4. The Role of Government in Linkages Between Multinationals and Local Firms

4.1 Introduction

The previous chapter indicated the business areas in which linkages are occurring between local firms and MNCs in the developing countries examined and the frequency of such linkages. MNCs, however, may not automatically form cooperative arrangements with local firms, even when they would be ultimately beneficial to the firms involved. The factors internal to the MNCs which influenced the linkages were also considered.

External factors, particularly government policies, can have a strong influence on the level and type of linkages formed between MNCs and local firms. Governments in many developing countries seek to attract investment by MNCs as such investment may supplement domestic savings, provide scope for expanded employment opportunities, and facilitate access to new management, technology, labour skills and overseas markets. These benefits are seen as giving rise to higher rates of economic growth and the prospect of enhanced living standards for those in the host countries. Once the companies have located in the host country, governments may then choose to encourage the transfer of information and know-how from MNCs to local firms, recognising the advantages that cooperative arrangements can provide. The impact of government policies, particularly host government industry policy, on these linkages are examined in this chapter.

4.2 The role of the state

Government is one of the prime movers in a nation's economy - affecting the operation of business through laws and taxes; playing an important role in the

development of a nation's institutions; providing the foundation for growth and guiding this along a steady path. Government policies in the areas of industry policy, taxation, industrial relations, trade protection and copyright all affect the operations of foreign owned firms.

The paradigm of what constitutes an appropriate role for government covers a broad spectrum, from the belief that the government should have only minor involvement and the market take centre stage, through to the government playing a direct role in promoting and assisting firms in specific sectors. Government policies affect linkages between MNCs and local firms either directly, by placing limits on how these linkages can be formed, or indirectly by influencing the environment in which all firms operate. The central issue for governments is the choice between taking either a direct or an indirect role in the formation of links between MNCs and local firms to enhance community welfare. This spectrum of government involvement is examined below.

4.2.1 Creating the best business environment

Neoclassical economic theory rejects the notion of industry policy as unwarranted government interference in the operations of the market, which will reduce the efficiency of economic activity. Its origins lie in the work of David Ricardo, who inspired the notion of comparative advantage to explain the different forms of activity across nations and the mutual advantages of trade between nations. This theoretical approach regards all forms of economic activity as intrinsically the same, and contends that the operations of the laws of demand and supply should determine the fate of all such activity. It sees the efficient allocation of resources as the engine of economic development (Wade 1990).

At the broadest level government involvement in the economy can create a business environment in which all firms, including MNCs, can interact freely and which promotes their improved productivity and profitability. Through doing this the government indirectly ensures that MNCs are better placed to create linkages

with local firms. Governments have come to recognise that a better business environment requires two factors - business certainty and an open market.

Unexpected and inconsistent changes in policies and regulations can prevent MNCs from playing a more constructive role in the economic development of host countries. Business decisions can benefit from an understanding of how likely future policy changes may affect their activities, as uncertainty makes it difficult to plan long term operations. Uncertainty increases the propensity of MNCs to take a short term focus, maximising their profits in the short term rather than planning for long term gains. This may include plans to 'get rich quick' and to disregard management practices essential for the maximisation of host country benefits (Contreras 1987). If the policy situation is uncertain, firms will have a preference for liquidity and self-reliance and so will be increasingly unwilling to cooperate with other firms, especially as there may be financial or time costs associated with this. Firms may also be more unwilling to cooperate when the outcome is uncertain or risky, such as in cases of cooperation which leads to innovation or new products. Therefore it would seem host governments need to establish clear rules of the game including well defined and pre-established conditions for change.

An open market is the second precondition for the maximisation of benefits from the presence of MNCs. The deregulation and liberalisation of many national markets has both opened up new opportunities for FDI and enabled existing MNC activities to be more efficiently organised. The promotion of freer trading and investment regimes is not only changing the locational parameters facing MNCs but also compelling governments to examine more carefully the pulling power of their own resources and capabilities including the basic legal and commercial infrastructure for wealth creating activities. UNCTC (1991) found more than 80 countries have liberalised their policies towards inward investment since the mid-1970s. The incentives to foreign investors have been stepped up while the more burdensome restrictions have been relaxed. Authorisation procedures have also been simplified and monitoring requirements much reduced.

While governments see clear benefits associated with MNC investment, they must ensure that their policy prescriptions do not impede the maximisation of these. The last twenty years or so have seen some fairly consistent and universal changes in government-MNC relationships within developing countries. The general tone of interaction between governments and MNCs has shifted from being adversarial and confrontational to being non-adversarial and cooperative.

The fact that MNCs and government are increasingly being seen as partners in advancing national competitiveness partly suggests that the objectives of the two parties are becoming mutually consistent, but also that governments are being forced to give more attention to restructuring or increasing the domestic value-added of MNCs, rather than seeking to get the maximum economic rent generated by their activities. They have also realised that the adoption of structurally distorting policies or confrontational stances towards MNCs is often counter-productive. By adopting market-oriented policies which promote the efficient deployment of both foreign and domestically owned assets, governments are increasingly acting as partners with MNCs.

4.2.2 Overcoming impediments to cooperation - a role for government

The main alternative to neoclassical theory has emerged from what can loosely be described as the "political economy" school. Adherents to this approach regard the process of capital formation as the engine of economic development, and envisage a central role for government in remedying market failure through various interventions (Wade 1990). The notion of an active industry policy is central to most political economy perspectives.

Gunnar Myrdal and Raul Prebisch were seen as dissenters in the 1930s and 1940s when they argued for a strong role for national governments in the development process. Prebisch argued that development policy should have industrialisation as its main objective and be comprised of import substitution through protection combined with selective export subsidies (Meier and Seers 1984). This is at the far end of the policy spectrum from the neoclassical stance and formed part of the

move to blame the problems of developing regions on the past and present policies of advanced industrial nations.

The precepts of neoclassical theory have been re-examined and softened in some respects in order to meet the more obvious criticisms and take up some of the alternatives suggested by the early development economists. The success of the East Asian developing nations with highly interventionist regimes is explained by the notion of the "simulated free market", an argument which suggests that the interventions have had little impact other than to facilitate the operations of the free market (Berger 1979).

