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TRENDS IN HORIZONTAL AND VERTICAL ARRANGEMENTS AND THEIR IMPACT ON COMPETITION: A Comment

Jürgen Stehn

As a discussant, I am really unhappy that I agree, at least to a considerable extent, with the considerations made by the speakers of this session since conferences like this and discussions in general gain from disagreements. But "fortunately" there are two additional points which have been only partly mentioned by the speakers and which should be kept in mind in evaluating the competition effects of foreign direct investments. In order to properly clarify my reasoning, let me start with a brief preface on the characteristic of foreign direct investments.

By definition, foreign direct investments are employed to exercise more or less strong influence on the operation and production of foreign firms. As a consequence, foreign direct investments, in contrast to portfolio investments, transfer not only financial capital but also other production factors such as commercial and technological knowledge, or marketing experiences to foreign countries. Thus, the establishment of foreign subsidiaries can be regarded as a specific strategy to utilize existing intangible assets at foreign markets. However, firms can also exploit their intangible assets abroad by producing exportable goods and services or by engaging in cross-border licensing and international management contracts. As a consequence, foreign direct investment, foreign trade, and cross-border licensing are competing internationalisation strategies. As it is ambiguous at first sight which internationalisation strategy will be advantageous for a given firm at a specific market, the determinants of foreign direct investments have to be deduced on the base of opportunity costs.

Empirical studies have pointed out that the internal decision of a firm between the export and the foreign direct investment strategy generally depends on the relative location-specific advantages of foreign and domestic locations as well as on the degree and structure of tariff and non-tariff barriers in international trade.¹ Firms may prefer the establishment of foreign subsidiaries if the endowment of a foreign country with immobile production factors such as land, physical capital, or immobile, high-qualified labour is superior to that of domestic locations, or if the institutional settings with regard to the education system, the tax system, or the degree of market regulation are more advantageous abroad. Moreover, incentives to shift or diversify production locations also arise if exports are impeded due to tariff and non-tariff trade barriers. In this case, foreign direct investment may serve as a substitute for international trade. Restrictions of foreign trade also give an explanation of the 'cross-hauling' in foreign

direct investment of advanced countries, since trade barriers may encourage firms to shift or diversify their production location even if foreign countries do not offer any location-specific advantages in the traditional sense.

In a comprehensive cross-section, multi-country regression analysis of the investment flows between major OECD countries we have tested this 'tariff-jumping' hypothesis.² The results clearly indicate that existing and expected trade barriers are a significant determinant of foreign direct investments in a great number of advanced countries and that in some countries they even exert a stronger impact on cross-border investment flows than traditional location-specific determinants. In other words, if the costs resulting from tariff and non-tariff trade barriers exceed a certain critical limit firms often change their strategy of internationalisation towards the establishment of foreign subsidiaries. As a consequence, competition on formerly protected foreign markets will be intensified.

In addition, foreign direct investments may strengthen competition in foreign markets if, due to the specific characteristics of intangible assets, cross-border licensing involves high transaction costs preventing, at least to some extent, international trade and competition in arm's length markets. In fact, the markets of intangible assets are often inefficient channels of transfer because of a number of infirmities resulting from the characteristics of intangible assets. Firstly, a severe information asymmetry may exist owing to the inability of the seller to make a convincing disclosure about the intangible asset. This is particularly the case with regard to unpatented process know-how. Secondly, unaffiliated firms abroad may fail to recognise the productive potential of technological developments taking place in a country. Thirdly, there may be buyers' uncertainty about the claims of the supplier about the potential value of the intangible asset. Fourthly, there may also be problems with the codification of knowledge since certain kinds of knowledge are enclosed in the skills of personnel or have a high "tacit" component. Finally, arm's length markets may fail to ensure uniform quality standards which are important particularly in the case of transfer of goodwill assets like brand names. These infirmities lead to high costs of market transactions of intangible assets. Firms tend to avoid these costs by using internal markets, that is to say by establishing foreign subsidiaries. Our empirical studies have shown that foreign direct investments are relatively high in manufacturing industries characterized by above average transaction costs of cross-border licensing. Hence, foreign direct investments may also contribute to intensify competition on international markets for intangible assets.

N O T E S

- 1 See, e.g., *Thomas Horst*, "Firm and Industry Determinants of the Decision to Invest Abroad: An Empirical Study". *The Review of Economics and Statistics*, Vol. 54, 1972, pp. 258-266; *Bernhard HEITGER*, *Jürgen STEHN*, "Japanese Direct Investments in the EC - Response to the Internal Market 1993?" *Journal of Common Market Studies*, Vol. 29, 1990, p. 1-15.
- 2 See *Jürgen Stehn*, *Ausländische Direktinvestitionen in Industrieländern - Theoretische Erklärungsansätze und empirische Evidenz*. *Kieler Studien*, forthcoming.