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## KOJIMA'S THEORY OF JAPANESE FOREIGN DIRECT INVESTMENT REVISITED

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### *Abstract*

Kojima's theory of (Japanese) direct investment represents a special case which cannot be generalised and it is outdated. It ignores the competitive process and misses opportunities to integrate internalisation concepts which could lead it from its static cul-de-sac. The approach is contrasted with an integration of the internalisation approach and competitive behaviour. It is suggested that the latter approach provides a more complete and satisfying theoretical framework.

### I. *Introduction*

Two recent publications by Kiyoshi Kojima (1989) (1990) present an opportunity to assess the development of his thought and to contrast it with developments in the mainstream or core theory of international business and the multinational enterprise [Buckley (1990)]. *Japanese Direct Investment Abroad* represents a compilation of Kojima's thought up to the end of 1987 and the 1989 article extends his work. It also contains further criticisms of the theory of internalisation.

Old arguments do not need to be rehearsed. My view, expressed in earlier articles [Buckley (1983a) (1985) and (1989)] that Kojima's basic approach is unduly narrow in its assumptions, inapplicable to most (Japanese) direct investment, lacks attention to the form of investment, is unduly static and relies on key concepts from the internalisation rubric, remain unchanged. Essentially, the general stance of criticism made here is that Kojima misrepresents internalisation theory in two ways. (1) His criticism attacks certain elements of internalisation theory which he believes to be implicit in the theory, but actually are not. (2) He often restates internalisation theory as if it were an integral part of the Kojima approach. However, with the adoption of 'agreed specialisation' as a response to scale economies and the evaluation of internalisation theory by Kojima, there does seem to be more hope for fruitful dialogue and perhaps even convergence. This article largely follows Kojima's (1989) in its structure.

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## II. *Kojima's Theorising*

It is essential to make a distinction between firm level economies of scale and plant level economies of scale. Kojima's discussion (1989, pp. 66–70) seems to concern plant level economies. In establishing production plants abroad it is essential to take into account the fixed costs of establishing the plant. This was explicit in Vernon's (1966) celebrated switching point in the product cycle model:

Invest abroad when  $MPC_x + TC > APC_A$

where  $MPC$  is marginal cost of production for export

$TC$  is transport cost to target market

$APC_A$  is average cost of production abroad

The Buckley and Casson development of this model (1981) refined this point by postulating two types of fixed costs. (1) A non recoverable set up cost, which is a once-for-all cost incurred as soon as the mode is adopted. (2) A recurrent fixed cost, independent of the rate of output, which results from indivisibilities in the factor inputs hired in connection with the market servicing activity. The introduction of economies of scale into the model provides a valuable service as the original mode of doing so ('production with large plant' versus 'production with small plant') was admittedly crude. However to do so whilst ignoring fixed costs and set up costs of any kind is to devalue the model and to make nonsense of the decision rules. Of course, plants with lowest average minimum cost will be most efficient in the absence of any balancing fixed costs. The concept of economies of scale at plant level used by Kojima may be becoming obsolete in the presence of changing demand conditions flexible manufacturing techniques, robotization and just-in-time inventory control. Although the imperative to achieve minimum efficient scale may have shifted to component suppliers rather than assemblers.

However, some of the major gains from multinational operations arise in the area of firm level economies of scale. These economies, through the operation of internal markets, allow the more efficient coordination of functions within the firm [Buckley and Casson (1976), Buckley, Pass and Prescott (1990)]. Coordination of functions such as production, R&D, finance and marketing and their subfunctions (distribution, inventory control, production promotion) allows costs to be decreased across the firm through the flow and control, not just of products, but of information. These gains will not show up as lower average costs of production but as dynamic gains in innovation and as lower selling costs, more rapid new production introductions, increased product variety, and in increased demand for the company by meeting the customers' needs more closely. The increasing capital intensity of production means that financing costs weigh more heavily (eg. fixed costs in plant establishment') and the variable costs of labour inputs declines—in many cases to a negligible part of total costs. Recent studies have shown falling plant level economies of scale Baden-Fuller et al (1988) show that, when reductions in minimum efficient scale at the plant level occur with local consumer demand shifts for greater variety, the benefits of international cost reducing investments are eroded and sometimes eliminated. To deal with such conditions, the form of the foreign investments necessary to coordinate supplies

is shifting the order to achieve improvements in relative quality, as measured by variety, service and product reliability, rather than achieving lower relative costs [Stopford (1990)].

### III. *The Gains from Internationalisation*

It has been explicit in the internalisation approach that in every cost of internalisation of a market, the benefits should be set against the costs of internalisation [Buckley and Casson (1976, pp. 37, 41–44)]. Indeed it has often been necessary to re-emphasise costs to reduce the ardour of the over zealous [Buckley (1983b) (1990)] and, whilst the decision-making firm will consider the decision in terms of its effect on long run profits, the welfare effects of the contrary pressures of cost and benefits have been frequently explicated [eg. Buckley (1987, p. 24) quoted by Kojima (1989, p. 75)].