As far back as 1962, market economists conceded that promotion of research and development was a legitimate area for government intervention (Charles 1992). There are many other weaknesses in the neoclassical view which have not been explained away (Tanner and Anderson 1994). The rigid notions of comparative advantage give rise to questions about what a nation with no apparent comparative advantages should do. The powerful impact of culture is ignored in neoclassical theory, and many other major factors such as environmental degradation and the broad public benefits of technological change are dismissed as externalities. Issues such as the vulnerability to shifts in the terms of trade, risks of substitution and employment multiplier effects are also not adequately accounted for.

The relatively low levels of cooperation between MNCs and local firms, at the same time as the recognition of benefits from this cooperation, is at odds with commonly held assumptions of the efficiency of markets and the firms. Understanding the constraints preventing markets and firms from achieving optimum business performance (through improved technology transfer, staff training, marketing, and management) is fundamental to designing measures to overcome these barriers. The capacity of the governments of host countries to deliver improved domestic-sector business performance and hence increased economic growth without jeopardising the competitiveness of industry rests on their ability to address, and overcome these constraints.

At the same time it is possible that unwarranted government intervention can reduce the efficiency of market operations. The costs of inappropriate intervention - 'government failure' - can be high and must be taken into consideration when examining ways for government to overcome the barriers to cooperation with local firms.

Market failure

Market barriers can prevent the efficient allocation of resources. In the case of business cooperation, the failure of markets to function optimally creates a 'gap' between the private level of technology transfer, staff training, marketing, and management, and that which is socially optimal. This is important given the driving role that business performance and industrial development play in the economic growth of developing countries. Sources of market failure which can be responsible for the 'business cooperation gap' are discussed below.

Technology transfer, staff training, marketing, and management training by MNCs can provide benefits (positive externalities) to people and organisations which are not party to those activities. As Chapter 3 showed, large local firms gain from MNC staff training programs. Yet an MNC's decision regarding investment or expenditure in this area does not take account of these benefits which leads to underinvestment in staff training from a social perspective. The difference between social and private costs which occurs in this instance is an example of market failure.

Determining the correct levels and associated prices of technology transfer, or staff training for instance, is difficult. The benefiting local firms may be easily identifiable or widespread and difficult to recognise. Policy solutions which will internalise the cost of such externalities, may include subsidised training programs, providing tax advantages for shared technology, or official accreditation or awards.

Information can have the features of a public good. It can be shared at minimal cost and its availability is undiminished by consumption. However, information

can confer an advantage on its possessor and there is often an incentive for it to be under-supplied by the market. Information deficiencies and asymmetries are characteristics of the industrial sector of developing countries and can cause the market to fail. MNCs have a huge advantage in this area over local firms. Uncertainty associated with the characteristics and uses of certain technologies possessed by the MNCs, often associated with the lack of clear and reliable information on technology performance and the excessive cost to local firms of individual verification, can undermine the ability of more efficient technology to obtain a premium price (Akerlof 1970). Porter and van der Linde (1995) also note that highly incomplete information is often associated with changing technologies. In such circumstances trade and cooperation between firms will tend to be dominated by low-price, low-efficiency products despite a willingness to pay a premium for better technology. Similarly a credibility gap can exist in the market for trained staff from MNCs, with risk adverse local firms unwilling to accept or act on the opportunities offered by these skilled staff and managers.

Information is often imperfect, making it necessary for firms to invest resources in the search for information. It would seem that there are advantages of scale in obtaining and assimilating information. Large companies can spread the fixed search costs over a much larger investment than can a small firm. This suggests that MNCs can spend more in the search for an ideal partner firm and so have more knowledge on which to base their decision. From this perspective small firms may be expected to make less of the opportunities of cooperation with MNCs.

Transaction costs have been described as:

> ... all costs incurred in negotiating terms or in discovering, correcting or defending any change in economic organisation, particularly a change towards an optimal position (Mishan 1981, p.403).

Within this taxonomy, search and organisational costs fall under transaction costs. Transaction costs add to the cost of doing business and can result in inflexibility and lack of incentive to innovate within the firm. Lowering transaction costs through the basic provision of ground rules, can allow markets to operate more efficiently by streamlining negotiations and trade between buyers and sellers. As

well as search costs, firms will also incur a range of other 'hidden' costs. For example, changing business operations within a firm can sometimes disrupt normal production processes and involve costs in the form of lost production and disposal of old equipment.

As Katz and Shapiro (1985) point out, transaction costs can be reduced by network externalities. There are benefits associated with mandating compatibility and comparability between products. This may be an area for government action, as is the monitoring of the efficacy of the standards in meeting their goals. This can be done with educational and training standards.

Impediments within the firm

There is often a discrepancy between the efficient behaviour of firms, as implied by economic theory, and their behaviour in practice. The survey of MNCs found that although opportunities for business cooperation with local firms existed, they are seldom the focus of managerial concern. Most local firms are insignificant in size when compared to the MNC, and in many cases the gains from business cooperation with these firms are significantly underestimated by MNC management.

Are there forces at work within MNCs, or even within local firms, which limit the pursuit of business cooperation opportunities? A body of theory sheds some light on the management practices of firms, and how these might diverge from those assumed under more traditional models. Porter and van Linde (1995, p.20) clearly express this shift from the traditional view of business management.

> ...dynamic competition is characterised by changing technological opportunities coupled with highly incomplete information, organizational inertia and control problems reflecting the difficulty of aligning individual, group and corporate incentives. Companies have numerous avenues for technological improvement, and limited attention.

While Palmer, Oates and Portney (1995) disagree with Michael Porter's thesis that inefficiency within firms may be commonplace, and defend the more traditional neoclassical model of business operation which assumes effective optimisation

within firms, they concede that '...[we] do not believe that firms are ever-vigilantly perched on their efficiency frontiers' (p.120).

Indeed Simon (1979) suggested that the very structure of modern corporations may mean that imperfect decisions and actions are the most effective tactics available to managers within firms, given the dynamic and uncertain framework in which decisions must be made. He noted that:

> Several procedures of rather general application and wide use have been discovered that transform intractable problems into tractable ones. One procedure is to look for satisfactory choices instead of optimal ones. Another is to replace abstract, global goals with tangible subgoals, whose achievement can be observed and measured. A third is to divide up the decision making tasks among many specialists, coordinating their work by means of a structure of communications and authority relations. These all fit the rubric of bounded rationality. Organisations are machinery for coping with man's limited ability to comprehend and compute in the face of complexity and uncertainty (p.497).

