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Article — Digitized Version

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Intereconomics

Suggested Citation: Lorenz, Peter (1978) : Trans-frontier capital links between socialist enterprises, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 13, Iss. 9/10, pp. 222-226, <https://doi.org/10.1007/BF02929245>

This Version is available at:

<https://hdl.handle.net/10419/139562>

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Trans-frontier Capital Links between Socialist Enterprises

by Peter Lorenz, Berlin *

It seems reasonable to assume that the East European efforts concerning the functional viability of strictly socialist International Economic Organizations will also improve the chances for East-West corporations in the medium term. The further development of these organizations deserves therefore to be watched. Impulses radiating from this field may make it possible to change over to a qualitatively new kind of economic relations between East and West.

The trade between the industrialized states of Western Europe and the member states of the Council for Mutual Economic Assistance has not expanded as much as was hoped when the policy of détente was initiated — the recent spectacular deals with the Soviet Union notwithstanding. Great interest continues to be shown in the East European markets for Western technology but the actual demand is kept in check by their shortage of foreign currencies. Compensation deals are therefore often suggested by interested parties in socialist countries. Western suppliers find such transactions however often unacceptable because the range of goods offered in compensation is insufficiently flexible or else inconsistent with the quality standards of Western markets. It may thus be said that the development of trade between East and West is to a significant extent hampered by the lack of a feed-back between the Western markets and the production structure of the socialist countries.

Unfulfilled Hopes

Intensification of what is known as extended co-operation¹, especially through formation of mixed corporations² operating in the CMEA countries,

could perhaps redress this unsatisfactory situation. It will be known that special statutory provisions³ for such participation by Western firms in the financing and management of socialist enterprises have existed in Hungary and Romania for several years now. The hopes entertained in Eastern and Western quarters for this form of cooperation have in fact however not been fulfilled: the functional problems facing such corporations cannot be surmounted by a legislative *tour de force*. The ideologically motivated insistence on a 51% share of the capital for the socialist partner would not really matter because the influence of foreign partners could be safeguarded by appropriate contractual provisions unrelated to the extent of the capital participation. The technical difficulties encountered in setting up mixed corporations are a consequence of the specific features of the economic system and external economic arrangements of the socialist countries and arise mostly from currency, pricing and planning issues. The main problem, in general terms, is how to integrate the mixed corporation with the economic system of the socialist host country without reducing the management participation desired by the foreign partner to the level of a loan operation.

This problem of integrating a foreign management participation with a domestic economy organized on the lines of a planned economy and therefore partitioned-off from the outside world is not spe-

* Osteuropa-Institut, Freie Universität Berlin. — The German version of this article appeared in *Recht der internationalen Wirtschaft*, 1978, No. 8. A comprehensive study of this subject by the present author, entitled "Multinationale Unternehmen sozialistischer Länder — die internationalen Wirtschaftsorganisationen im Rat für gegenseitige Wirtschaftshilfe" (Multinational enterprises of socialist countries — the International Economic Organizations in the Council for Mutual Economic Assistance), was published by Nomos Verlag in July 1978.

¹ Terminology as in H.-J. Moocke, *Vertragsgestaltung bei Ost-West-Kooperationen*, AWD 1973, No. 2.

² The use of this term is not uniform. The term should be reserved for companies with a "mixed" capital from "capitalist" and "socialist" sources which are operating in the socialist economic area.

³ A translation into German is given in "Einfache und erweiterte Ost-West-Kooperationen", Vol. 46 of the publications of the Federal Office for Foreign Trade Information concerning foreign economic and taxation laws, Cologne 1973. — A special arrangement has existed in Poland since 1977, but it applies only to Poles living abroad. — Legal provisions for mixed corporations also exist in Yugoslavia, but this country is not a CMEA member and has a different economic system.

cific to mixed corporations but is inevitably also met when transnational links are forged between socialist enterprises. The CMEA states have made great efforts in this field of integration since the Complex Programme was proclaimed in 1971. Several so-called International Economic Organizations have been set up as a result. The best-known examples are: INTERATOMINSTRUMENT (established in 1972 and engaged in coordination and joint production in the field of nuclear power station technology), INTERCHIMVOLOKNO (1974; coordination of the chemical fibre industry and production in own plants) and the "Freundschaft/Przyjazn" cotton mill which was set up as a so-called Joint Enterprise.

