resulted in a large number of UK-based free-standing rubber plantations in which a small number of trading companies had minority stakes.

This pattern was not particular to British trading companies in Malaya, but also applied to British and non-British trading companies in the rest of the world. American and British trading companies, such as Grace, set up and ended up owning minority shares in manufacturing and extractive ventures in South America.[28] Dutch trading firms floated the shares of plantations set up in the Dutch East Indies and became their managing agents.[29]

In the post-Second World War years Japanese trading companies have followed similar strategies, sponsoring a number of manufacturing and service ventures overseas as a way to increase their trade opportunities. They have played a pioneering role in the overseas expansion of Japanese manufacturing firms and in the development of new industries (for example in the development of chicken production[30] and in the import of natural gas). As in the case of all other trading companies, they have tried to keep their equity investments to a minimum, helping the development of new customers through loans, or, when equity was

needed, through the establishment of joint ventures rather than wholly owned subsidiaries. As of 1979 the nine major Japanese trading companies had made equity investments in 1,360 overseas projects, with the trading company share generally less than 30 per cent and as low as 1 per cent.[31] In contrast to nineteenth-century British traders, the firms they have sponsored abroad have never been home-based (that is, Japan-based) free-standing ones. Instead, they have been overseas-registered joint ventures with local (and also sometimes Japanese) partners.[32]

Belgian, French, and German sellers of electrical equipment, South African mining houses, British, Dutch, American, and Japanese trading companies all exhibit similar behaviour: in all cases expansion of the business required an increase in the number of customers, but the high level of uncertainty and the size of the investment discouraged the spontaneous emergence of new firms or the transformation of existing ones. Sellers of equipment and of managerial and trading services then took the initiative of developing potential customers by sponsoring the establishment of new firms. With the exception of the eastern 'agency' houses, they were not interested in running these new businesses. Hence they tried to limit their stake to a level just sufficient to guarantee that their offspring would give them their business. They ended up with minority stakes in a large number of firms. In the case of the agency houses, the business—the service sold—was management; the agency houses, however, benefited most from the trade that these new units in the group generated.

Yet it is clear from the previous examples that a theory of minority ownership cannot fully account for free-standing firms. The overseas joint ventures established by Japanese trading companies have not been floated on the Tokyo stock exchange as free-standing firms, but instead have been registered locally. Most of their financing has not been subscribed directly by the public, but has come from the venture's parents. Our next step must therefore be to investigate the conditions under which the offsprings of trading companies and/or equipment vendors are likely to take the form of free-standing firms.

A Transaction-Cost Theory of International Transfers of Financial Capital

Consider the London-based rubber planting free-standing firms discussed earlier. We call them free-standing firms because they were registered in London and transferred equity capital to Malaya.[33] This set-up is only one of eight alternative ways in which firms can be financed. A firm can be funded (1) through local or through foreign sources, (2) through equity and through debt, and (3) through intermediated or through non-intermediated capital transfers (Fig. 2.1).[34]

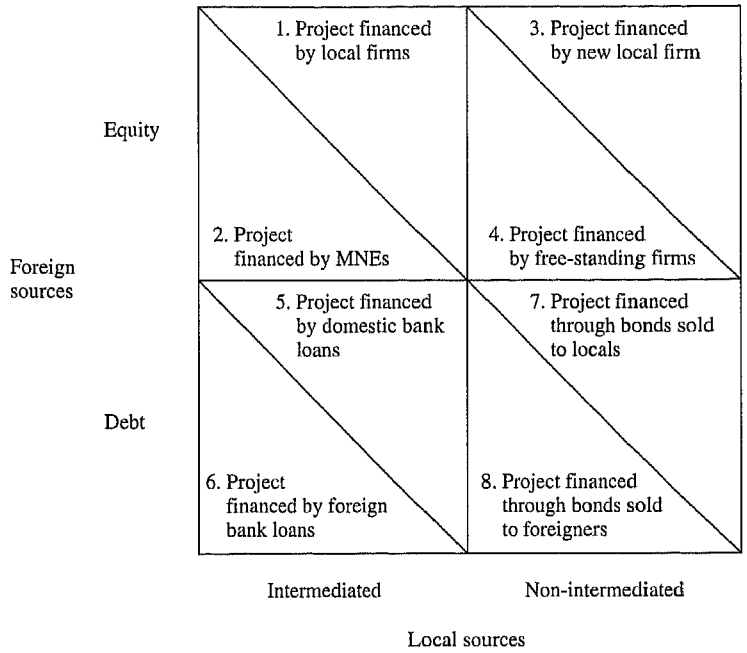

Fig. 2.1. Types of international financial capital transfers
Note: Intermediation occurs when firms or individuals raise funds in their own name and transfer them to other entities, thus allocating capital internally.

Malayan rubber plantations could have been locally registered and financed through the sale of shares to Malayan investors (as were the so-called 'dollar' companies) (cell 3), they could have been set up as wholly owned subsidiaries of locally registered companies (cell 1), or of foreign-based multinational firms (cell 2) (some American rubber-tyre makers invested in Malayan rubber plantations). The plantations could have been financed by locally registered firms through the sale of bonds to local investors (cell 7) or to foreign investors (cell 8). Lastly, the plantations could have been financed by loans extended by local banks (cell 5) or by foreign banks (cell 6). Instead, the case of free-standing firms (cell 4) corresponds to that of foreign-registered firms selling their shares on foreign stock markets.

To explain the free-standing firm one must therefore answer the following questions. Why was capital obtained in London, and not locally? Why was capital raised through equity, as opposed to debt? Why was not equity intermediated (why was it subscribed directly by the public, as opposed to taken by intermediaries, such as other firms or banks)?

The answer to the first question would seem obvious. Capital was raised in London because the mobilization of savings and their channelling to

investments was more efficiently performed there than in Malaya. As noted above, not all rubber estates established in Malaya during the rubber boom were registered in London. Dollar companies were floated in Singapore. One observes the same coexistence between foreign-based and locally registered companies in other countries and industries (for example, in the Dutch East Indies, in India, in Ceylon, and in tea, sugar cane, and cinchona).

One would expect that companies would be floated in foreign stock markets rather than locally when the following conditions obtain:

- The less developed and the less liquid the domestic stock market, the greater the proportion of firms in that country registered in foreign countries.
- The larger the investment, the more likely the firm will be foreign-registered.
- Firms which are oriented towards exports are also less likely to find favour with local investors, and more likely to be registered in another country—and especially in importing countries—especially at early stages of the development of an activity.

The heavy concentration of free-standing firm operations in the least developed parts of Europe, in the regions of recent settlement, and in developing countries, and their registration in countries with liquid equity markets are consistent with the first of these expectations.