In such a situation business cooperation with local firms may not tend to attract a high level of managerial concern. This can be rationalised as the optimal use of scarce managerial resources. Given the uncertainties and disparate goals which can prevail within firms, managers tend to spend their time on core activities with little or no emphasis on the potential savings available through adopting a more innovative approach to business cooperation. Three main problems which can lead to inefficiency within firms are discussed in detail below.

In modern corporations the division between management and ownership can lead to decisions which are not profit-maximising when managers' objectives differ from those of the owners of the firm.

> Large corporate bureaucracies, with ownership separated from control, were plagued by information-bias, by risk aversion, by expense preference, and also by satisficing, rather than optimising, behaviour on the part of managers (Marris and Mueller 1980, p.36).

A similar incentive-incompatibility problem arises between managers and their employees. Lack of competitive pressures, the separation of ownership and control, and performance monitoring difficulties, can give rise to 'organisational slack' or 'X-inefficiency' (Liebenstein and Maital 1994). Depending upon the

degree of competition within markets and the capacity to institute incentives between owners, managers and employees, X-inefficiencies may exist over the long run. The presence of X-inefficiencies may be signposted by lack of close or complex relationships with other firms and a lack of interest in innovation and continual improvement. If competitive pressures are weak some organisations may opt for a comfortable existence rather than pursue profit-maximisation.

The Karpin Task Force (1995) has examined the leadership and management skills of Australian managers and points to a broad range of areas for improvement, including strategic skills and the ability to manage diversity. Changes in management and corporate culture may be a key factor in promoting willingness to cooperate with other firms along with core issues within the firm.

As well as affecting market participants, asymmetries of information can also be a characteristic of the relationship between owner and managers, and between managers and staff. Even when owners, managers and employees share common goals, difficulties in communication can undermine the efficiency and responsiveness of an organisation. The bureaucratic structure of large firms and MNCs attempts to limit the span of control through delegation and prioritisation to allow effective processing of information - but it can also have the effect of magnifying errors and so requires an extensive monitoring process (Williamson 1970).

The hierarchical nature of the firm sometimes makes it difficult to communicate detailed corporate goals along the chain of command. Although the potential benefits of cooperation between MNCs and local firms may be recognised on the workfloor, there may be difficulty in passing the information, and its significance, through communication channels to the management.

Scarf (1994) examines the extent to which indivisibilities in the production process provide a rationale for the existence of the large firm. Management can be viewed as a finite input to production and there is a limit to the number of tasks over which a manager's time can be spread before effectiveness is impaired. Management

attention and resources are often scarce and so must be concentrated on those areas deemed most crucial to a firm's success. Simple rule of thumb decision-making for non-core investments and activities, such as inter-firm cooperation, can be understood as attempts to optimise productivity and profitability subject to constraints imposed by the devolution of control within the firm and the opportunity cost of the manager's time. Similarly the benefits from cooperation may be difficult to monitor and isolate from other functions of the MNC, leading to their under-estimation.

Moreover, Pindyck (1991) showed that when decisions are irreversible and involve sunk costs, as is the time invested in organising cooperation between firms, risk and uncertainty can induce actions to be put off or be targeted at quick returns. Janda (1994) found there was a significant bias against new technology in many firms - and this can be interpreted as a preference for established (and possibly superseded) equipment and processes. This preference will place limits on the types of cooperative relationships MNCs and local firms are interested in developing.

The relatively low-level of linkages between MNCs and local firms indicate there may be some market barriers present. The majority of MNCs, nearly 60 per cent, did note the existence of disincentives to dealing with local firms. These included language problems, poor quality products, low skill levels, poor service, and low safety standards. The issue of low safety standards is widely recognized, for example in Thailand in many instances working conditions are poor and building and safety measures are substandard (Edwards, Edwards and Muthaly 1995). MNCs claimed the low level of development of local firms has led to a general feeling of mistrust on their part. This situation is exacerbated by entrenched ways of doing things in MNCs, such as using existing suppliers.

The existence of these barriers to cooperation, both within the market and within the firms themselves, suggests governments can go beyond implementing policies to improve the business environment and in addition design policies and programs which specifically target the formation of linkages between MNCs and local firms.

Governments must also ensure their intervention is not unnecessary and so result in the reduced efficiency of market operations.

4.2.3 Compulsory cooperation

Various governments have tried another option to ensure interaction between MNCs and local firms - they have legislated to enforce it. Nationalisation of industries, foreign ownership restrictions, and performance requirements, are among the methods used by governments to compulsorily require MNCs to work with local firms.

Nationalisation of foreign owned investments by developing country governments reached a peak in the mid 1970s with 68 cases in 1974 and 83 in 1975 (Jenkins 1987). These were heavily concentrated in the primary resources sector. Nationalisation has associated costs including the direct costs of compensation, marketing problems, lack of finance for new investment, increased opportunities for official corruption, and discouragement of further foreign direct investment. This example provides a salutary warning of the problems caused by extreme forms of government intervention in the market.

Foreign equity restrictions on firm ownership are, perhaps, the most common example of compelled cooperation. In many countries FDI legislation still permits only minority equity participation of foreign investors in joint ventures, unless the transfer of technology or the promotion of exports is involved. Such policies also promote the development of the indigenous industrial sector by protecting domestic companies from foreign affiliates operating in the country. The requirement of potential host governments for local joint-venture partners may, however, have the unwanted side-effect of reducing the FDI inflow through scaring away the MNCs, with a loss of potential benefits greater than the reduction in costs.

Another example of government legislation to enforce desired behaviour upon MNCs are government policy actions to increase local employment by MNCs. The

ILO (1976) examined the impact of such policies and showed the existence of unwanted side-effects. The policies examined included restrictions on the entry of foreign staff; the submission of proof that locals could not do the jobs; income tax discrimination; quotas for foreign staff and compulsory employment of a minimum number of local executives. The increased local employment resulting from these policies was not of a sufficient level to outweigh the negative impacts in areas such as reduced MNC output and reduced MNC investment.