The feature of this form of civil-law undertaking which sets it apart from the international legal forms employed earlier in the CMEA (e.g. Intermetal 1964) is that the new organizations are not intended to confine themselves to coordination between the "participants", i.e. between the partners, but are to acquire operating capacities of their own – either by taking over existing production facilities of the participants, which makes the International Economic Organization something like a merger, or conceivably by assuming particular functions, e.g. marketing, and using the proceeds from these to finance subsidiaries to be set up subsequently. It is also possible – and typical of the Joint Enterprises – that one partner contributes capital for the erection of a production plant in the country of the other partner and is in return given a share in the management and in the output or earnings of the International Economic Organization. In particular this last-mentioned variant is comparable with the mixed corporation.

It would be wrong to gather from this that viable models of East-East corporations are already in existence and need only be imitated by East-West corporations; the productive use of plants owned by International Economic Organizations, and even more of plants of subsidiaries in other countries, has not yet advanced beyond the stage of experiments and discussions. This is only to be expected because the outlined integration problem is bound to be encountered no matter whether the foreign investor is domiciled in the socialist world or in the capitalist world. The socialist countries have however by now gathered a great deal of experience with efforts to set up viable East-East corporations, and this information has

been discussed by socialist economists⁴ at international conferences and elaborated in the literature. This material has not yet been evaluated outside the socialist countries in regard to its applicability to the formation of East-West corporations.

Comparability of East-East and East-West Corporations

The neglect of these studies seems inappropriate, if for no other reason, because in setting norms the CMEA presumes that East-West corporations do not present any fundamentally different functional problems than do East-East corporations. Both types are regarded as forms of International Economic Organizations: In 1973 the executive committee of the CMEA approved "Model conditions for the formation and activities of International Economic Organizations in the member states of the CMEA"⁵; they were amended early in 1976 by the "Uniform Regulations". Article 1 IV of the Model Conditions specifies: "Participants from CMEA member states as well as from non-CMEA countries may become members of an International Economic Organization. Membership of participants from non-CMEA countries is permissible provided such participants recognize the aims and principles on which the International Economic Organization is based." – This means that an organization of this kind can be formed by one socialist⁶ and one capitalist enterprise without either an agreement between the country of the capitalist enterprise and the CMEA or a commitment by the capitalist enterprise to the objectives of the CMEA.

In this context it has to be pointed out however that the Model Conditions – and the Uniform Regulations likewise – are not immediately valid law in CMEA countries; they are a CMEA-sanctioned legislative model which is to form the basis in certain circumstances of an agreement between the CMEA countries for the standardization of their internal statutory arrangements. – Aside from the aspect of the comparability of East-East and East-West corporations which is of interest in this context, the quoted passage has a political aspect: it gives the CMEA member countries which are willing to set up East-West corporations an assurance that the CMEA and its leading power, the Soviet Union, has no ideological or political objections to the acceptance of foreign capital of capitalist origin although to go by the marxist doctrine it serves the purpose of exploitation.

⁴ E.g. June 1973 (Prague), conference report: V. Válek, Podstata a funkce mezinárodních ekonomických organizací v rámci RVHP (Nature and functions of the CMEA International Economic Organizations, Czech), in: Finance a úvěr 1973/8, p. 565 ff.; December 1973 (Sofia), conference report: B. Atanasov, Stopanska smetka v meždunarodnite stopanski organizacii na strane členki na SIV (Economic accounting in International Economic Organizations of the CMEA member countries, Bulg.) in: Ikonomičeska misul 1974/6, p. 81 ff.

⁵ Cf. Appendix of the study by P. Lorenz, Multinationale Unternehmen . . . , op. cit.

⁶ Socialist enterprises have of course no freedom of association at the present time and central state organs have therefore to be interposed each time. This does not however alter the fact that on the Eastern as well as the Western side in principle only enterprises, and not the states, are to be parties to the corporate relationship (Art. 1 I, II of the Model Conditions).

The subject of price determination will be discussed in the following in order to illustrate the present state of the debate about the functional problems of the International Economic Organizations in the CMEA countries. The concepts under consideration in the socialist literature will be collated systematically for this purpose. A critique of the tested models of existing International Economic Organizations must however be omitted for lack of space⁷.

According to the socialist terminology International Economic Organizations are to perform "operational economic activities" on the basis of "economic accountability". In other words, the results of their activities are to be recorded in a profit and loss account which shows the profit shares⁸ of the partners. From this derives the material interest of the partners in the prices applied to the purchases and sales of the International Economic Organizations.