Some evidence on the second point is given by Ben Gales and Keetie Sluyterman, who compared free-standing companies registered in the Netherlands in 1912 to the population of all Dutch limited liability companies.[35] They found that free-standing firms had higher capitalization than domestic firms, since the former made up 9 per cent of all Dutch limited liability companies in 1912, but accounted for 31 per cent of all paid-up capital. Another bit of evidence comes from a comparison of companies registered in the host country with their free-standing firm counterparts. In the Dutch East Indies, free-standing companies registered in the Netherlands worked side by side with locally registered firms. Their capital, according to Gales and Sluyterman, was substantially larger than that issued by locally registered firms and Gales and Sluyterman note that 'registration in the mother country was preferred if links with the capital market were more important'. In Malaya, London-based (and Australia-based) free-standing firms coexisted with local Chinese or Western companies. The same link between access to capital and foreign registration is shown by the fact that some locally-registered Western tin-mining and smelting firms reincorporated in London as their financial needs grew. For example, Bruseh Hydraulic Tin, one of the first hydraulic

mines in Malaya, was floated as a dollar company in Singapore in 1901 by the Borneo Company, and reconstructed as the Bruseh Tin and Rubber Estates in London in 1911. Similarly, the smelter built by Leh Chin Ho in Penang to smelt local tin ores and incorporated locally as the Eastern Trading Company was reincorporated in 1911 in London as a free-standing company. The Chinese directors argued that by floating the firm in London 'they could get fresh capital there more easily than they could get it locally'.[36] Sluyterman notes the same pattern of existing Dutch East Indies sugar factories and tea plantations switching their registration to the Netherlands to raise additional funds.[37]

The third hypothesis has been advanced by M. D. Morris, who, to explain the peculiar pattern of British free-standing firms in India, argues that exporters are more likely to obtain finance in the importing country than in the country of production.[38] British free-standing firms dominated the Indian jute industry by 1914, but were nearly absent from the cotton sector where Indian enterprise flourished. He argues that British firms had a comparative advantage in jute because its demand was international, while that for cotton textiles was primarily domestic. British trading companies, with their extensive involvement in international trade, were in a better position to forecast the former than the latter, and may therefore have been obliged to play a larger role in the development of jute than in that of cotton-spinning enterprises. A similar pattern can be found in Ceylon, where tea-growing was undertaken by both sterling (London-registered) and rupee (locally incorporated) companies. Sterling companies were located up-country and specialized in the highest tea quality, which was sold in London, while rupee companies, which were generally smaller than the sterling ones, sold their produce on local markets.[39]

So far we have shown that in some cases it is easier for a firm to find financing overseas than at home. We must now explain the particular form taken by the London financing of our rubber free-standing firms. Floating free-standing firms was not then (and neither is it today) the only way of funding plantations. In the 1990s most plantations in developing countries are not financed by floating free-standing firms on the stock markets of developed countries, but by having locally incorporated firms obtain loans from foreign banks or sell bonds and shares to foreigners. A third possibility is to sell the estate to a foreign-based multinational enterprise. For example, a decade after British trading companies started to float rubber estates as free-standing firms in London, the US Rubber Company, an American rubber manufacturer, established wholly owned subsidiaries to plant rubber in Malaya.[40]

Hence, to explain free-standing firms one must show why the transfer of financial capital from capital-rich to capital-poor countries took the form of equity (as opposed to loans) and why this equity was subscribed directly by the public (as opposed to held by a multinational firm). The first issue involves the choice between equity and debt. The second has to do with the optimum degree of intermediation.

Assuming that capital could be obtained more cheaply in the UK, why did the owners of rubber estates in Malaya choose to float the firm on the London or Edinburgh stock markets, rather than keep the company private and borrow from London banks? Why did the British trading companies not finance the development of these estates exclusively through debt?

One possible clue might be to look at debt and equity as alternative governance structures.[41] Seen in this light, the difference between debt and equity is that debt does not give the lender any right to the residual value of the venture—i.e. it does not remunerate the provider of funds through a share of the profits, while equity control does. Compared to equity owners, lenders have also much more limited rights to direct the behaviour of borrowers.

Remunerating savers with the profits of the venture and giving them the right to direct the implementation of the investment using their savings is a better solution than lending if the market for loanable funds is subject to high transaction costs.

There are two main reasons why lending money is subject to significant transaction costs.[42] The first one is the non-simultaneity between the two sides of the transaction: the lender makes funds available today to the borrower, to be repaid later with interest. Secondly, the chances of default are increased by a difference in incentives between lenders and borrowers: borrowers have incentives to take on risky projects, since they get to keep the entire gain over the stipulated interest costs if the venture is successful, while they may escape relatively unscathed if the project fails and they default.

Lenders can use a number of strategies to protect themselves against default. One of them is to ask the borrower to pledge collateral to be forfeited in the case of default. If borrowers have no private fortune, they will have to pledge the assets financed through the loan. The collateral value of these assets may vary a great deal across projects: transportation equipment is an excellent collateral; mines and research and development facilities are not.

A second strategy is to screen projects and applicants based on past record. As a result, new investors and new projects are likely to be turned down. A third option is to monitor the use of funds. While lenders are

not allowed to interfere in the day-to-day management of a company, they can have loaned funds earmarked for specific investments.

When none of those strategies is effective in reducing default, the best solution is internalization. Internalization in this case means that savers will take equity in the projects financed by their savings, giving them the right to decide how the funds will be invested, or to direct employees to do it in their name. The pay of these employees need no longer be related to the profits of the venture, so as to reduce the incentives they have to misrepresent projects.[43] Default is also less likely because savers can now carefully monitor the behaviour of their employees. The efficiency of the internalization solution hinges, however, on the costs of monitoring the behaviour of the employees carrying out the investment.

The preceding considerations suggest circumstances where the international transfer of capital is likely to be internalized (i.e. to take the form of equity). We would expect this to be the case when (1) the activity to be financed does not provide good collateral, (2) when prospective projects are new and unproved, and (3) when potential borrowers are relatively unknown to lenders. Inversely, projects which provide good collateral and which are in more established fields of business are more likely to be undertaken by locally organized firms selling bonds to foreigners or borrowing from foreign banks.

Some of the empirical evidence on free-standing firms is consistent with our hypothesis. We have seen that free-standing firms were concentrated in mining and plantations. Mining is a very risky endeavour. Most of the money invested in mining is sunk in diggings which offer little collateral. As a result, new mining ventures cannot generally obtain debt financing, and have to be financed through equity. Initial exploration and development are generally financed by the personal funds of owners of mining claims and by those of their friends and relatives. Once minerals are found, a public stock offering is usually made on stock markets. In the 1980s and 1990s, shares of small companies developing North and South American mines are sold directly to the public on the penny stock markets of Spokane, Denver, and Vancouver,[44] as they were in London in the heyday of the free-standing firm. The reliance on equity is due to the poor quality of the collateral of mining ventures.

Plantations seem to have been the second largest field of activity of free-standing firms. The type of plantations financed through free-standing companies is consistent with our theory. Free-standing companies played a large role in the early development of rubber and cinchona in South East Asia.[45] The production of both these products in South East Asia was very speculative when introduced around the

turn of the century. The investment was substantial, since it takes seven years between planting and yield for rubber and fifteen years for cinchona. It was risky because there were then no settled techniques of cultivation and the size of the market was unknown.[46] The main collateral for plantations is land. Whether plantations can or cannot borrow depends on whether their land has value for alternative uses. When previously undeveloped land is used for new, speculative export crops, as was the case with rubber in South East Asia, it probably has little collateral value, and equity financing must be sought.

Activities that provide good collateral are more likely to be financed through lending, either bank lending or bonds. Hence the foreign financing of railroads in nineteenth-century USA was different from than that of mines. While the bulk of foreign investment in US mining took the form of UK-registered free-standing companies, most of the financing needs of US railroads were obtained through US-incorporated firms selling bonds to foreigners.[47] The land owned by US railroads provided good collateral. Railroads were also the first regulated enterprises in the USA, and as early as 1909 had to follow a standard balance sheet, making it easier for lenders to monitor the borrowers.[48] The risk of default was therefore much lower than for mining.