By legally forcing decisions on MNCs, such as to take on local partners or local staff, the government is regulating for lowered performance. If the enforced choice was the best economic choice for the MNC then market forces could be expected to push the MNC towards this choice, barring the existence of market failures. Even if, as the section above suggests, there are impediments either within the market or within the MNCs or local firms themselves which prevent this close cooperation, regulations reducing the decisional freedom of MNCs are not the way to overcome these. A government policy to enforce joint ventures, for example, is tackling the symptom rather than the root cause of the problem - the impediments themselves - hence is inefficient.

A balance must be struck between the creation of a favourable investment climate and the judicious use of incentives on the one hand, and the use of regulations to ensure MNC activity is in accord with the development priorities on the other.

4.3 Policies in Indonesia, Malaysia and Thailand

The governments of Indonesia, Malaysia and Thailand have all, to some degree, employed policies that have distorted the flow of FDI to their economies. During the 1960s and 1970s, questions about the positive contribution of FDI to economic development led to the general practice in the developing world of adopting restrictive policies to regulate the entry, activities and operations of MNCs. Asian countries with large domestic markets and infant industries often established mechanisms to protect domestic enterprises from foreign competition in order to

encourage their development. These included the screening and registration of foreign investment; the prohibition or restriction of foreign participation in certain sectors; the control of takeovers; the restriction of foreign capital to minority holdings in certain sectors; the specific regulation of technology agreements; the control of restrictive business practices; and performance requirements for the MNCs (UNCTC 1983).

During the 1980s, however, changing conditions in the world economy renewed the interest of developing countries in FDI as a source of funds for growth. Recognising the importance of competing in global markets, most developing countries which had offered a protected domestic market in the past have now reduced protection and taken steps to promote exports. This process accelerated during the late 1980s due to the two opposing forces of a balance of payments and growth problem and the growing expertise of developing countries in dealing with MNCs.

None of the three countries examined could have attracted significant FDI flows without sustained trade-reform enabling them to keep up with the pressure of international competition. All have carried out substantial domestic economic reforms to encourage private sector development. They have essentially succeeded in stabilising the macroeconomic environment, reducing price distortions, deregulating investment procedures, and increasing general economic efficiency - getting the fundamentals right for all private investment, domestic and foreign.

In addition to an overall liberalisation of FDI regimes, countries have amended their legislation to fulfill such specific objectives as the growth of individual industries, the transfer of technology and the promotion of exports. Most governments have recognised the need for investment protection, and many have guaranteed equal treatment for foreign and national investments.

One interesting point to note is that the control of MNCs by third world governments tends to be individualistic, on a case by case basis. The legislation

and regulation of FDI often formally allows for exceptions, while the process of screening and approval is not clearly specified or uniform.

4.3.1 Indonesia

Originally, manufacturing policy in Indonesia was generally directed towards encouraging import replacement (Department of Trade 1984). The Capital Investment Coordinating Board vetted foreign investment, except in the energy and financial sectors. Since 1987, however, there has been an easing of investment regulations and the introduction of a negative list system to limit the types of investments that require screening and approval. There has also been a reduction in public investment commensurate with the increase in private investment.

Despite moving down the track of investment liberalisation, Indonesia today has some industries remaining closed to FDI unless certain conditions, including export and local content requirements, are met. Performance requirements covering local content, are especially important for engineering, transport and various metals-based manufacturing activities. Restrictions have been maintained on sectors such as logging, motor vehicles, aircraft, retail and wholesale trade, the media, alcoholic beverages and traditional herbal medicines (Davis 1996). While such measures may increase national autonomy, they reduce national efficiency and thus national welfare in the host country.

As well as these somewhat negative restrictions on investments by MNCs, foreign investment in what are broadly called export-oriented industries is specifically encouraged. Full foreign ownership is allowed for firms that export all output, for firms with investments worth more than US$50 million, and for FDI in designated areas. The government provides tax exemptions and reductions in import duties to foreign-owned firms for imported capital goods and raw materials and additional incentives to foreign-owned firms that export more than 65 per cent of their production. Despite export requirements for several sectors, there are no exchange controls (Davis 1996).

4.3.2 Malaysia

A similar pattern of investment restrictions and promotion as for Indonesia, exists in Malaysia. Foreign investment is controlled by the Malaysian Industrial Development Authority (MIDA) using the Promotion of Investment Act 327 (1986) and Investment Regulation No.410 (1988).

Malaysia has strong restrictions on FDI in certain sectors, for example the mass media is entirely closed to FDI. In other sectors all FDI proposals need to be licensed and guidelines on foreign equity participation exist for entry. Entry for foreign investors is governed by:

- the level of exports proposed by the foreign company;
- the level of technology;
- location; and
- local content.

As a result of these guidelines, export requirements set according to the level of foreign equity apply to almost all sectors, there are technology transfer requirements for FDI, and local content is required in certain sectors (Davis 1996). Further to these limitations, restrictions also exist on the employment of foreign personnel. In terms of foreign equity ownership, Malaysia has become more flexible - foreigners may hold 80 per cent of projects that export at least 80 per cent of output. A higher percentage of wholly-foreign ownership is allowed upon approval.

Malaysia has a substantial list of priority sectors, ranging from export-oriented manufacturing (broadly defined) to agriculture, technology and tourism. Incentives exist primarily to encourage FDI in the production and exportation of manufactures. These include tax concessions, low interest rates, and tax exemptions for R&D. As with Indonesia, there are no restrictions on the transfer of profits.

4.3.3 Thailand

Thailand's industrialisation was shaped in the 1960s by import substitution encouraged by high tariff barriers, but in the late 1970s government policy shifted towards an emphasis on manufacturing for export (Department of Trade 1984).

Thailand continues to impose specific restrictions on foreign ownership. In Thailand today foreigners are generally not allowed to own land and foreign investors must acquire an Alien Business Licence. Joint venture requirements apply to some agricultural and mining activities. Additionally, if less than 80 per cent of the production is for exports, restricted ownership applies.

The Board of Investment (BOI), through the Promotion of Investment Act (1977) encourages private investment in priority areas. FDI is encouraged to complement local business and to encourage the transfer of technology. Projects to be given special consideration by BOI include those which strengthen domestic output growth through exports, increase employment and promote regional development. Investment promotion incentives are available to both local and foreign investors. Many incentives exist, including tax concessions for imports of raw materials and machinery. Performance requirements, such as export performance and local content, may be imposed on investment projects granted incentives. As with Indonesia and Malaysia, no restrictions apply to the transfer of profits. Wholly-owned foreign companies can also sell on the domestic market without restriction.