Kojima's points on gains through internalisation hardly represent refutation of this position. The original examples of the advantages of the firm (or organisation) over the market were presented by Coase (1937), largely in terms of the benefits of a longer run flexible labour contract versus the costs of constantly hiring workers on short run contracts. The transaction cost reductions of the substitution of entrepreneurial control of workers' time rather than exceedingly detailed labour contracts are well known. Of course this is not to deny the benefits of part-time workers and subcontracting, particularly in times of turbulence. The limit to internalisation of workers' contracts is set by the firm's judgement of the benefits given by control and direction of full-time internal workers, plus the dynamic learning, loyalty and trust effects to which Kojima [(1981), p. 71] alludes, versus the flexibility and speed of adjustment to change. Modern corporations, including Japanese ones, use a combination of these means of filling labour needs with a core, tenured or permanent staff being complemented by a periphery of more casual contracted labour.

The issues of licensing-in versus developing technology and the optimal strategy of the licensor are key elements in the internalisation approach [Buckley and Casson (1976), Casson (1979)]. There is no suggestion that internal development of technology is always superior to licensing in. Indeed, the dangers of innovating a radical breakthrough have also been dealt with [Buckley (1983b)]. The choice of research expansion paths is crucial too, because as Kojima says [(1979), p. 72] "it is too expensive to innovate every kind of technology the firm needs." Licensing in technology may also provide a faster route to market as Japanese firms have proved repeatedly. The costs of innovation are high and rising, but what is crucial is the link between R&D and production, marketing, finance and the other functions of the firm through internal markets. In this way, dynamic welfare benefits through innovation can occur. To continue the quote which Kojima attenuates [Kojima (1989, p. 75, note 7) quoting Buckley (1987, p. 24)] "It is important to see also the dynamic elements. The multinational's internal market allows greater inter-plant and function cooperation (eg between production, marketing and R&D) and in the long run this will stimulate the undertaking of R&D and its effective implementation in production and marketing and improving welfare." Follower advantages are undeniably often strong, and part of the fascination of business strategy lies in the ability of followers to capitalise on their position, of which one area of strength is not to bear the huge financing costs of innovation.

It is essential to emphasise revenues as well as costs. Many of the dynamic gains arise from higher revenues, not reduced costs. Further, it is important to distinguish on the cost side between production costs and transaction costs.

Location endowments are not under the control of multinationals. Location decisions of multinationals, including the foreign direct investment decision, are designed to take advantage of differences in location endowments—immobile factors such as labour and raw materials—and to use the mobile assets of the firm to exploit protected markets, financing ability and the use of internal transfer pricing to reduce the impact of government intervention. The effects of the latter group of motives have welfare implications for host and source countries and the world economy which do not satisfy first-best comparisons. Free trade would be a more welfare enhancing solution, but often the motives for foreign direct investment are complex.

In examining the role of transfer pricing it is necessary to distinguish two types of internal prices. One use of transfer pricing is to minimise government interference, notably taxation. Another theoretical possibility is that transfer prices are market perfecting, that is, such prices are shadow prices approximating to the perfect market solution rather than the external imperfect market prices. It is possible that transfer prices following this rule lead to welfare enhancement through improved resource allocation.

