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The Conduct of International Enterprises in Developing Countries

An Empirical Review of Some Prejudices

by Ehrenfried Pausenberger, Gießen*

Do multinational enterprises act in developing countries as a motive force for progress or do they perpetuate colonialism by different means? The fierce controversy on this question still continues, fuelled not only by basic ideological differences but by dearth of empirical evidence. Prof. Pausenberger is helping to overcome the lack of knowledge.

The effects of the activities of international enterprises on the economies and social structures of developing countries are still fiercely contested in the discussions on development policy. Some observers regard them as the only efficient promoters of economic and social progress in developing countries and argue that they are particularly efficient in introducing capital, technologies and management know-how into these countries. Others take the view that international enterprises perpetuate colonialism in a modified form; they were depriving the developing countries of their natural and economic resources, curtailing the opportunities for autonomous development and prolonging their dependence on the industrialized countries.

The conflict between these two assessments is not solely due to different ideological positions but is reinforced by the dearth of empirically-founded knowledge. A well-founded objective verdict on the effects of the international enterprises operating in developing countries seems however essential: On the one hand this information is needed by the developing countries in order to set appropriate parameters for the activities of foreign enterprises in the light of their own interests; on the other it is indispensable for the conception of a global coordinated development policy.

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The present author has inquired into strategies and experiences of international enterprises in developing countries in a sizable study¹ in order to minimize the deficiency of empirically founded knowledge. The inquiries concentrated on one major Swiss and nine big German enterprises which are especially active in developing countries². Exhaustive interviews were conducted with senior management responsible for subsidiaries in developing countries; in addition, data were collected from about 70 such subsidiaries concerning the date of the start of production and its form, motives, capital structure and participation, delivery relationships and delegation of personnel. No inquiries have as yet been carried out in developing countries as part of this study.

Entrepreneurial Objectives

Information concerning 69 subsidiaries in developing countries led to the following grading of motives for establishment or purchase of local firms, with priority figures indicating the weighting of the motives:

¹ Ehrenfried Pausenberger: Internationale Unternehmungen in Entwicklungsländern. Ihre Strategien und Erfahrungen (International enterprises in developing countries. Their strategies and experiences), Düsseldorf and Vienna 1980.

² AEG-Telefunken, Frankfurt; BASF AG, Ludwigshafen; Bayer AG, Leverkusen; Daimler-Benz AG, Stuttgart; Hoechst AG, Frankfurt; Mannesmann AG, Düsseldorf; Metallgesellschaft AG, Frankfurt; Nestlé S. A., Vevey (Switzerland); Siemens AG, Munich; Volkswagenwerk AG, Wolfsburg.

**Motives for Establishment or
Purchase of Local Firms**

Rank	Motive	Priority Rating
1	Gaining markets/using chances for growth	181
2	Safeguarding markets against competitors	179
3	Safeguarding markets against state interference (e. g. by import restrictions)	140
4	Stable political and social conditions in the host country	112
5	Promoting sales of German products	100
6	Factor cost advantages	59
7	Financial incentives offered by the host country	34
8	Financial incentives offered by the Federal Republic of Germany	26
9	Safeguarding raw material supplies	16

This chart of motives confirms the findings of other motivation studies³ which showed direct foreign investment in developing countries to be predominantly sales-oriented while factor cost advantages were found to be of less importance. The list of investment motives also shows that the "charge" of predominantly profit-oriented motives levelled at international enterprises is justified: In their operations in developing countries the enterprises from industrialized countries are guided by earning-power considerations and not by development-policy objectives. Private commercial activities have however normally manifold effects on development, and the business firms maintain that they take these into account when deciding their policies.

In view of the predominance of sales objectives it is not surprising that the economic activities of international enterprises in the least developed countries are minute. Twenty relatively advanced developing countries account for 95 % of the total sales of the interviewed enterprises in developing countries (of which there are altogether 159). The manpower distribution is similar. Such regional imbalance serves to underline the special need for public development aid for the least developed countries.

International enterprises are occasionally reproached for taking over indigenous firms in order to

infiltrate the market of the host country quickly. It is argued that promising incipient moves towards independent industrialization of the developing country are being thwarted in this way.