Investments in remote areas are granted additional incentives (Sexton 1996). A BOI industrial scheme encourages companies to bypass Bangkok when setting up new operations. The scheme is based on three industrial zones, with the maximum tax holidays and import duty reductions offered in the area furthest from Bangkok - zone three. The Board created the scheme to reduce chronic and escalating industrial pressure on Bangkok's infrastructure. More than 50 per cent of development was concentrated in Bangkok and its immediate surrounds when the scheme was in its infancy in 1991. Now 1460 new projects have been approved to enter zone three in the past two years. Zone 3 takes in 60 regional provinces and

incentives include a corporate income tax exemption for eight years followed by a 50 per cent reduction for five years. Import duty is reduced by half on raw materials and machinery and a discount of 25 per cent is offered on the cost of installing infrastructure.

4.4 Summary

The MNC subsidiary is a part of a wider global network and it will always be responsive to the demands of the parent company's global strategy. On the other hand the government of the host developing country within which the subsidiary is located will be pursuing its own objectives with respect to economic development in general and industrialisation in particular within its own country. As a result, there is often conflict between these competing sets of objectives.

Understandably, MNCs will not always attach importance to the development priorities of host countries if their satisfaction does not lead to a financial profit. In the absence of restrictive policies they will tend to put private gain before social benefit. They are likely to succeed in doing so in countries where public institutions and policies are weak.

External assistance is not the panacea for all cooperative business arrangement impediments. At the end of the day MNCs and local firms have to make the fundamental decisions themselves. External bodies can however play a significant role in informing and educating firms as well as in overcoming impediments to cooperation, both informational and practical.

The following, final, chapter uses the information in this and preceding chapters to indicate government policies to encourage the flow of information and technology between MNCs and local firms. Additionally, moves that can be made by local firms and MNCs to make this form of cooperation more attractive to each other are also examined.

5. Moving to Better Practices in Working with Multinationals in Developing Countries

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5.1 Introduction

From the previous chapters it is clear that MNCs are storehouses of technology and information, the sharing of which would greatly benefit local firms. Chapter 3 showed the limited extent to which this occurred. How to encourage the transfer of this information and technology is a problem with which many governments have struggled. However, it is not just governments that have an important role to play in linkage formation - the MNCs and local firms themselves can alter their own behaviour so as to maximise the benefits each obtain from cooperation. This chapter provides an outline of best practice behaviour for all three parties that will maximise the benefits from the presence of MNCs in developing countries, to the host economy, local firms and the MNCs themselves.

5.2 Best practice in government policies

The major problem facing policy makers in developing countries is essentially how to manipulate societal conditions in such a way that MNCs acquire an interest in sustaining and accelerating the country's internally oriented economic development. The policy makers, in some way, must induce the MNC to provide larger financial resources, more adequate technology at lower costs, access to global distribution and marketing systems, and other resources in the broadest sense, to local firms. It is a question of how to influence the flows of capital, technology and other resources to the maximum benefit of the host country's economic development. As is shown below, countries have used a variety of ways to do this.

5.2.1 General policy measures

The World Bank (1991) indicated that governments need to avoid intervening in areas where the market is functioning well, but should instead concentrate their efforts in areas where markets prove inadequate. On this basis the World Bank indicated that governments should develop improved links with the international economy (for example, by liberalising capital and product markets), provide a better enabling climate for business (for example, by ensuring adequate infrastructure is available and by adopting pro-competitive regulations and related policies), undertake investment in people (education and training) and seek to maintain a stable macroeconomy.

Similarly Kasper (1991) considers governments need to:

> offer competitive tax rates and an infrastructure that supports productivity growth, as well as secure, simple transparent regulations and a speedy, consistent administration that imposes low compliance costs. The focus should be on business-friendly ways to achieve given regulatory purposes (for example, to ensure given safety or environmental objectives), and to avoid erratic, uneven, profit destroying interventions.

Thailand is the classic example of manufacturing outpacing infrastructure and provides a clear demonstration that the development of efficient and effective infrastructure should be a high priority for developing country governments. Infrastructure development and human resource development were important factors in the success of both Singapore and Hong Kong (World Bank 1993)

Singapore and Hong Kong also made use of an export promotion strategy. The principal virtue of this, with its emphasis on neutrality of policy as between the import and export sectors of the economy, is that it allows for a free play of market forces and the allocation of resources on the basis of comparative advantage (Balasubramanyam, Salisu and Sapsford 1996). Furthermore, because of the neutrality of its policy orientation it offers none of the incentives for rent seeking which an import substitution policy provides. The competition it allows for from both international trade and domestic sources encourages research and development and investment in human capital. Allocation of resources on the basis

of comparative advantage and market forces also promotes specialisation and scale economies.

Governments need to persevere with reforms already underway, including the reduction or removal of government involvement from particular areas, for example the privatisation of public utilities; or the removal of outdated codes and regulations which may have a negative impact on investment decisions (Janda 1994). Economic opening is the necessary stick to force competition and shift resources to their most productive uses.

In discussing the role that governments can play in shaping the environment in which businesses operate, Porter (1990) has concluded by using a case study framework that policies which succeed are those which create an environment in which firms are able to gain competitive advantages, rather than those which involve governments directly in the process.

Kokko et al (1996), however, suggested that it is difficult to formulate general policies to maximise the spillover benefits from FDI for developing countries. Measures to actively promote direct investment from abroad may not be sufficient to generate spillovers. Cantwell (1989) implies that general subsidies to foreign firms and attempts to benefit from MNCs in the development of new industries are not likely to be economically beneficial.

5.2.2 Specific policy measures

While improvements in the broad environment in which businesses operate have a major role to play, a number of specific policy measures are available to governments to influence the behaviour of MNCs. These policies primarily overcome informational failures and provide public goods which would otherwise be unavailable. These can be divided into direct intervention and informational assistance which are further discussed below.