#### IV. *Monopoly or Competition*

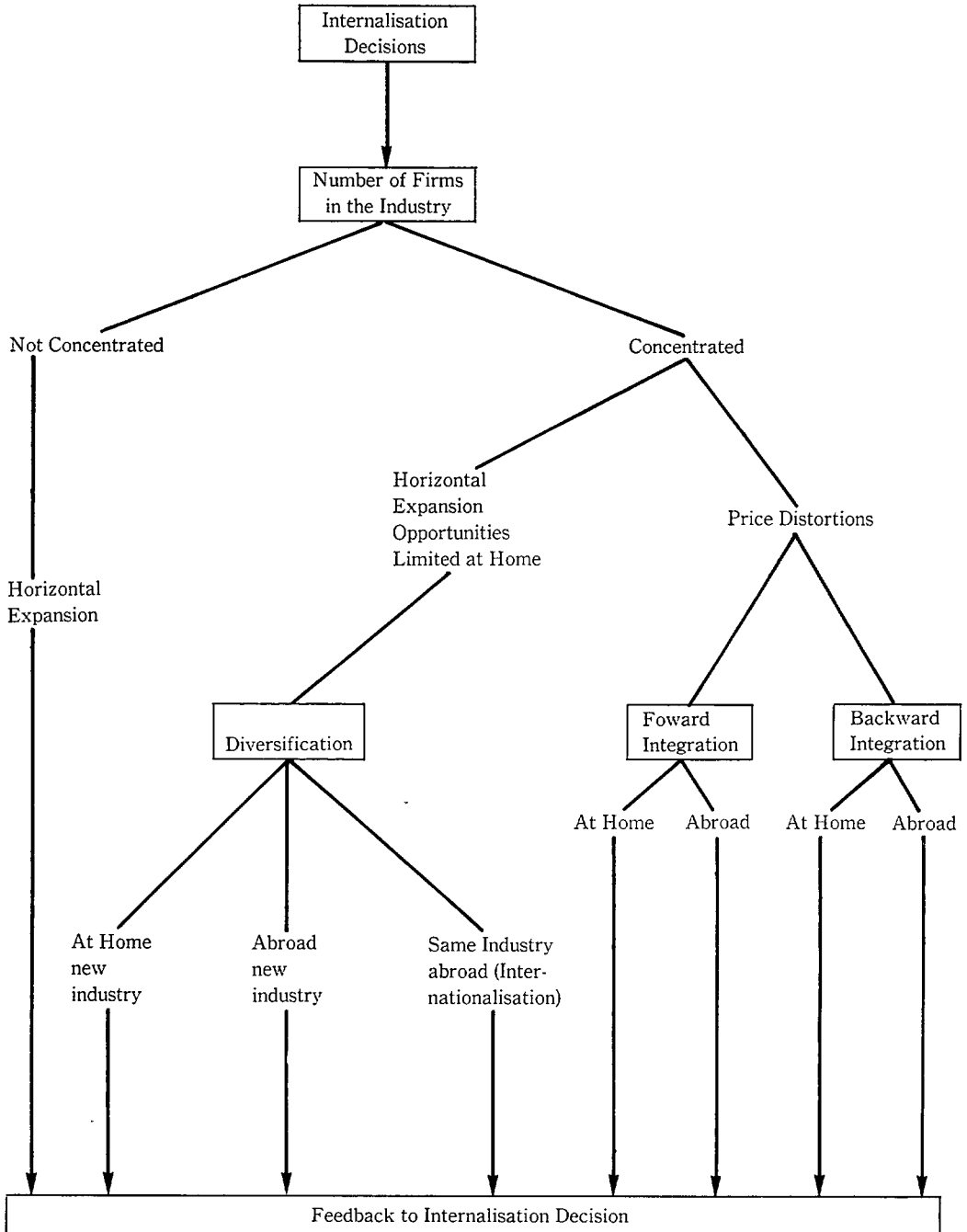
It is nonsense to state that the theory of internalisation justifies monopolistic behaviour [Kojima (1989), p. 75]. The costs and benefits of internalisation are spelled out in the quote from Buckley (1987) and its continuation. Of more interest is the interaction between internalisation decisions and market structure. A recent article [Buckley (1990)] drawing on Hymer's (1968) article in Casson (1990) attempts to integrate internalisation decisions with market structure. This interaction is illustrated in Figure 1. A satisfying model can thus be derived.

It is insufficient to specify multinational firms as monopolists. The nature of monopoly must also be specified. Much of the "justification" of monopoly practices which Kojima perceives actually relate to attempts made by multinational firms to capture part of the social gain of innovation as private rents in a situation of defective property rights. Other types of monopoly produce different welfare outcomes. The use of scale as a barrier to entry does indeed constitute a welfare loss rather than an issue of appropriation of benefits.

#### V. *Conclusion*

Despite moves to incorporate elements of the internalisation approach in his thinking, Kojima's theory is seriously flawed. First, it represents a special case because of its restrictive assumptions and lack of general applicability. The incorporation of entrepreneurial advantages reduces it to a special case of a special case [Kojima (1990)]. It cannot be generalised beyond an explanation of a particular type of investment (Japanese?) in a particular host country (less developed). Second, it is outdated. The emphasis on plant

FIGURE 1. THE INTERACTION BETWEEN INTERNATIONALISATION DECISIONS AND MARKET STRUCTURE (AFTER HYMER 1868)



level economies of scale ignores flexible manufacturing techniques, computer controlled manufacturing and inventory control, all of which require a radical re-evaluation of economies of scale. Further, the impact of increasing automation and robotization on relative costs suggest that pace Kojima, fixed costs are rising and variable costs decreasing (labour costs in some cases falling asymptotically towards zero). Third, the competitive process is ignored. Special skills of companies—firm specific advantages in the short run—are ignored, together with the whole phenomenon of imperfect competition dynamics. Quality and variety competition, innovation strategy and barriers to entry are all conflated into economies of scale and the reduction of variable costs. As part of this process, economies of scale may be traded off for local customer services. Competition is not based solely on the reduction of costs. Fourth, the role of services is ignored. This is true both for service production and for the increasingly important phenomenon of the internal flow of services in the modern corporation. Fifth, and surprisingly, Kojima ignores the role of national, regional and local culture, which provides an important explanatory factor in outward foreign investment and its preferred destinations [Buckley and Casson (1990)].

The welfare effects which Kojima emphasises are indeed important. Protected markets may induce inward investors to produce behind tariff walls with plants of less than efficient scale. Free trade here would be the best solution. Whilst the switch to foreign production may be below the minimum efficient scale, there may be other reasons for this shift—to supply more adequately local demand, for instance. It is arguable that the Single European Market Act 1992 has had just such an effect on (potential) Japanese investors.

The danger of Kojima's approach is that it leads into a conceptual 'cul de sac' [Mirza (1989)] from which its proponent finds it increasingly difficult to re-emerge. The way out is clear. It is represented by a more wholehearted acceptance of internalisation concepts and integration with the strategic trade approach of modern international economies.

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