The Extraterritorial Model

When this question was raised for the first time in 1970, it was taken for granted that all economic activities of International Organizations would have to be based on the "prices in the major markets for goods" expressed in terms of the "international currency of the CMEA countries"⁹. This meant that the accounts would have to be made up in the usual currency for intra-CMEA settlements — the Transfer Rouble (TR). So if an enterprise, for example, purchases raw materials from its country of domicile or from the country of the supplier of the capital, the price it pays for them is what is known as the "adjusted" prices of the (capitalist!) world market, converted into TR by recourse to a certain TR-dollar coefficient. The TR amounts are entered in the TR account over which the foreign trade transactions between the country of domicile and the country of the foreign investor are settled (as the Transfer Rouble is not convertible, these accounts have of course to be balanced bilaterally¹⁰).

According to this model — which as far as ascertainable has not yet been put into effect — the

enterprise occupies a quasi-extraterritorial, quasi-insular position in the currency and price system of the country of domicile. For lack of convertibility between the domestic currencies of the CMEA and the TR the enterprise could only enter into economic relations with organizations which are authorized to have transfers entered in TR accounts — i.e., in the main, with foreign trading organizations. Direct deals, e.g. with other enterprises in the country of domicile, would be ruled out.

This "extraterritorial" model is however hardly practicable: opposite international prices do not exist for many of the cost factors which have to be included in the operations account, as they are not traded internationally. This is true of land and premises, of charges for the exploitation of mineral resources and, above all else, of the remuneration for the workers. As far as these and some other cost factors are concerned, *ad hoc* prices would have to be negotiated, possibly after operations have started, which involves a substantial risk for the foreign investor.

But even if it were possible to ascertain international prices in this way, an International Economic Organization managing its affairs according to this model would not be very attractive for a foreign investor, for it is an essential motive for effecting investments abroad that the country of domicile of the enterprise to be established offers in certain respects more favourable production factors than exist in the investor's own country or in any third country. It goes without saying that this is a major consideration also for socialist investors.

There is no doubt therefore that this model will not be generally acceptable. In the literature this solution is recommended by a few writers on the ground that it is desirable for the future¹¹ even if it is admittedly impracticable at present. For practical purposes the advocacy of this model is immaterial. Its supporters are paying lip-service to it because of an ideologically hazardous aspect of the problem. The Soviet economist Lebedinskas made this clear when he said¹²: If the country of domicile provides the International Economic Organization with more labour than corresponds to its relative share of the equity capital (and profit!), it is in fact exporting labour "as far as the social-economic content is concerned". Lebedinskas hastened to add that under the conditions of the socialist economies — here existed a fundamental

⁷ Information about several existing International Economic Organizations is to be found, for instance, in J. A. Konstantinov, *Finansi na meždunarodnite specializirani ikonomičeski organizacii* (Finances of specialized International Economic Organizations, Bulg.), in: *Finansi i kredit* 1977/2, p. 3 ff., 3, p. 3 ff., 4, p. 3 ff.

⁸ Cf. the study by P. Lorenz, *Multinationale Unternehmen . . .* for information about taxation, application and transfer of profits.

⁹ B. W. Reutt, *Miedzynarodowe formy specjalizacji produkcji krajów RWPG* (International forms of production specialization by the CMEA countries, Pol.), in: *Integracja ekonomiczna krajów socjalistycznych*, Warsaw 1970, p. 173.

¹⁰ Concerning the problem of bilateralism in the trade relations of the socialist states cf. the comprehensive account in: J. M. van Brabant, *East European Cooperation — The Role of Money and Finance*, New York 1977.

¹¹ E.g. J. Jakubowski, *Miedzynarodowe zjednoczenia i przedsiębiorstwa krajów RWPG* (International associations and enterprises of the CMEA countries, Pol.), in: *Socjalistyczna integracja gospodarcza*, Warsaw 1974, p. 161.

¹² A. A. Lebedinskas, *Problemy cenoobrazovaniia v meždunarodnykh chozjajstvennykh ob-edinenijach* (Pricing problems in international economic associations, Russ.), in: *Izvestija akademii nauk SSSR, Serija ekonomičeskaja*, 1975/5, p. 129.

difference from those of capitalism — this cannot possibly lead to relationships of exploitation. This is nevertheless the crucial point. — It will be interesting to see which politico-economic subterfuge will be used in order to clear socialist investments in other countries of the stigma of exploitation without having to cleanse capitalist investments in other countries of the same charge ¹³.