N. Ramachandran's study of the financing of free-standing firms in the rubber and tea industry of Ceylon at the turn of the century also supports the hypothesis that equity is used to finance activities with poor collateral.[49] He found that the ordinary share was the only type of security used by rubber companies to raise initial funds, while the tea companies made greater use of debentures when they were established in the 1890s. He attributes the difference in finance to differences in riskiness for lenders. By the time tea plantations were established in Ceylon, tea cultivation was well established in India. Debentures could therefore be secured by the value of the estates. By contrast, rubber-growing was quite speculative at the time: methods of cultivation were still unsettled, and the size of the market was unknown. The land on which rubber was grown had been previously uncultivated, and thus had little collateral value.

The third distinctive aspect of free-standing firms is that most of their equity was held directly by the public, as opposed to taken by intermediaries, such as other firms or banks. Our third question was, why was not equity intermediated? We have already noted that at early stages of the development of some projects outside financing (whether through shares, bonds, or from banks or other lenders) is very difficult to obtain. The flow of capital for projects at very early stages usually comes from the profits of existing concerns (manufacturers, traders) or from the funds of project initiators and of their friends and relatives.

But when initial development is completed and outside capital can be obtained, the initiator can either decide to keep full equity in the project or to float all of it, or part of it, to the public.

When capital comes from an existing firm, this corresponds to the case of the modern multinational enterprise. Financial capital transferred through the multinational enterprise is intermediated in the sense that the funds transferred to the foreign subsidiaries have been raised by the parent for general purposes, and have not been earmarked for any particular investment. The multinational enterprise then allocates the funds thus raised between all of its new and existing projects. In that sense, multinational firms intermediate the fund-raising process. The case of zero intermediation is that of free-standing companies, created by professional promoters, who eventually placed all of the shares allotted to them with the general public. The third possibility (partial intermediation) is that of free-standing firms partially owned by trading companies, mining finance houses, and manufacturers of electrical equipment.

Since investors can choose between intermediated and non-intermediated channels for their investment, it would appear that for intermediated channels to be selected they must be more efficient than non-intermediated ones. As I am defining it, intermediation means that an intermediary (a firm in the case of equity transfer, a bank in the case of loans) screens projects and allocates the funds it receives from savers. In the case of non-intermediated transfers, there is no intermediary between savers and investors: screening is done by savers.

Hence the extent of intermediation should depend in part on the costs of obtaining information about projects. The greater the complexity of projects, the more it pays to have someone (the intermediator) specialize in screening them. We would expect more intermediation, everything else being constant, for new industries and for more complex technologies. For example, the part played by British trading companies in floating rubber-planting companies in London declined as the industry became more established; then an increasing number of firms were created by London stockbrokers as fully independent entities i.e. without any intermediation.[50]

The second factor is the minimum size of the investment. When the investment has a larger minimum size, the personal funds of the promoter are no longer sufficient to bring the project to flotation, and it becomes necessary to finance its initial development from the profits of other businesses. For example, the shift from outcrop mines to deep levels in South African gold-mining led to the establishment of the Group Administration system, in which the profits from existing mines were used to generate the significant sums necessary to bring the

capital-intensive deep levels to the state where a public flotation could be attempted.[51] Similarly, as gravel-pumping was replaced by dredging, a technique thirty times more capital intensive, many of the free-standing tin-dredging firms operating in Thailand, Burma, Malaya, and Nigeria were floated by mining finance houses, such as Anglo-Oriental, that owned minority stakes in a portfolio of mines.[52] Earlier, many gravel pump mines had been floated by individual sponsors.

In conclusion, free-standing firms were characterized by low intermediation. Some of them—such as the large British-controlled railway companies on the West Coast of South America or most of the British free-standing mines in the American West—were totally independent.[53] Others were linked into networks organized around a trading company, a mining finance house, or an equipment seller. In that case there was a limited amount of intermediation, caused by the increased complexity of the business and the need to finance the early development of new projects from the profits generated by existing ones.[54]

In brief, within the category of firms that had been set up by sponsors (promoters, equipment sellers, sellers of management and of marketing services), free-standing firms had three distinguishing characteristics: they were registered in foreign countries, they raised the bulk of their finance by floating shares, and most or all of those shares were placed directly with the public. In the preceding pages we have analysed the conditions necessary for choosing this distinctive way to raise capital. Free-standing firms appeared because tapping foreign sources of finance was cost-effective, but obtaining loans from foreign banks or selling bonds to foreign investors was impossible or very costly because of the high risk of default. Most or all of the equity was sold directly to the public as opposed to intermediated via a multinational enterprise because the projects were simple enough to assess and small enough in scale, so that they could be nursed to the flotation stage by single-project promoters or syndicates.

Some Testable Implications of the Theory

The model developed in the previous section has interesting implications as to the reasons for the emergence of free-standing firms, the type of projects we would expect to see financed through them, the characteristics of countries which should be home and host to them, and lastly the conditions under which they should flourish.

First, the model suggests that free-standing firms existed primarily to internalize the market for equity capital between home and host countries. While one might see free-standing firms also contributing other

factors (such as technology), the capital contribution is both necessary and sufficient for free-standing firms to emerge.

Secondly, one would expect to see free-standing firms used to fund ventures which cannot usually rely on debt because of the poor quality of their collateral: mining, new speculative export-oriented agriculture, and research-and-development intensive ventures are all examples.

Thirdly, we would expect free-standing firms to be based in the most liquid equity markets of the time. Because the internalization of equity finance through free-standing firms makes sense only if local equity markets are inadequate, we would not expect to see many free-standing firms created to operate in countries with efficient equity markets (for example, a Brussels-based free-standing firm operating in the UK should be an anomaly).

Fourthly, setting up a new venture as a free-standing firm is efficient as long as equity capital can be raised more efficiently in the foreign country (the UK, Belgium, etc.) than locally. More precisely, this arrangement is efficient as long as the savings in the procurement of equity capital overseas are greater than the additional cost of managing the operation from afar. The development of efficient equity markets in the free-standing firms' country of operation should reduce the gains from internalizing capital from foreign bases and one should witness a gradual reduction in the number of new free-standing firms created to operate in that country. Likewise, the need to internalize the procurement of capital should decrease as the industry becomes more established.

Existing free-standing firms—those created before the development of local equity markets or when the industry was still seen as speculative—may survive some time after their *raison d'être* has disappeared, but, if access to cheap equity capital was the sole reason for their existence, the costs of being managed at a distance should start to reduce the efficiency of these firms relative to their local rivals, and we would expect free-standing firms to be eventually liquidated, sold to local firms, or reincorporated as local concerns.

The empirical evidence provides some support. The first point, that the rationale of free-standing firms must be found in the desire to internalize the market for equity capital (and not necessarily that for technological know-how), is supported by evidence that shows that in some cases technical expertise was held not at headquarters, but instead in the country where the investment was made.[55] Gravel-pumping, the technology used by the early British free-standing firms mining tin in Malaya was not used in Cornwall, but was transferred to Malaya, from California gold-mining.[56] So, too, Gales and Sluyterman note that the Dutch owners of free-standing firms operating in the Dutch East Indies

could not draw on their domestic experience, as 'metropolitan and colonial agriculture had almost nothing in common'.[57]

Secondly, we have seen that the activities undertaken by free-standing firms were concentrated in sectors (such as mining) which provided poor collateral and which still in the late twentieth century must rely on equity capital.