Direct intervention can be in either a positive or a negative sense. On the positive side direct assistance involves governments taking a closer and more active role in bringing MNCs and local firms together in cooperative arrangements. Firms are provided with more 'concrete' assistance to get cooperative arrangements up and running. Governments can directly assist local firms to work with MNCs through the provision of a broker/facilitator; actively introducing firms to MNCs; providing training in the formation of such links; and financial assistance. There are several limitations to the benefits to be gained from this form of direct assistance. It is difficult to design assistance programs that won't be used by firms who were going to form linkages anyway. If programs don't target firms well, they dissipate most of their resources without changing firms' behaviour.

A government industry policy aimed at improving the competitiveness of domestic firms will assist in reducing sources of market failure. Experience in many countries suggests public support of efforts to make firms more efficient is urgently needed. For example, now that international investors have begun to be more interested in high productivity than in low labour costs, government assistance is needed to upgrade technology and labour skills in many developing countries. Those governments that have succeeded in attracting FDI have focused their attention on improving general education, on industrial skill training and on labour and managerial discipline (Bergsman and Shen 1995). Such reforms promote competition within the economy and provide a stimulus to firms to seek out and adopt measures for reducing costs and optimising performance.

Many governments have sought to place performance requirements, a negative form of direct intervention, on MNCs. Performance requirements are conditions which form part of an agreement between a host government and the foreign investor and generally cover areas such as the sourcing of local inputs, employment and training of the domestic workforce, and technology transfer (UNCTC 1988). However, this policy objective may be better addressed by host governments directly supporting the learning efforts of domestic firms (Wang and Blomstrom 1992). It seems likely that these firms will more actively seek new technologies in a competitive environment. Additionally, host governments have renewed

confidence in their ability to defend national interests through calibrated systems of monitoring and control of MNCs behaviour rather than through the use of specific restrictions (Tavis 1988).

Governments can provide information on how to form linkages; on possible partners; on the benefits of linkages; and can identify market/business opportunities for firms. Governments can act as a clearing house for information on inter-firm cooperation and promote techniques which lower the perceived riskiness of working closely with other firms. Providing information to firms allows governments to reach a larger audience more cheaply than direct assistance, while leaving it up to individual firms to form closer relationships. This solution looks easy - simply provide the information - but information is not always credible, even if it is true. There may be grounds therefore, for subsidising an activity in order to demonstrate its real benefits to the user.

Questions can be asked as to whether the government is always the best body to provide the support services required by industries. In some cases they could be delivered by private institutions, such as industry associations, rather than government. In developed countries this is already the case, but in developing countries the necessary private bodies may not exist, or may not be fully resourced. A further role for developing country governments may be to encourage and support the development of these institutions.

What is clear is that the role of governments is becoming more complex. Governments can no longer act simply as monopolies providing certain services or goods, or even simply as regulators. Their functions must include those of organiser, coordinator, assistant and partner. Government policies must be carefully designed and consistently applied to ensure that benefits can accrue to the host countries as well as the MNCs. To succeed, many developing country governments will need to change their orientation and acquire new skills.

5.3 Best practice in MNC behaviour

For MNCs to improve their level of linkage formation with local firms, it may simply be a matter of their gathering information about the business possibilities with local firms. For some, as shown in Chapter 3, this may involve a shift in decision-making power between the parent company and the subsidiary, but for others it may be as simple as calculating the potential benefits. Once an MNC has its eyes opened to a profitable business opportunity, it is not likely to ignore it.

Working with local firms is part of becoming a better corporate citizen in the host country. MNCs are becoming better corporate citizens, but there are strong moves from several directions towards the adoption of a wide-ranging code of conduct to place some pressures on MNCs to improve their operations and practices more rapidly. The form any such code would take is uncertain. Codes may be multilateral or drafted on a bilateral basis, be voluntary or strictly enforced.

The *OECD Guidelines for Multinational Enterprises* (OECD 1994) were first compiled in 1976 and their use is supported by UNCTAD (Moran 1996). The OECD's Guidelines are recommendations from OECD governments to MNCs to help ensure that MNCs operate in harmony with the policies of the countries where they operate. These guidelines cover all areas of MNC operations including worker and product health and safety, competition, financing, taxation, employment and industrial relations, environment and quality standards, as well as locational incentives, extraterritorial mandates and restrictive business practices (Moran 1996). MNCs, through the OECD's Business and Industry Advisory Committee support the Guidelines as a fair and balanced approach to addressing questions arising from the operations of MNCs. They are, however, voluntary standards and have been specifically designed to comply with the existing legislation in the 24 OECD countries. They could, however, provide a useful model for a code of conduct applicable to MNCs operating in developing countries as most of the guidelines are easily transferable to the developing country situation.

More recently the World Trade Organisation (WTO) has embarked on a concerted effort to introduce global rules to govern foreign investment policies. There is considerable resistance, however, from some developing countries against any move to establish a multilateral agreement. The WTO argues the present development of international rules is *ad hoc* and needs more coordination (Dwyer 1996).

Within Australia there is pressure for a code of conduct for Australian-owned firms operating overseas (Burstin 1996, The West Australian 1996). The International Commission of Jurists claimed that Australian companies were engaged in activities in developing countries that would not be allowed in Australia including bribing officials, using child labour and ignoring environmental standards (Burstin 1996). The use of military force to quell worker unrest was an example of this problem that was cited in this dissertation's survey. Other issues seen to be important, and which would need to be examined in the context of a code of conduct, included illegal business practices, taxation, and trade practices including monopolising markets, consumer protection and human rights. The aim of a code would be to force Australian firms operating overseas to maintain the same standards as they do in Australia. The proposed code would be drafted by a group representing the interests of government, business, conservation groups and unions.

For those MNCs which already operate within the standards of any proposed future code of conduct, the impact of a code can be expected to be positive in that other MNC competitors will be operating at the same base level and so will not have any unfair price advantages. A code would also be beneficial in that it could play a role in improving the attitude of some governments, and even the attitude of vocal opponents of MNCs, to the MNCs operations in developing countries. That is, all MNCs will not be punished because of the poor behaviour of a few MNCs.

There are also a few negatives associated with such codes of conduct. Because they will only be applied to MNCs, a much higher standard of business behaviour may be expected of MNCs than of domestic firms, giving local companies an unfair

advantage over MNCs. Bilateral codes, or a code enforced by one developed country on its own firms' foreign direct investment, may also have a distorting effect on MNCs investment decisions. For example, if Australian MNCs were legally required to abide by a code of conduct they may find it harder to compete against MNCs from other countries whose operations are not similarly restricted by codes of conduct.