On the strength of data concerning 65 subsidiaries we have established that the take-over strategy is playing a subordinate role in developing countries: 75 % of the subsidiaries were newly established; 5 % were taken over from other international enterprises, and in only 20 % of all cases were indigenous businesses bought up. Almost all the latter were either in trouble or their survival was in doubt because of lack of financial, technological and/or management potential. The take-over was usually followed by an expansion of the firm's capacity or volume of business. In none of the examined cases were there cogent reasons justifying a negative view of the take-over strategy under development-political aspects. In many cases the interviewed enterprises were urged to take over indigenous businesses.

Another charge brought against international enterprises is that they eschew commitments unless they are given (through a shareholding) full or at least majority control over the local firm. Many developing countries are however afraid that as a result of this strategy their economies may be brought under foreign control and for this reason quite often limit the participation quota of foreign firms (so do for instance the Andean Pact countries). The "maximum finance" argument, i. e. the demand that the foreign enterprise should provide the whole of the equity capital, an argument which is forced on almost all developing countries by the dearth of capital, is hardly ever accepted under these circumstances.

The majority of the interviewed enterprises desire 100 % ownership. They argue that this

- ☐ offers the best guarantee for uniform management to make sure of synergic effects,
- ☐ protects their technological know-how against seizure, and
- ☐ renders mismanagement and obstruction by partners impossible.

The German parent companies own more than 50 % of the capital of 140 of altogether 191 subsidiaries and associated companies in developing countries which were covered by our study. Half of the 140 firms are fully-owned; of the others the German parents own on average 77 %. Of all examined companies in developing countries they own on average 74 %.

³ Cf. Wolfgang R. Fikentscher, Peter Moritz: *Auslandsproduktion, Absatzgebiete, interne Lieferungen und Finanzierung der deutschen Industrie in Entwicklungsländern* (Foreign production, sales areas, internal supplies and finance of German industries in developing countries), in: *Recht der internationalen Wirtschaft/Außenwirtschaftsdienst des Betriebs-Beraters*, 24th year (1978), p. 26-31, see p. 28; Dietrich Kebschull, Karl Fasbender, Ahmad Naini: *Entwicklungspolitik* (Development policy), Opladen 1975, p. 219.

The majority of the shareholdings of 50 % or less were kept down to this level because of legislative or administrative acts by the host country. International enterprises accept the status of minority partner as a rule only if the country in question offers a large and expanding market and an adequate measure of influence on the business policy can be ensured (through the articles of association). The Daimler-Benz AG and the Nestlé group may be quoted in illustration of the importance of minority holdings: Two-thirds of the former's major commitments in developing countries did not exceed 50 % of the capital, and the latter is a minority partner in 41 manufacturing ventures in developing countries.

Financial Policy

The complaint is heard that international enterprises are making an insignificant contribution to overcoming the shortage of capital in developing countries because they tend to

- ☐ keep the equity ratio of the subsidiary (the ratio of equity to total assets) as low as possible,
- ☐ raise the required liabilities in the host country, and
- ☐ distribute and transfer earned profits as quickly and fully as possible.

The policy of keeping the equity of subsidiaries in high-risk areas to a minimum is perfectly logical from a commercial point of view because it minimizes the effects of exchange rate movements, transfer restrictions and expropriation. It is all the more surprising to discover as a result of our inquiries that the surveyed German firms provided their subsidiaries in developing countries with more equity than the average for enterprises in the Federal Republic of Germany. The equity ratio of the subsidiaries in developing countries is 35 %, that of all German enterprises is 31 %, that of all German corporations is 29 % (according to 1977 figures). The higher equity contributions to the subsidiaries in developing countries may be due to constraints on or serious drawbacks of capital transfers (blocked funds) but certainly reflect a wish of group managements to adhere to local practice in regard to capital structures and to promote the financial independence and growth potential of the subsidiary⁴.

⁴ Cf. the more extensive and detailed discussion in Ehrenfried Pausenberger: *Eigenkapitalausstattung deutscher Tochtergesellschaften in Entwicklungsländern* (Equity resources of German subsidiaries in developing countries), in: Ehrenfried Pausenberger (ed.): *Internationales Management. Ansätze und Ergebnisse betriebswirtschaftlicher Forschung* (International management. Attempts and results of micro-economic research), Stuttgart 1980, p. 195-218.