Free-standing firms were also based in countries boasting efficient and liquid equity markets (the UK, Belgium, etc.). The development of US-based free-standing firms after 1900 also supports the view that the main factor determining where free-standing firms are based is the relative efficiency of equity markets (while the main factor determining where they will operate is the country's lack of an efficient equity market). Miller notes that by the 1920s the informal controls exercised by the Bank of England made it very difficult to raise money in London for ventures located outside the Empire.[58] By 1902 a thriving equity market had developed in the USA.[59] British capital controls helped New York displace London as the world's largest stock market.

Wilkins, among others, has documented the demise after 1914 of the British free-standing firms operating in the USA and the absence of new London flotations to operate there.[60] That fate, which she attributed to the free-standing firms' lack of firm-specific advantage, makes sense when one considers that by 1914 the *raison d'être* of British free-standing firms operating in America—to procure cheap access to equity financing—had disappeared with the development of an indigenous stock market.

By contrast, many new British free-standing firms were created after 1914 to operate in parts of the Empire with poorly developed capital markets. Fifty-nine Malayan rubber-growing free-standing companies were floated between 1923 and 1929.[61] The flow of British capital invested in free-standing tin-dredging firms in Malaya peaked in 1925–7,[62] while the bulk of the capital of British-based free-standing tin-mining firms in Nigeria was also invested in the inter-war period. All these firms prospered until the late 1960s. As late as 1967 UK-registered free-standing companies were producing over 75 per cent of Nigeria's tin output. These firms lost their free-standing status the following year when the Nigerian government forced them to re-incorporate in Nigeria.[63] The fate of British free-standing firms in Malaysia was similar: they were bought by the Malaysian government in the mid-1970s. By then most of their stockholders were Malaysian. The demise of British free-standing firms in America and their survival in countries with undeveloped equity markets is consistent with the view that their *raison d'être* was to internalize the market for equity capital.

Also consistent with our theory is the flotation of American free-standing companies in the 1920s to operate mines, utilities, and

plantations, mostly in Latin America. One sees US-based free-standing companies running mines in Mexico and other Latin American countries. For example, a large number of American free-standing firms were organized in the 1920s to prospect for oil in Colombia and in Venezuela.[64] Much of the Cuban sugar-cane industry was developed by US-based free-standing firms after the First World War.[65] In some cases these free-standing firms purchased the plants of UK-based free-standing firms.[66] Miller's statement that 'difficulties in raising new finance to expand facilities may have lain behind some of the decisions taken at the end of the 1920s to sell [British free-standing] assets in Latin America to US businessmen'[67] supports our point that the main *raison d'être* of free-standing firms was access to finance and that the USA had by then replaced the UK as the most efficient source of equity capital.

Some Criticisms of the Model

How does the model presented here differ from those presented by Casson and Wilkins? In the next chapter, Casson disputes the view that the transfer of funds within a firm constitutes the internalization of an international market in capital and that the free-standing firm is therefore a direct investor. For Casson, the internalization concept cannot be applied to financial capital, and hence the only direct investors are firms that internalize other markets, such as those for technological knowledge.[68]

Casson's criticism reflects what seems to be major differences in our views on the meaning of internalization and control. Casson believes that it is inappropriate to speak of internalization of capital markets:

> For a start, capital is a factor of production and not an intermediate product. According to internalization theory it is intermediate product markets that are internalized, and not factor markets. Factor markets link household with firms, and cannot normally be internalized, whereas intermediate product markets typically link one firm with another, and can be internalized quite easily.[69]

The idea that capital transfers cannot be internalized because capital is a factor of production may arise from a confusion between households as consumers and households as economic agents. When consumers invest, or when they borrow to support a business, they are acting as economic agents. Were one to follow Casson's view, one would speak of the internalization of capital flows when capital is intermediated (for example, when a bank acquires a firm to which it intends to lend) because the resulting transaction links one firm with another, but not when an entrepreneurial nephew with a good business plan persuades

his rich uncle to bankroll his project and to hire him to implement it (a transaction between two households). Yet clearly the two phenomena must be explained by the same theory. Interestingly, Casson himself has discussed this last example in his book, *The Entrepreneur* (1982).[70] In that book he argues that entrepreneurs will often experience difficulties borrowing from banks and may find it easier to get financing from family members, thus internalizing the capital market.[71]

We also seem to have different views on what constitutes internalization. For Casson, internalization theory 'explains why two distinct activities in two different countries are brought under common control'. Because he subscribes to this view, he finds it difficult to deal with the free-standing company, since that company has no manufacturing activity in the home country, only a headquarters. Casson adopts the convention that 'being a headquarters is not an activity, so that a headquarters office is not an activity unless it performs some other functions as well'. This assumption leads him to the conclusion that free-standing firms in which the directors did not have specific expertise were not foreign direct investments at all, and are therefore of limited theoretical interest.[72]

My view of internalization is somewhat different. I see internalization as the extension of managerial control across national boundaries. Internalization takes place when the coordination of agents in two separate countries is effected not by prices, but by managerial directives. This does not require that there be extensive manufacturing activities in the home country. In the case of free-standing firms, we have internalization because coordination between lenders in one country and borrowers in another is being organized within the free-standing firm through employment contracts. Hence the free-standing firm is a transnational (or a multinational) firm.

Casson's view of internalization is linked to his definition of what constitutes a multinational firm. Casson defines a multinational as an enterprise that owns and controls activities in more than one country. Framed in these terms, whether the free-standing firm is a multinational or not again hinges on whether the headquarters is an activity. There is, however, a much simpler and general way to define a multinational firm, and that definition avoids the somewhat artificial question of whether the headquarters constitutes an 'activity'.

The issue that captured my interest in the multinational enterprise in the 1970s—and that of many other scholars—was why, in spite of the costs of doing business in a foreign country, firms exercised managerial control across national boundaries.[73] I defined a multinational (or transnational) firm as one that uses hierarchical links to coordinate the behaviour of agents located in more than one country, without

much concern as to whether employees at home or abroad were in R&D, marketing, extractive activities, or manufacturing. Other researchers, interested by the extent to which national firms were becoming more independent of domestic economic and political conditions, defined multinational firms in terms of the extent of their foreign manufacturing activities and of the international dispersion of these activities.[74] Then the level and type of foreign activities and their international dispersion becomes relevant. The issue raised by free-standing firms is obviously of the first type: we want to know why a tea plantation in India was registered and ostensibly run from London, given the communication and control problems involved.

Casson's definition of what constitutes a multinational firm forces him to make a complex distinction between multinationality and foreign direct investment. His final conclusion is that most of the free-standing firms described in this chapter are neither multinationals nor foreign direct investors. Only when headquarters export both technology and information is the free-standing firm both a multinational firm and a foreign direct investor. He classifies many of the free-standing firms described in this book, where the headquarters had neither technological expertise nor the knowledge to direct day-to-day operations, as neither direct investors nor even quasi-multinational firms, and little more than 'shell companies for tax avoidance, or even devices for "laundering" illegal funds'.

The complex distinction between foreign direct investment and multinationality is unnecessary if one sticks to the definition that a multinational firm is an institution that organizes the interactions between agents located in at least two distinct countries through an employment contract, and foreign direct investment is the financial consequence of that relationship. Casson's analysis is, however, useful in bringing up the point that there are two separate issues concerning control in free-standing firms: (1) was control exercised by the owners? (2) were owners always resident of the country of registration?