The Integration Model

A possible alternative to this "extraterritorial" concept is the model of an integrated International Economic Organization, i.e. one which is fully integrated with the economic system of the country of domicile: all purchases and sales would be based on the domestic prices of the country of domicile and stated in its currency, so that the enterprise would be in a position to deal directly with other enterprises in the country of domicile.

This however would expose the foreign investor to the vagaries of the price policy of the country of domicile. As a matter of fact it has happened to certain precursors of the International Economic Organizations of today that instead of earning profits as planned they incurred unforeseen losses when the country of domicile raised the prices for material-technical supplies or the wages ¹⁴. On the other hand it is most unlikely that the country of domicile will agree to having the prices which are most important to the International Economic Organization fixed in the articles of incorporation for this would hinder the price reforms to which all planned economies have to resort from time to time. — Misgivings of this kind probably explain why the Integration Model finds no outright supporter in the socialist literature although it has been discussed by several writers ¹⁵.

The Cost Price Model

In the models discussed above the selling price is derived from a given price system and not calculated from the costs actually incurred by the enterprise. This may result in losses which would have to be made good by subsidies of the partners. Difficulties are also apt to arise if profits

are earned because they raise the problem how the profit share due to the foreign partner is to be transferred: a profit recorded in the currency of the country of domicile could, even after translation into TR, only be used in bilateral trade between the countries concerned; provision for this would therefore have to be made already when the commercial treaties are concluded.

This is probably the reason why it is being stressed over and over again in the socialist literature that it is not the main purpose of the economic activities of International Economic Organizations to make profits in money terms but to "satisfy the requirements on economic grounds of the participants in terms of service value" ¹⁶. The profit is thus to be distributed in a covert form, namely by way of appropriately reduced prices for sales to the partners. In the simplest variant of this model the partners would thus be entitled (as well as obligated!) to receive products of the International Economic Organization in proportion to their relative share of the capital.

The Cost Price Model has been studied intensively by Bulgarian authors. It is probably the most modern concept and has the relatively best chance of being put into effect. There are a large number of possible variants. The starting point for the choice of a variant is the question of which factors are to be taken into consideration in calculating the "cost price". Another problem is posed by the question from which price system the prices for these cost factors are to be derived.

It is beyond question that the outlay on wages and material-technical supplies must be included in the cost calculations. There is some doubt however about the costing of services which are normally financed over the state budget such as education, health service and infrastructure (road-building, etc.). Atanazov ¹⁷ evidently believes that these social costs have to be taken into account because the benefit of the products of the International Economic Organizations — as distinct from those of national enterprises — does not accrue solely to the country of domicile which bears these social costs. He goes further and suggests that the enterprise should recompense the country of domicile periodically for the use of premises, exploitation of mineral resources, etc.

¹³ The accessible socialist literature on East-West corporations always avoided any explicit reference to the problem of exploitation although this is clearly the motive for the 51 % rule. In consistent application of the socialist doctrine it would probably have had to come to the unwanted conclusion that formation of a mixed corporation was tantamount to a government licence for the exploitation of socialist workers, which would not have been a point in favour of cooperation.

¹⁴ J. F. K o r m n o w, *Spezialisierung und Kooperation der Produktion der RWG-Länder* (Specialization and cooperation in the production of the CMEA countries, Germ.), Berlin (East) 1974, p. 261.

¹⁵ E.g. V. V á l e k, *Principy chozrasčotu v rámci mezinárodních hospodářských organizací členských států RVHP* (Principles of economic accounting by International Economic Organizations of the CMEA member countries, Czech), in: *Finance a úvěr* 1975/4, p. 235 f.

¹⁶ L. R ü s t e r, *Funktion und Rechtsstellung internationaler Wirtschaftsorganisationen im Prozeß der sozialistischen ökonomischen Integration* (Function and legal position of International Economic Organizations in the process of the socialist economic integration, Germ.), in: *Sozialistische ökonomische Integration — Rechtsfragen*, Berlin (East) 1974, p. 104.

¹⁷ B. A t a n a z o v, *Metodičeski vuprosi na formirano i prilaganeto na cenata v meždudržavnite socialističeski predpriatija* (Methodological questions bearing on the determination and use of prices in inter-state socialist enterprises, Bulg.), in: *ikonomičeska misul* 1975/3, p. 5.