These figures also show that the opportunities for using outside finance are not exploited on an extensive scale. Most developing countries do not have enough long-term capital; in a few cases (in Mexico, for instance, for many years) foreign companies were not allowed to borrow at all; and foreign companies are also denied access to official government financing programmes. It has to be noted however that all the interviewed international enterprises advocate a policy of local financing, i. e. of raising the requisite liabilities as far as possible in the host country itself. Borrowings in other countries can be inhibited by obstruction of amortization and interest payments and, in part, high exchange risks.

Our inquiries showed that the size of the profit distributions is definitely overestimated. It is the policy of all the interviewed enterprises to retain a high proportion of profits so as to strengthen the growth potential and competitiveness of their foreign companies. According to the collected data 70-80 % of the profits of the German subsidiaries in developing countries are (on average) reinvested by them; this is far above the profit retentions by enterprises in the Federal Republic which averaged about 40 % in 1975. It may however be assumed that the ratio of distributed profits will rise in the next years because the German subsidiaries in developing countries are by and large past the stage of foundation and establishment.

Creation and Transfer of Technology

International enterprises are subjected to the charge that they do little to raise the technological level of the developing countries – far less than they could do. They are criticized in particular for

- ☐ doing almost all their research and development work in their home countries, thereby perpetuating the technological backwardness and dependence of the developing countries,
- ☐ transferring capital-intensive and labour-saving technologies which are geared to the conditions in industrialized countries and fail to yield the anticipated employment effects in developing countries, and
- ☐ insisting on restrictive conditions for the transferred technologies (e. g. to prevent their diffusion) and charging excessive fees for their use.

Our inquiries reveal indeed a massive centralization of the creation of new technological knowledge in the industrialized countries and in the parent establishments of the international enterprises. None

of the interviewed firms undertakes basic research in developing countries; they engage in a few developing countries (e. g. Brazil, India, Egypt) on a modest scale in applied research. Significant development work was only done on the adaptation of products and processes, mostly in newly industrialized countries.

Micro-economic calculations suggest adjustments of the production processes for the purpose of cost minimization in the light of the differences in factor availability and factor prices between industrialized and developing countries. This micro-economic aim of cost minimization is in principle consistent with the macro-economic objective of increasing job opportunities. It emerged from our inquiries that international enterprises are willing to adapt their technologies but are encountering tight limits: In some cases the production processes themselves are invariable, in others a lowering of the technological level is ruled out by humane, legal or safety considerations; and what scope there is left for adjustments can often not be used because of a professed wish of the developing country for the most modern technology. Besides, owing to lower labour productivity, high absenteeism, etc., the wage costs per unit in developing countries are despite moderate wage levels not lower than those in industrialized countries. The smaller plant sizes and production runs in developing countries are in practice the principal cause of adaptive measures and necessitate a lower degree of mechanization and automation than that pertaining in industrialized countries.

The charge that international enterprises impede or forbid the dissemination of technological know-how available in their subsidiaries is not warranted in this indiscriminative form. The efforts to keep know-how secret apply primarily to the highly-developed key technologies specific to the company operations of which indigenous firms in developing countries would in any case be unable to avail themselves without extensive assistance by the technology owner. In important areas the international enterprise has indeed an intrinsic interest in technology diffusion: It depends on downstream customers mastering techniques for product application (e. g. in the chemical industry), on independent service operators acquainting themselves with the product and the maintenance techniques and on suppliers of upstream products reaching and

holding the required quality level which implies in turn mastery of modern production techniques. One final point: The native staff of the subsidiaries gain knowledge of production and administration techniques and thus acquire know-how and skills.

Correct is the assumption that contractual technology transfers generally involve stipulations in regard to quality control by the technology donor, arrangements on procurement and exports and agreements for free information feedback.

The depreciation of intra-group fees for technology raises doubts on fundamental grounds. The "common heritage approach" treats modern technology as the outcome of the process of development of the whole of mankind and thus as a free benefit whereas the "dowry theory" operates with the concept of a balance of contributions: The developing country permits market opportunities to be utilized; the international enterprise equips its subsidiary with the requisite technology and is adequately remunerated by the withdrawal of profits. Both concepts suffer from a misapprehension: Technology is in fact an independent, scarce and costly production factor, a depreciating asset for the use of which a compensation is due from the beneficiary.