The first issue is whether the equity stake taken by the suppliers of capital in the implementation of their foreign investment plans qualifies as the extension of hierarchical control across countries. If one joins Casson in denying it, then the free-standing firm is not, according to my own definition, a multinational firm. The second issue is whether effective control in free-standing firms always emanated from the country of registration. This is not crucial to my definition of free-standing firms as multinational firms, since this issue has to do with where control was located, and not whether it was exercised by owners.

The main reason why Casson denies the status of multinational and of foreign direct investor to all free-standing firms whose headquarters

did not transfer technology or management to their foreign operations is because he denies that equity carries control. For him, 'possession of equity is not synonymous with the right to control'. The control right of shareholders is embedded in the right to vote. Casson argues that this right is more often symbolic than effective, especially in large corporations.[75] For Casson, control is located where 'competence and integrity reside'. He sees an apparent contradiction between my observation that competence was often located overseas and my statement that control was always held at headquarters.

My theory of free-standing firms is based on the assumption that the type of control held by equity owners on the use of their funds differs from that obtained by lenders. If there are no differences between the type of control exercised by owners and lenders, then the choice between lending and owning is trivial, and the rationale for free-standing firms must be found elsewhere (for example, in a transfer of knowledge from headquarters).

Casson's argument that equity does not carry control seems at odds with his earlier writings in *The Entrepreneur*. There he anticipates my argument that lenders can reduce the risk of default by becoming owners of ventures and taking entrepreneurs as their employees because equity (ownership) gives owners greater control over borrowers than that available to lenders:

> So far as the lender is concerned, full and accurate reporting of the information is crucial in minimizing the risk of loss. A lender is not automatically entitled to information of this kind. Even if he were to contract to receive such information, he would still need to check that there is no concealment, or deliberate distortion. . . . To check that the entrepreneur is not concealing information, the lender needs to be able to monitor the implementation of the activity himself. He must have unrestricted access to the premises where the activity is carried on. As new information becomes available he must have the right to consult with the entrepreneur and, if things turn out badly, the right to overrule the entrepreneur in the interests of reducing the loss and protecting the repayment of his loan. This suggests that the lender should participate in the project as one of its principals, with the entrepreneur assuming the role of delegate. . . . The simplest way for the entrepreneur to act as delegate is to become an employee.[76]

Casson's more recent position that equity does not provide control may, however, apply in the case of the modern corporation where he asserts that 'collective control by shareholders is obviously a myth'. This point seems, however, somewhat overdrawn. While it is true that in many cases the control rights of some shareholders in firms with dispersed ownership seem more potential than real, a shareholder's

right to vote assures potential ultimate control, though the way this control is exercised can take many forms. First, core shareholders or groups of shareholders often exercise effective control in many corporations, and the same appears to have been true in many free-standing firms.[77] Secondly, coalitions of stockholders can be formed to oust poorly performing managers (IBM, American Express, Compaq, Digital Equipment, Kodak, Hartmarx, Tenneco, Westinghouse, Morrison-Knudsen, and W. R. Grace are recent examples).[78] Thirdly, votes can be bought by outside raiders intent on displacing existing managers. In short, while shareholders may choose not to exercise control in most circumstances, this does not mean that they do not have it.

The same distinction between potential ultimate control and day-to-day control, or between strategic and operational control, plays out in multinational corporations of the 1990s. Because competence often resides in the foreign subsidiary, the headquarters of most multinational firms do not intervene in the day-to-day operations of their foreign affiliates. Instead the head offices make strategic decisions, such as where to reinvest the cash flows generated by the enterprise, which subsidiaries to expand, and which ones to liquidate. That ultimate control is held by headquarters is widely accepted by managers of multinational firms.[79]

The separation of strategic control from operational responsibilities which characterize the modern multinational seems also to have been the norm in free-standing firms. While the head office of many free-standing companies was small, it was not always ineffective. Drawing from the histories of a number of Dutch free-standing companies, Gales and Sluyterman conclude that the board in Holland exercised strategic control because it held the purse strings.[80] The distinction between strategic and tactical control is also nicely described by Geoffrey Jones in the case of Britain's multinational banks: he notes that the London offices, despite their small size, added significant value to the operations of the bank by providing overall strategic direction, by hiring and firing managers, by instilling a company culture, and by tightly supervising and monitoring the business of the overseas branches.[81] T. A. B. Corley also provides examples of British free-standing firms where headquarters maintained strategic control through their power to hire and fire managers and to authorize expenses.[82] It is because the stockholders of free-standing firms had—or had the potential to have—strategic control over the use of their funds, including the right to fire the overseas managers responsible for the day-to-day conduct of foreign operations, that they were more willing to subscribe shares in the enterprise than to buy its bonds.

The second issue is whether control in free-standing firms was always

exercised from the place where the company was registered. This does not seem always to have been the case.[83]

While Casson denies that the internalization of capital could provide a rationale for the free-standing firm, another group of authors represented by Clark C. Spence, Donald G. Paterson, and Wilkins agree that free-standing firms made foreign direct investments, but they have emphasized the short-lived character of these firms.[84] Wilkins wrote:

> Fundamental to the free-standing company was its inherently weak managerial structure at origin, causing it to depend on outside providers for service. This initial lean governance structure was responsible for the short life or failure of many of the British businesses operating overseas.[85]

These authors tend to stress the inefficiencies of free-standing firms and their high failure rates due to incompetence and fraud. This verdict is in large part based on the experience of mining firms, which, we have seen, made up the largest proportion of free-standing firms, and more particularly, of those in North America.

Lending to mining firms is a very risky proposition because of the lack of good collateral. Hence mining has always relied on equity financing. While the floating of mining stocks has often been accompanied by fraud, the efficiency of this process must be assessed in relative, not in absolute terms. The 1980s performance of international bank lending to mining firms in developing countries suggests that, in spite of considerable abuses, free-standing firms were a comparatively efficient method of funding foreign mining ventures.

When one looks at mining firms outside North America, and at free-standing companies in other industries, free-standing firms do not seem to have a particularly high failure rate. As mentioned above, were it not for political factors, British free-standing tin-mining firms would still be active today in Nigeria and Malaysia. The British overseas banks—another group of free-standing companies—were still very much in evidence in the 1960s.[86] Gales and Sluyterman show that the survival rate of Dutch free-standing companies varied with their industry and location: 77 per cent of all companies doing business in 1913 in the Dutch Indies (mostly plantations) had not disappeared twenty-four years later, versus 41 per cent for those in other countries (principally mortgage companies).[87] These rates compare favourably with some studies of the 1980s and 1990s survival rates of foreign affiliates.[88] Many British free-standing firms in the West Coast of Latin America did also survive for long periods.[89]

Since the rationale for free-standing firms was the funding of risky ventures overseas, keeping the firm no larger than that of an efficiently sized production unit may have been efficient, since it made it possible

for investors to diversify their investment across a large number of firms. Keeping free-standing firms small reduced their cost of raising funds. Subcontracting basic administrative services, marketing, and local management avoided diseconomies of scale. Developing a sizeable corps of managers at headquarters would have been useless if the main role of headquarters was to give strategic direction and not detailed operational instructions.