5.4 Best practice in local firm behaviour

For the local firm it is not enough to rely on government policy, such as those forcing joint venture partnerships on MNCs or requiring local content targets to be reached, to enhance their linkages with MNCs. Local firms should actively seek out the opportunities that the presence of MNCs present. The number of local firms in developing countries is enormous and a firm cannot wait to be spotted by the MNC. Instead they must differentiate themselves and promote themselves to MNCs to tap into the technological, marketing and managerial benefits available.

When entering into cooperative arrangements with MNCs, local firms need to maintain control over their own operations and have a clear and realistic idea of what they aim to gain from the relationship in addition to what they can give. Those local firms already in the most common relationships with MNCs - the customer/supplier relationship - should look to build on this relationship in ways which can benefit both partners. Local firms must move towards being internationally competitive and act to increase their innovativeness. These attributes will act to enhance both their attraction as partners to MNCs and their competitive ranking amongst other domestic firms. Competition from foreign firms can be expected to push local firms towards best practice.

Above all, local firms cannot afford to rely solely on MNCs. There remains an urgent need for developing countries to encourage their own technologies or, at least, to acquire the capacity to adapt or modify imported technologies. There is a growing awareness that the benefits accruing to the national economy depend on

the building up of national industrial, entrepreneurial and technological capabilities (UN 1983).

5.5 Areas for future research

The involvement of MNCs in the economic growth and development process of less developed countries is a popular area for research. This dissertation examined one facet of MNC behaviour, that of linkages to local firms. It has, however, raised two areas where further research would be beneficial.

The first would be to conduct a similar survey to the one used in this dissertation, but from the perspective of local companies looking at the operations of MNCs in their country. Asking local firms what they have gained (and lost) from the presence of MNCs, and linkages with them, would provide useful balance to the work presented here. This was not possible in this dissertation because of the difficulties involved in developing a list of local companies working with MNCs in the three target countries.

Secondly, it was pointed out that in many cases the benefits supplied by MNCs can be accessed separately without the actual physical presence of MNCs. For example, where transaction costs are less than internalisation costs for an MNC, licences and other forms of commercial arrangements could be used to provide technology. A comparison, perhaps using case studies, of the benefits and costs of the differing forms of transferring technology, workforce skills, managerial skills and so forth, may provide information useful to the governments of LDCs.

Appendix 1

Survey form sent to Australian-owned MNCs in Indonesia, Malaysia and Thailand

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A pilot survey was sent to the head offices of five Australian MNCs. The responses and comments from these companies were used to fine-tune the survey used in the three target countries. The final survey form forms Appendix 1.

MULTINATIONALS AND LOCALLY OWNED FIRMS

Purpose of this survey

This survey is to identify the level of cooperation between MNCs and locally owned firms in Thailand, Indonesia and Malaysia. The survey is being undertaken as part of my Master of Economics degree from the University of New England, Armidale, Australia. The analysis of results from this survey forms a substantial component of this degree.

Your completion of this survey will assist in a greater understanding of the relationship between multinational companies and local firms. A summary of the results will be forwarded to all participants.

Due date

Please return the completed questionnaire by __________ and mail it to:

Ms E Ferguson
24 Allott Place
Emu Ridge ACT
Australia 2617

Confidentiality

All information obtained through this survey is strictly confidential, with results not attributed to any individual firms.

Help available

If you have any problems completing this form, or feel you may have difficulties in meeting the due date, please contact Ms Emma Ferguson on **Phone: +61 6 276 4661** or **Fax: +61 6 276 4870.**

Contact

Please indicate the person to be contacted if any queries arise regarding this form.

Name:______________________ **Telephone number:** _____________

Position:____________________ **Facsimile number:** _____________

PLEASE READ BEFORE COMPLETING THIS FORM

- **All questions refer to the company identified on the front page.**
- **A 'local' firm is one which is at least 50% locally owned.**
- **Small firms have less than 10 employees; Medium firms have 10 to 50 employees; Large firms have more than 50 employees.**
- **Please note the currency used when answering questions.**
- **Please feel free to include any literature on your company's operations and to attach pages for any further comments.**

1. Year company's operations established in this country: ___________

a. Did this involve a buy out of existing local company? ☐ Yes ☐ No

b. What is the capital investment in this company? ______________

2. Level of Australian ownership ___________%

3. Most recent annual turnover (please note the currency and the year) ____

4. Proportion of production exported (by value) _________%

5. List three major products

a. ____

b. ____

c. ____

6. For the major product:

a. Number of competitors located domestically:

☐ Less than 5 ☐ 5-9 ☐ 10 or more competitors

b. Proportion of competitors with majority local ownership: ___ %

c. Number of competitors internationally:

☐ Less than 5 ☐ 5-9 ☐ 10 or more competitors

7. Which of the company's business decisions are made locally?

a. Output levels ☐ Yes ☐ No

b. Hiring of labour

management ☐ Yes ☐ No

other ☐ Yes ☐ No

c. R&D ☐ Yes ☐ No

d. Investment ☐ Yes ☐ No

e. Choice of suppliers ☐ Yes ☐ No

A. LABOUR

8. Please fill in numbers:

Number of employees	Local	Foreign nationals
Unskilled		
Skilled		
Managerial		

9. Does the company have any policies or programs to specifically put nationals into managerial positions? (Briefly describe)

____

____

____

____

10. Has the company led to the introduction of new management practices to local firms? (Briefly describe) ____________________

____

____

____

____

____

11. Has the company led to the introduction of new workforce skills in the host country? (Briefly describe) ____________________

____

____

____

____

12. Level of staff movement to majority locally owned companies:

	Average number annually	Average size of company they move to:		
a.	unskilled _______	☐ Small	☐ Medium	☐ Large
b.	skilled _______	☐ Small	☐ Medium	☐ Large
c.	management ______	☐ Small	☐ Medium	☐ Large

13. On average does the company pay higher wages than local competitors?

☐ Yes ☐ No

Why? ______________________________________

____

____

____

14. Are company workers covered by a union? ☐ Yes ☐ No

B. EXPORTS

15. Does the company have export arrangements with local companies?

☐ Yes ☐ No (go to question 16)

a. What percentage of exports does this cover? ____________%

b. On average are the firms involved:

☐ Small ☐ Medium ☐ Large

c. Please describe these arrangements ________________________

____

____

____

____

____

16. Is the company located in an export processing zone? ☐ Yes ☐ No

If yes, has this affected contact with local firms? (Briefly describe)

____

____

____

____

C. TECHNOLOGY

17. What is the nature of the technology used?

a. ☐ Basic ☐ Intermediate ☐ Final

b. ☐ Single product ☐ Multiproduct

c. ☐ Simple product ☐ Complex product

d. ☐ Single process ☐ Multiple process

18. What type of technology has been transferred to local firms?

	Direct transfer	Leakage
☐ production/capital technology	☐	☐
☐ process technology	☐	☐
☐ managerial technology	☐	☐
☐ marketing technology	☐	☐
☐ other ____________________	☐	☐

19. What level of technology does your company use compared to local competitors?

☐ Lower technology (more labour intensive) ☐ Same technology ☐ Higher technology (more capital intensive)

20. Has the company established R&D facilities in the country?

☐ Yes ☐ No

21. Does the company carry out joint R&D with local firms? ☐ Yes ☐ No

If yes,

a. How many firms are involved? _______

b. What is the annual value of this R&D expenditure? _______

c. What were the three main factors that motivated your firm to enter into technical collaboration with local firms?

____

____

____

22. Do staff meet officially with local companies to discuss technology/ technological problems? ☐ Yes ☐ No

How often? ________________

23. Has the company developed distinctive products and/or technologies for the local market?

Products: ☐ Yes ☐ No

Technology: ☐ Yes ☐ No

24. Has the company been involved in the introduction of new technology to the host country (Briefly describe) ________________________

____

____

____

____

____

____

____

____

D. CUSTOMER/SUPPLIER

25. What proportion of output (by value) is sold as an input to local firms? ________%

a. In general, are these firms: ☐ Small ☐ Medium ☐ Large

b. Level of technology of these firms: ☐ High ☐ Medium ☐ Low

26. What percentage of inputs are bought from local firms? ________ %

a. Are these inputs:

☐ Raw materials ☐ Semi-processed ☐ Highly processed

b. Are these firms: ☐ Small ☐ Medium ☐ Large

27. Are activities subcontracted to local firms? (Briefly describe)

____

____

____

____

____

____

____

28. Have new products been developed with domestic suppliers?

☐ Yes ☐ No

E. OTHER ISSUES

29. Did the presence of any local firms influence the choice of location? (Briefly describe) ______________________________

____

____

____

____

30. Have national government policies or programs influenced the level of company's working with local firms? (Briefly describe)

____

____

____

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____

____

____

____

____

31. Is cooperation with local firms consistent with your corporate strategy? (Briefly describe)

____

____

____

____

32. What are the major disincentives to dealing with local firms? (Briefly describe) ____

____

____

____

____

____

THANK YOU FOR YOUR ASSISTANCE

Appendix 2 Firms surveyed

A2.1 Introduction

This appendix expands on the information presented in chapter 1 (section 1.3) concerning the conduct of the survey of Australian-owned MNCs' operations in Indonesia, Malaysia and Thailand. It also presents information on some of the characteristics of the respondent firms.

The address list of the surveyed companies was developed by gathering names of Australian companies with operations in the target countries. This was done by searching the IBIS database which is a CD-ROM containing information gathered from the annual reports of major Australian companies. These Australian-based companies were then contacted by letter or telephone and contact names and addresses for their overseas operations requested. In total 51 Australia-based firms were approached for these details, 26 responded positively which provided a total of 62 addresses for Australian owned operations in Indonesia (23), Malaysia (30) and Thailand (9).

A self-administered mail survey was chosen as the appropriate way to collect opinions, attitudes and factual data from the geographically dispersed sample. Of the MNC subsidiaries surveyed, two replied that the survey was not applicable to their operations, 12 (20 per cent of the remaining 60 firms) responded positively and the remainder were registered as non-responses.

Responses were received from all three target countries, but the response rate varied between these countries. Thailand had the highest response rate (44 per cent), Malaysia followed with 15 per cent, and Indonesia had a response rate of 13 per cent. The 20 per cent overall response rate (after a reminder letter) was considered to be satisfactory.

A2.2 A profile of survey respondents

The respondent MNCs were members of corporate groups which ranged from small to very large organisations, both in terms of staff levels and turnover (see table A2.1). Although no primary industries were represented among the respondents, there were both service industries and manufacturers.

Table A2.1: Characteristics of respondent MNCs

MNC	Estab.	Australian ownership (%)	Exports (%)	Annual Turnover, $m (1996)	Staff	Country	Products
1	1988	100	0	12	90	Thailand	Protective coatings Timber finishes Decorative paints
2	1971	100	0	-	4	Malaysia	Financial services
3	1994	100	0	-	5	Thailand	Fibre cement Sandwich panel
4	1988	75	5	593	76	Indonesia	Paint
5	1991	35	20	209	352	Malaysia	Ethylene Propylene Pyrolysis gasoline
6	1991	30	40	180	220	Malaysia	Polyethylene
7	1994	50	0	38	80	Indonesia	Project mngt. Design Construction mngt.
8	1993	100	0	44	66	Thailand	Project mngt.
9	1992	49	0	64	1569	Thailand	Construction Civil engineering
10	1991	51	35	6	100	Malaysia	Plastic packaging Plastic crates Plastic drinkware
11	1994	65	15	63	171	Indonesia	Zincalume steel Colorbond steel
12	1979	30	35	15	46	Malaysia	Metal roof tiles Metal roof sheets Accessories
Av.	**1989**	**65**	**12.5**	**135**	**232**	-	-

A2.3 Non - response

A major weakness of any mail survey is non-response. Nothing is known about these non-response companies and, as they form a substantial part of the sample population, this can be a major problem. Non-response leads to the possibility of the response being skewed.

The overall response rate of 20 per cent means that 80 per cent of those MNCs who were sent surveys did not complete and return them. The survey responses pointed to a general lack of cooperation and close business relationships between MNCs and local firms. From this it can be hypothesised that many of the non-respondent firms did not cooperate with local firms to any great extent, or at all, and therefore did not see the survey as relevant to them. If this were the case, the results of the survey would be biased, overestimating the level of cooperation occurring between MNCs and local firms.

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