The remuneration for intra-group technology transfers from one country to another has to be fixed on the terms for at-arm's-length transactions and is subject to fiscal control.

Procurement and Sales

International enterprises are criticized for obligating their subsidiaries in developing countries to obtain upstream materials from group companies which are for the most part located in industrialized countries. This imposes a burden on the foreign exchange accounts of the developing countries. It is argued that this curbs the impact of the subsidiary on the general economy and that the activities of international enterprises in developing countries tend on balance to increase their imports.

For the 50 examined production enterprises in developing countries the intra-group inputs from other countries averaged 23 % of the total supplies⁵. Another 12 % were from other sources. This means that two-thirds of the required inputs are obtained inside the country concerned.

This attitude in regard to the supply strategy is due to two facts. One is that subsidiaries are normally under instructions to buy from group companies except if an

⁵ One-fifth of the subsidiaries do not record any intra-group purchases; two-thirds obtain less than 30 % of their inputs from sources inside the group. The proportion of intra-group purchases is highest in the chemical industry (37 %) and lowest in the metal industry (8 %).

outside supplier offers goods of the required quality more cheaply. Chemical manufacturers must often set exacting standards for their input products and avoid unsuspected side-effects that could arise from using materials from other sources. Intra-group raw materials and other inputs are therefore in many cases indispensable.

Another factor is that the subsidiaries in developing countries are almost without exception subject to more or less stringent import restrictions which make it impossible for them to draw on what are commercially the best sources. There is a wide range of restraints, from dilatory handling of licence applications and demands for proof of local unavailability to high tariff barriers, stipulations concerning local content, cash deposits or foreign currency proceeds, and banning of imports.

It is expected of international enterprises that they will, through their export activities, contribute to an improvement of the foreign currency situation of the host country. If they fail to do so, suspicions are uttered that group headquarters have ordered their foreign subsidiaries to abstain from export activities.

The average export performance of the examined subsidiaries is as a matter of fact very modest – no more than 6 % of total sales. They are not making the hoped-for contribution to the improvement of the foreign currency situation.

We found that nearly half the companies did not export at all. Insofar as subsidiaries in developing countries engaged in exports, intra-group transactions played a very small role; their share in total sales varied between 0.7 % in the chemical industry and 14.1 % in the automobile industry.

The low export ratio is stated to be due to

- ☐ the large and growing demand in developing countries (seller's market),
- ☐ lack of competitiveness of the products from developing countries – partly in quality, partly in costs,
- ☐ import restrictions by other states.

As regards the transfer prices for intra-group supplies and services a suspicion is often expressed

that they are manipulated in the interest of the group and thus lead to a latent shifting of profits and assets⁶. As a matter of fact intra-group deliveries and services do not involve two independent parties in a market so that it is in principle possible for the group management to fix the prices.

The fears entertained in this context are however in our view exaggerated. Firstly, it has to be borne in mind that the volume of intra-group deliveries and services is rather small and cannot be extended at liberty. Secondly, tax and customs authorities of the host and home countries subject such deliveries to strict price controls; under German law (Art. 1 of the *Außensteuergesetz*/External Taxation Act) supplies and services to group companies abroad have to be charged as if made to third parties, and the fiscal authorities may later order the prices to be revised. If there are minority shareholders in the developing country, they exercise in their own interest an additional control over the intra-group price determination. Besides, the managements of foreign subsidiaries have an interest in the use of market prices because they are, in keeping with the usually applied profit-centre concept, held responsible for the generation of a profit. Finally, it must be remembered that industrialized countries charge higher profit taxes than developing countries so that there is no inducement on taxation grounds to shift the tax liability away from the developing countries.

Personnel Policy

On the subject of personnel policy the interviews were chiefly concerned with two sets of problems: the remuneration of staff in the developing country and the appointment of staff to senior posts in the subsidiaries.

In regard to their wage policy the international enterprises face two opposite demands: On the one hand they are expected to pay native staff according to performance; on the other hand they are to adjust the pay to the local level so as not to draw trained people away from indigenous enterprises and thus create a privileged section of skilled workers.