Wilkins's second point was that British free-standing firms failed because their contribution 'was often solely financial; the British free-standing firm had no sustained advantage'.[90] This assumes that a firm needs advantages to operate abroad. Yet observation of vertically integrated multinationals shows that this is not the case. Multinational firms arise to internalize markets, not necessarily advantages. Steelmakers have invested in foreign iron-ore mines even though they have no expertise in mining (most of their captive mines are managed by specialist iron-ore-mining firms). They have developed foreign mines to internalize the market for iron ore, not to exploit abroad some type of advantages. One would expect them to sell off their mines or to operate them at arm's length if the market for iron ore became competitive.

Similarly, free-standing firms were created to internalize the international market for equity capital. When this market became more efficient, they lost their *raison d'être* and evolved into domestic companies. Their disappearance was the logical consequence of changed market conditions. When markets improve, vertical disintegration follows, and this is as true in the market for equity capital as in that for iron ore.

Conclusion

The goal of this chapter has been to develop a theory of free-standing firms, looking both at the way they were created and at the particular form they took. While some free-standing firms were clearly completely free-standing, others were linked in clusters to traders, sellers of capital equipment, and mining consulting and engineering firms. Free-standing firms have two main characteristics that challenge the usual rendition of the eclectic theory of foreign direct investment. First, in contrast to the prediction of the theory, these firms did not grow from a domestic base from which they could transfer 'ownership advantages' to their foreign operations. Secondly, many were linked to their sponsors through minority stakes. These stakes are difficult to explain in terms of the eclectic theory, for they were not taken by parents internalizing proprietary knowledge through wholly-owned subsidiaries, as is the usual pattern with today's multinational firms.

In this chapter I argue that the existence of free-standing firms and their minority equity links to sponsors can be explained by a three-pronged extension of the eclectic model. First, we need to understand that the presence of equity links between firms does not require the exploitation of advantages. Multinational firms arise to internalize international markets, not necessarily international advantages. They do not need to possess advantages to expand abroad. Their expansion can be explained by the internalization of markets. Secondly, while the focus of the international business literature has been on the internalization of markets for technological know-how, the theory can be extended to that for financial capital. Free-standing firms can be seen as institutions that reduce transaction costs in the markets for financial capital by having savers control the investment of their funds in a foreign project through an employment relationship. This is shown to be efficient when the market alternative of lending would experience high costs because the project is new and unproved, it does not provide good collateral, and its sponsors are unknown to lenders. This explanation is consistent with the main features of free-standing firms: their registration in countries having liquid equity markets, the absence of domestic activities (other than those of the head office), their lean headquarters staff sometimes lacking technical expertise, the concentration of their activities in risky projects in capital-starved countries, their high capital intensity, and their reliance on equity.

The presence of minority equity links between free-standing firms and their sponsors can be explained by the desire of sellers of goods and services to integrate vertically forward. Sellers were forced to sponsor the establishment of customer firms because such enterprises would not have appeared spontaneously otherwise. The involvement of sellers can be explained by the superior information they possessed and their inability to transfer it to local entrepreneurs because of the well-known problems encountered in the sale of information.[91]

But while suppliers had to establish equity links between themselves and their potential customers, they generally did not need to take full equity. Full integration would have involved more costs than benefits. Sometimes the suppliers did not have all the requisite skills to operate locally, especially a knowledge of local conditions. Taking more equity than the minimum required to obtain the custom of their progeny would have yielded few benefits to suppliers of heavy equipment and to traders, while substantially increasing the size of their operations and hence their management costs. Hence traders and heavy-equipment makers ended up owning minority stakes in a large number of customer companies.

Lastly, under the free-standing firm pattern each project was basically undertaken as a separate firm, as opposed to as part of a large firm, with funds raised by the large firm and then internally allocated to each project, as is the norm with today's multinational enterprises. The reason is that, given the small minimum efficient size and the relative simplicity of the technology involved, there was no need to transfer funds internally from existing to new projects. Instead independent sponsors could finance the early development of projects and bring them successfully through flotation. Some partial intermediation did take place when the scale of the project was so large that it could not be prepared for flotation by isolated sponsors. Then the development of new projects was financed by trading firms, financial holding companies, and mining finance houses from the cash flows of existing ones.

NOTES

1. M. Wilkins, 'The Free-Standing Company, 1870–1914: An Important Type of British Foreign Direct Investment', *Economic History Review*, 2nd ser., 41 (May 1988), 259–82.
2. The following are just a few examples gleaned from press articles: Affymax NV, a public company incorporated in the Netherlands whose only activity is doing research on combinatorial chemistry in Palo Alto, California; Vengold Ltd., floated on the Vancouver Stock Exchange to develop gold properties in Venezuela; Musto Explorations, a Canadian company traded on the Vancouver Stock Exchange, whose main asset is a 50% interest in a copper/gold project in Argentina; Gold Reserve Corp., an American company initially floated on the Spokane stock exchange, now on NASDAQ, whose sole asset is a gold mine in Venezuela. See *Wall Street Journal*, 27 and 31 Jan. 1995; *Financial Times*, 27 Apr. 1995; *Spokesman Review*, 28 May 1994.
3. C. J. Schmitz, 'Patterns of Scottish Portfolio Investment 1860–1914', unpublished report to ESRC (1994). See Table 1.1 herein.
4. US Federal Trade Commission, *Report on Cooperation in American Export Trade* (Washington, 1916), pt. 2, 537.
5. Ben Gales and Keetie Sluyterman, Chapter 11 herein.
6. Wilkins, 'The Free-Standing Company'.
7. J. F. Rippy, *British Investments in Latin America, 1822–1949* (Minneapolis, 1959), 59.
8. A. Wright and H. A. Cartwright, *Twentieth Century Impressions of British Malaya* (London, 1908).
9. J. H. Dunning, *International Production and Multinational Enterprise* (London, 1981).
10. Wilkins, 'The Free-Standing Company', 279.
11. The point is made implicitly in J.-F. Hennart, *A Theory of Multinational Enterprise* (Ann Arbor, Mich., 1982); and explicitly in M. Casson, 'General Theories of the Multinational Enterprise: Their Relevance to Business History', in P. Hertner and G. Jones (eds.), *Multinationals: Theory and History* (Aldershot, 1986), 42–63.