Prices have to be fixed for these cost factors. Kalčev¹⁸ has discussed the following variants:

□ The costs arising in the country of domicile are assessed at the prices of the country of domicile while those attributable to deliveries by the foreign partner are assessed at international prices: this introduces an element of instability into the cost accounts because the cost price will in this case depend upon the (variable) relationship between the two groups of costs.

□ If the foreign trade organization of the country of domicile is interposed and pays international prices to the foreign partner for his deliveries while charging domestic prices to the International Economic Organization, additional benefits or losses will arise for the country of domicile via the budget of the foreign trade organization.

□ Of the other variants special mention deserves to be made of costing on the basis of so-called real costs: Costs in the country of domicile are assessed at domestic prices while supplies from other countries are entered at their domestic prices (CMEA contract prices in TR or world market prices in dollars). The main problem encountered in this variant is how to translate these real prices into the accounting or costing currency of the International Economic Organization. Atanazov¹⁹ suggested that the currency in which the International Economic Organization effects most of its sales should be chosen. Different coefficients should be agreed for the conversion of the various product groups, evidently for the reason that the great divergences between the price structures of the individual CMEA countries make the selection of a universal conversion coefficient for all goods impracticable.

Compound Forms

In addition to these various models which are all based on one uniform economic concept, consideration has been given to variants which combine individual features of the described models. The most important one among these compound forms has found its way into another CMEA document entitled "Model conditions for the financing of and settlements between International Economic Organizations of the interested member states of the CMEA (international economic organizations and associations)", which was adopted by the CMEA executive committee in January 1975²⁰.

According to this concept the prices of the country of domicile are to be used for supplies from and sales in the country of domicile while the international prices are to be applied to those by and to the foreign partner. — This concept avoids the costing difficulties inherent in the cost price model but does not rule out the risk of partners participating in the benefits of cooperation

in quite different measure and gives the country of domicile a chance to manipulate the costing operations.

The present survey has shown that no solution capable of general application has yet been found for this cardinal functional problem of the International Economic Organizations. Intensive work is however being done in Eastern Europe to find such a solution through special CMEA working groups, in the Institute for the Economics of the Socialist World System (Moscow)²¹ and elsewhere. The lack of convertibility of the domestic currencies of the CMEA countries — on a multi-lateral level (i.e. through the Transfer Rouble) or even on a bilateral level — is rightly deemed to be the principal obstacle.

The gradual elimination of this obstacle as postulated in the socialist literature will cause the greatest difficulties, for convertibility, even in a limited regional area, opens the domestic system of the planned economy to the outside world and thereby puts its operational viability at risk. Nevertheless it may be taken for granted that the CMEA states will not acquiesce in the currency-technical *status quo*. All of them with the exception of the Soviet Union are relatively small so that transnational capital links — with other socialist countries at least — are indispensable for their further economic development.

It seems therefore reasonable to assume that the East European efforts concerning the functional viability of strictly socialist International Economic Organizations will also improve the chances for East-West corporations in the medium term, and it is not impossible that solutions adapted to the specific circumstances of particular economic situations will be found already in the short term. The mentioned example of the "Friendship" cotton mill shows this to be a practical possibility. This enterprise at Zawiercie (Poland) was founded jointly with the German Democratic Republic which has also a large stake in the management. It started production in 1975 and may be regarded as a kind of pilot project. — The further development of the International Economic Organizations deserves therefore to be watched. Impulses radiating from this field may make it possible to change over to a qualitatively new kind of economic relations between East and West.

¹⁸ V. Kalčev, *Proizvodstveni razchodi i cenoobrazuvane v suvmestnite predprijatija na stranite-členki na SIV* (Production costs and pricing in joint enterprises of the CMEA member countries, Bulg.), in: *Ikonomičeska misul* 1973/8, p. 33 ff.

¹⁹ B. Atanazov, *ibid.* (cf. Note 17), p. 8.

²⁰ Cf. Appendix II of the study by P. Lorenz, *Multinationale Unternehmen* . . . , op. cit.

²¹ The so far most comprehensive study of functional problems of International Economic Organizations has been presented by assistants of this institute in cooperation with Bulgarian economists: *Problemy funkcionirovani sovmestnykh predpriyatij stran SEV* (Functional problems of joint enterprises of the CMEA countries, Russ.), Sofia 1975, 250 pages.