In this dilemma the interviewed enterprises follow two essential rules: a large measure of decentralization with personnel decisions placed in the hands of the foreign subsidiary and adherence to a "cautious vanguard concept", a term which denotes a policy of keeping wages and social benefits slightly above the national level (in industrial centres). Our own and other empirical studies confirm that this is their attitude⁷.

⁶ Thus also the North-South Commission: North-South: A Programme for Survival. Report of the Independent Commission on International Development Issues, London and Sydney, 1980, 2nd printing, p.188f.

⁷ Cf. Grant L. Reuber: Private foreign investment in development, Oxford 1973, p. 175 f.; Klaus Matthies: Transnationale Unternehmen in Mexiko (Transnational enterprises in Mexico), Hamburg 1977, p. 115-119; International Labour Office (ILO): Wages and working conditions in multinational enterprises, Geneva 1976.

As for the senior posts in the subsidiaries, the international enterprises are being accused of reserving the most important ones for expatriates. This is said to have the result that

- locally recruited staff are relegated to second-rank posts with a lower remuneration and inferior career prospects, and
- in business decisions more weight is attached to the interests of the international enterprise than to those of the host country.

To go by the available empirical data, very few of the staff abroad have been sent out from the home country. In the examined 69 subsidiaries in developing countries the proportion was 0.7 % overall; it ranged from 0.4 % in the automobile industry to 1.8 % in the chemical industry. No more than 13 % of the expatriates belonged to the top management; 63 % were engaged in production and sales below this level. Native staff occupy a definite majority of the managerial posts; there was not a single case in which the management consisted entirely of expatriates.

Aims of Personnel Delegation

The surmise that headquarter staff are sent out to the foreign subsidiary primarily for the purpose of controlling its management is refuted by inquiries into the aims of delegating personnel to them. The content and importance of the aims pursued in practice have been investigated by the present author in another empirical study⁸. He arrived at the following order of priorities:

- (1) Transfer of know-how,
- (2) Development of the management skills of the expatriates,
- (3) Making up for lack of native personnel for senior posts,
- (4) Ensuring uniform management practices throughout the group,
- (5) Training and practical instruction of native leadership cadres,
- (6) Safeguarding of uniform accounting procedures in the group,
- (7) Representation of various aspects in decision-making bodies (e. g. at international headquarters),
- (8) Development of a global outlook among senior personnel.

The low incidence and major objectives of staff delegation to foreign subsidiaries and the types and

levels of work on which the expatriates are employed are convincing arguments against the charge that they are given preference. Incidentally, headquarter staff show little liking for working abroad, and the high cost of expatriate labour is another bar to its use on a larger scale.

Common Interests

Our inquiries have in part disproved and in part confirmed the charges levelled at the international enterprises operating in developing countries which have been outlined in this article. All the criticized aspects have to be subjected to a judicious appraisal in order to arrive at an objective verdict.

The background of the various charges is, one feels, the conviction that there is a fundamental and irreconcilable conflict between the objectives of the development policy of the developing countries and the commercial profit-oriented conduct of the international enterprises. Contrary to this view it has to be pointed out that in important spheres of economic activity the interests of the two sides run largely along parallel lines: To give the subsidiaries in developing countries access to modern technologies is consistent with a fundamental demand of these countries and with micro-economic needs. The same is true of the supply of capital, the education and training of native personnel, the introduction of local suppliers and industrial customers to a higher level of technology, etc. It is thus seen that the commercial requirements of the international enterprise and the demands of development policy are in a number of areas congruent.

The far-reaching congruence of objectives does not rule out conflicts of interest which may lead again and again to open clashes. Mention must be made in this context in particular of the transfer of profits and charges for technology, the import and export activities of the subsidiaries and their integration with a world-wide group in which the group management has to take and enforce central decisions. To sum up our findings in a comprehensive verdict: There can be no doubt that international enterprises are making an important contribution to the industrialization of the developing countries and are thus – one might almost say, unwittingly – important performers of development functions.

⁸ Cf. Ehrenfried Pausenberger, Gerd F. Noelle: Entsendung von Führungskräften in ausländische Niederlassungen (Delegation of senior personnel to foreign establishments), in: Zeitschrift für betriebswirtschaftliche Forschung, 29th year (1977), p. 346-366, see p. 347.