12. J.-F. Hennart, 'International Financial Capital Transfers: A Transaction Cost Framework', *Business History*, 36 (Jan. 1994), 51–70.
13. J.-F. Hennart, 'A Transaction Costs Theory of Equity Joint Ventures', *Strategic Management Journal*, 9/4 (1988), 361–74; J.-F. Hennart, 'The Transaction Costs Theory of Joint Ventures: An Empirical Study of Japanese Subsidiaries in the United States', *Management Science*, 37 (Apr. 1991), 483–97.
14. Hennart, *A Theory of Multinational Enterprise*.
15. G. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism', *Quarterly Journal of Economics*, 84 (1970), 488–500.
16. Shirking can be defined by the failure of employees to live by the spirit of their employment contract. Shirking takes the form of failure to work during work hours, to show initiative, to collect information, to respect company property, and/or to obey managerial directives. Note that our description of what goes on in firms simplifies in assuming that firms use pure hierarchical control modes. In fact, firms use a mix of price and hierarchical controls. See J.-F. Hennart, 'What is Internalization?', *Weltwirtschaftliches Archiv—Review of World Economics*, 122/4 (1986), 791–804; J.-F. Hennart, 'Explaining the "Swollen Middle": Why Most Transactions are a Mix of Market and Hierarchy', *Organization Science*, 4 (Nov. 1993), 529–47.
17. Hennart, 'A Transaction Costs Theory'.
18. For some empirical evidence supporting the theory, see Hennart, 'The Transaction Costs Theory of Joint Ventures'.
19. See the case of tramways in J. McKay, *Tramways and Trolleys* (Princeton, 1976) and the hypothesis of Tamás Szmrecsányi, Chapter 10 herein.
20. P. Hertner, 'The German Electrotechnical Industry on the Italian Market before the Second World War', in G. Jones and H. Schröter (eds.), *The Rise of Multinationals in Continental Europe* (Aldershot, 1993), 157.
21. Some of these financial holding companies were established in joint ventures with banks in Switzerland and in Belgium. Hence AEG established in 1895 the Bank für Elektrische Unternehmungen (Elektrobank) in Zurich with the Deutsche Bank and in cooperation with the Credit Suisse and other German, Swiss, and Italian banks, and in 1898 SOFINA in Brussels in collaboration with Belgian banks. Those two countries were ideal locations to finance operations outside Germany because they were neutral and had very liberal company law and stock-exchange regulations. The US General Electric Company seems to have adopted a similar strategy. In 1905 it set up the Electric Bond and Share Company to finance the acquisition of utilities. That subsidiary acquired or created a large number of electric traction and lighting companies. At least some of those were free-standing companies with stock sold to the public—for example, the Cuban Electric Company (incorporated in 1927 to supply electric power to Cuba). In 1923 Electric Bond and Share organized the American and Foreign Power Co. to hold its foreign properties. See M. Winkler, *Investments of United States Capital in Latin America* (Boston, 1929), 190; M. Wilkins, *The Maturing of Multinational Enterprise: American Business Abroad from 1914 to 1970* (Cambridge, Mass., 1974), 131; W. J. Hausman and J. L. Neufeld, Chapter 14 herein; Hertner, 'The German Electrotechnical Industry'; A. Broder, 'Banking and the Electrotechnical Industry in Western Europe', in R. Cameron and V. I. Bovykin (eds.), *International Banking, 1870–1914* (New York, 1991), 468–84.
22. In 1898 Schneider took an 8% participation in the Société Franco-Russe pour l'Industrie Électrique in order to obtain orders for their electrical works in France. See C. P. Beaud, 'Investments and Profits of the Multinational Schneider Group: 1894–1943', in A. Teichova, M. Lévy-Leboyer, and H. Nussbaum (eds.), *Multinational Enterprise in Historical Perspective* (Cambridge, 1986), 87.

23. J. McKay, *Pioneers for Profit* (Chicago, 1970), 100–2. Electric tramways needed a large and reliable supply of electricity, and hence were a good market for companies that were selling heavy electrical generating equipment. See, for example, D. McDowall, *The Light: Brazilian Traction, Light and Power Company Limited, 1899–1945* (Toronto, 1988).
24. R. Turrell and J.-J. van Helten, 'The Rothschilds, the Exploration Company, and Mining Finance', *Business History*, 28 (Apr. 1986), 188; M. Fraser, 'Editor's Introduction', in L. Phillips, *Some Reminiscences* (Johannesburg, new edn., 1986).
25. Having a trading firm as a minority share owner is also useful to the free-standing firm, since it helps guarantee marketing support from the trader and provides credibility *vis-à-vis* customers. For a discussion in the context of Japanese trading companies, see T. Roehl, 'A Transaction Cost Approach to International Trading Structures: The Case of the Japanese General Trading Company', *Hitotsubashi Journal of Economics*, 24 (1983), 119–35.
26. J. H. Drabble and P. J. Drake, 'More on the Financing of Malayan Rubber, 1905–23', *Economic History Review*, 2nd ser., 27 (1974), 108–20.
27. J. H. Drabble, *Rubber in Malaya 1876–1922* (Kuala Lumpur, 1973), 85.
28. R. Miller, Chapter 8 herein.
29. Gales and Sluyterman, Chapter 11 herein.
30. Mitsubishi Shoji was in the mid-1960s the largest importer of animal feeds. As an outlet for its feeds, it fostered the development of broiler farms and of processing plants. To absorb the resulting broiler meat, it entered a 50–50 joint venture with Kentucky Fried Chicken to introduce fried chicken fast-food restaurants into Japan. See Y. Tsurumi, *Multinational Management* (Boston, 1977); M. Yoshino and T. Lifson, *The Invisible Link* (Cambridge, Mass., 1986).
31. K. Hayashi and S. Robock, 'The Uncertain Future of the Japanese General Trading Companies', *Kajian Ekonomi Malaysia*, 19/2 (1982), 45–67; K. Kojima and T. Ozawa, *Japan's General Trading Companies: Merchants of Economic Development* (Paris, 1984).
32. An example is Sangkasi Thai Co., a manufacturing joint venture between Mitsui & Co. (24% owner), C. Itoh (16% owner) and local interests (60%) which manufactures galvanized iron sheets in Thailand. These sheets used to be exported from Japan by the trading companies. They set up Sangkasi Thai and similar ventures when their export business was threatened by Thai tariffs. Mitsubishi Brunei LNG project is a three-way joint venture between the Government of Brunei, Royal Dutch/Shell, and Mitsubishi Shoji. The joint venture (Brunei LNG Sendirian Berhad) is domiciled in Brunei. See T. Cappielo, 'The Changing Role of Japan's General Traders', *Journal of Japanese Trade and Industry*, No. 4 (1982), 18–30.
33. Note that they sometimes transferred other inputs besides capital. In this chapter, however, we focus on their role as conduit for financial capital.
34. In practice, pure types are rare, most firms being financed through a mix of debt and equity, through both intermediated and non-intermediated transfers, and through both foreign and domestic sources. It is, however, convenient to look at pure types to understand the trade-offs involved. Note, also, that the underwriting of bonds and stocks by banks or other intermediaries is not considered intermediation here. In this chapter, intermediation is considered to occur when individuals or businesses raise funds in their own name and transfer them to other entities, thus allocating capital internally.
35. Gales and Sluyterman, Chapter 11 herein.
36. Article on Leh Chin Ho in the centenary number of the *Pinang Gazette* cited in J. W. Cushman, 'The Khaw Group: Chinese Business in Early Twentieth Century Penang', *Journal of Southeast Asian Studies*, 17 (1986), 58–79.

37. K. Sluyterman, 'Dutch Free-Standing Companies between 1870 and 1940', unpublished paper (1994).
38. M. D. Morris, 'South Asia Entrepreneurship and the Rashomon Effect, 1840–1947', *Explorations in Economic History*, 16 (1979), 341–61.
39. K. Stahl, *The Metropolitan Organisation of British Colonial Trade* (London, 1951), 167.
40. C. Lewis, *America's Stake in International Investments* (Washington, 1938), 284.
41. O. E. Williamson, 'Corporate Finance and Corporate Governance', *Journal of Finance*, 63/3 (1988), 569–98.
42. For a more extensive discussion, see Hennart, 'International Financial Capital Transfers'.
43. On the other hand, they will be less motivated to exert effort and to collect information, and more motivated to embezzle.
44. R. Mikesell and J. Whitney, *The World Mining Industry* (Boston, 1987).
45. Hennart, 'International Financial Capital Transfers'; Gales and Sluyterman, Chapter 11 herein.
46. R. T. Stillson, 'The Financing of Malayan Rubber, 1905–1923', *Economic History Review*, 2nd ser., 24 (1971), 589–98; C. G. Allen and A. G. Donnithorne, *Western Enterprise in Indonesia and Malaya* (London, 1957).
47. M. Wilkins, *The History of Foreign Investment in the United States to 1914* (Cambridge, Mass., 1989).
48. J. Baskin, 'The Development of Corporate Financial Markets in Britain and in the United States, 1600–1914: Overcoming Asymmetric Information', *Business History Review*, 62 (Summer 1988), 228.
49. N. Ramachandran, *Foreign Plantation Investment in Ceylon, 1899–1958* (Colombo, 1963).
50. Drabble, *Rubber in Malaya*, 85.
51. P. Richardson and J.-J. van Helten, 'The Development of the South African Gold-Mining Industry, 1895–1918', *Economic History Review*, 2nd ser., 38/3 (1984), 319–40.
52. Yip Yat Hoong, *The Development of the Tin Mining Industry of Malaya* (Kuala Lumpur, 1969).
53. Miller, Chapter 8 herein; M. Wilkins, 'The Impact of Multinational Corporations', *South African Journal of Economic History*, 4 (Mar. 1989), 4–20.
54. Miller (Chapter 8 herein) observes that free-standing companies in the West Coast of South America fell into two such categories: those basically independent and those linked to traders, such as Gibbs and Balfour, Williamson & Co.
55. J.-F. Hennart, 'Free-Standing Firms and the Internalisation of Markets for Financial Capital: A Response to Casson', *Business History*, 36 (Oct. 1994), 122.
56. Ibid. Similarly, dredging was not a British technology, but was borrowed from New Zealand gold-mining.
57. Gales and Sluyterman, Chapter 11 herein.
58. Miller, Chapter 8 herein.
59. T. Navin and M. Sears, 'The Rise of a Market for Industrial Securities', *Business History Review*, 29 (1955), 105–38.
60. Wilkins, 'The Free Standing Company'.
61. Drabble and Drake, 'More on the Financing', 116.
62. Yip, *The Development of the Tin Mining Industry of Malaya*.
63. L. Schatzl, *The Nigerian Tin Industry* (Ibadan, 1971).
64. Winkler, *Investments of United States Capital in Latin America*, 118–23 and 158–75.
65. Farr and Co., *Manual of Sugar Companies* (New York, 1925).
66. This pattern can be seen in mining and petroleum, with US firms buying

British free-standing firms in Mexico and Venezuela. For example, Lago Petroleum, incorporated in Delaware in 1923 to prospect for oil in Venezuela, acquired in 1924 the British Equatorial Co. Ltd.; the Colon Oil Corp. was organized in the USA in 1928 to take over the Colon Development Company Ltd., registered in 1913 in the UK to explore for oil in Venezuela. International Telephone and Telegraph, which seems to have had the characteristics of a US-based free-standing firm, acquired in the late 1920s a series of British-based free-standing telephone utilities (the Chili Telephone Co. Ltd. and the Montevideo Telephone Co. Ltd. in 1927; the Peruvian Telephone Co. Ltd. in 1930). See Winkler, *Investments of United States Capital in Latin America*; Miller, Chapter 8 herein.

67. Miller, Chapter 8 herein.
68. Casson, Chapter 3 herein.
69. Casson, Chapter 3 herein.
70. M. Casson, *The Entrepreneur* (Oxford, 1982).
71. Casson (ibid. 199) writes: 'It is worth noting that the family is capable of internalizing not only the labour market, but the capital market too.'
72. Casson, Chapter 3 herein.
73. Hennart, *A Theory of Multinational Enterprise.*
74. See, for example, R. Vernon, *Sovereignty at Bay* (New York, 1971).
75. Casson supports his point that possession of equity is not synonymous with right to control with the example of Chinese railways, where the bondholders had the right to name the general manager. He also argues that control of firms that have failed to make interest payments has been taken over by committees of bondholders. These two examples are not persuasive because they correspond to abnormal situations. In the case of Chinese railroads, the first best solution of lenders would probably have been to hold equity in the railroads, but this was probably frustrated by the Chinese government's insistence on ownership. Hence to attract funds the Chinese government was probably obliged to offer additional control rights to bondholders. The second example corresponds to a case where lenders, having suffered the consequences of lack of control, try to obtain it ex post. See Casson, Chapter 3 herein.
76. Casson, *The Entrepreneur*, 212–13.
77. This is the case in many family-controlled public corporations. For some evidence of tight family control in some British free-standing firms, see Hennart, 'Free-Standing Firms'.
78. See, for example, H. Smith, *Rethinking America* (New York, 1995), 274–92.
79. As the British managing director of an American-owned subsidiary put it to Michael Brooke and Lee Remmers, 'the manager of a subsidiary must accept that he enjoys a subordinate status, that a subsidiary company is an organ of the parent company, and that policy is basically formulated and handed down by the parent company'. See M. Z. Brooke and H. L. Remmers, *The Strategy of Multinational Enterprise* (New York, 1970), 8.
80. Gales and Sluyterman, Chapter 11 herein.
81. Geoffrey Jones, Chapter 13 herein. The London offices also performed banking functions, such as the discounting of bills received from their foreign branches, the confirmation of letters of credit, and the purchase and sale of bullion and securities.
82. In his comment on Hennart, 'International Financial Capital Transfers', Corley argued that the evidence of effective strategic control by directors over the operations of free-standing companies shows that the directors were internalizing knowledge from headquarters, and that the need to include financial capital as an intermediate factor becomes therefore less compelling. My point is that

the free-standing firm was the vehicle to link through hierarchical processes individuals with projects (entrepreneurs) and those with funds (investors)—i.e. the savers became owners of the project. Sometimes the entrepreneurs became co-owners of the firm, sometimes they became employees of the savers, and sometimes they were themselves savers. In all cases the market for financial capital was being internalized. My views are therefore compatible with those of Corley if one realizes that the market for financial capital links individuals with projects (with privileged information on profitable use of funds) and those with financial resources. See T. A. B. Corley, 'Free-Standing Companies, their Financing, and Internalisation Theory', *Business History* 36 (Oct. 1994) and Corley, Chapter 4 herein.

83. For example, Aramayo Francke Ltd., a company floated in London to mine tin in Bolivia, was controlled by the Bolivian Aramayo family. Miller (Chapter 8 herein) provides other examples. Many free-standing companies floated in London to mine in South Africa were German and French controlled. See Wilkins, 'The Impact of Multinational Corporations', and Wilkins, Chapter 1 herein.
84. C. C. Spence, *British Investment and the American Mining Frontier* (Ithaca, NY, 1958); D. G. Paterson, *British Direct Investment in Canada 1890–1914: Estimates and Determinants* (Toronto, 1976); Wilkins, 'The Free Standing Company'.
85. Wilkins, 'The Free Standing Company', 279.
86. Jones, Chapter 13 herein.
87. Gales and Sluyterman, Chapter 11 herein.
88. For example, only 41% of the foreign subsidiaries of a sample of Norwegian firms in 1982 were still active ten years later. See G. Benito, 'Disvestment of Foreign Production Operations', paper presented at the 2nd Workshop in International Business (University of Vaasa, Finland, 1995). The survival rate of Japanese manufacturing subsidiaries in the USA between 1980 and 1989 is 89% (author's database of Japanese subsidiaries in the USA).
89. Miller, Chapter 8 herein.
90. Wilkins, 'The Free Standing Company', 276.
91. See, for example, Hennart, *A Theory of Multinational Enterprise.*