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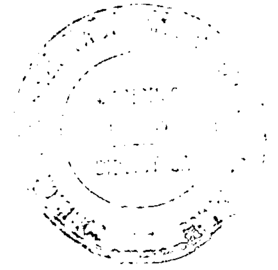

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The Role of Transnationals in a Western Hemisphere Free Trade Area

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The Role of Transnationals
in a Hemisphere Free Trade Area

With the wave of liberalization that is sweeping through much of the western hemisphere, various national leaders have advanced the idea of creating a western hemisphere free trade area.[1] Seen by some as an obvious extension of the liberalization process and by others as a prudent response to the strengthening of the European Community, the possibility has gained some added credence with the negotiations over a North American Free Trade Area, which would encompass Mexico, Canada, and the United States.

In all these proposals, however, one can observe a curious omission--the absence of any direct reference to transnational enterprises, epitomized by such entities as IBM, Toyota, Siemens, and other such organizations. These entities usually consist of a network of related enterprises, with a parent domiciled in one country and a web of subsidiaries in a number of other countries, all operating in response to a common strategy and drawing on a common pool of technological and financial resources. Entities such as these, it is widely agreed, will be major actors in the creation of a western hemisphere area. Yet the distinctive issues

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1. In his 1992 State of the Union Address, President Bush said, "[I]n our major trade negotiations, I will continue pushing to eliminate tariffs and subsidies... within our hemisphere through the North American Free Trade Agreement, and through the Enterprise for the Americas Initiative." Transcribed in "State of the Union," New York Times January 29, 1992, p. A16. President Carlos Salinas de Gortari of Mexico and Prime Minister Brian Mulroney of Canada, are also on record in support for a successful conclusion to a North American free trade agreement. Guy Guliotta, "Talks on North American Free Trade Pact Advance," Washington Post, Jan. 16, 1992, p. A28.

generated by the creation and operation of these networks are scarcely recognized in the provisions under consideration for the formation of such an area.

Antecedent Agreements

The absence of any direct reference to the transnational enterprise is not unique to the western hemisphere proposals. The same characteristic is to be found in the various agreements and proposals that have been serving as antecedents to the western hemisphere proposal, notably the four-year-old US-Canada free trade agreement and the gestating North American Free Trade Agreement.[2] Yet even a casual perusal of these agreements fortifies the conclusion that the policies of transnational enterprises are likely to be critical in determining their consequences. The 21 chapters of the US-Canada agreement, wide-ranging, ambitious, and complex, embody numerous provisions that are having their effects largely through the responses of such enterprises, including provisions for the step-by-step reduction and eventual elimination of tariffs between the two countries, for the continuation of a free trade arrangement that had previously been in effect in automotive products, for participation in government procurement and in the provision of selected services by suppliers from the other country, for the temporary entry of business persons, and for

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2. For the text of the Canada-US agreement, see Canada, Department of External Affairs, International Trade Communications Group, The Canada-US Free Trade Agreement, Quebec, 1988. A 40-page summary of the 2000-page draft treaty containing the North American Free Trade Agreement has been distributed by the governments of Canada, Mexico, and the US, entitled "Description of the Proposed North American Free Trade Agreement," August 12, 1992.

national treatment to investors from the other country. The North American free trade arrangement covers roughly the same ground, extending and enlarging the provisions in various respects to include Mexico. Nowhere, however, will these undertakings directly acknowledge the existence of transnational enterprises.

Treaties of a similar kind elsewhere in the world are also silent on the existence of such institutions. The treaty establishing the European Community, for instance, makes no direct reference to the existence of transnational enterprises. But the Community's institutions, including notably its Council of Ministers and its Court, are endowed with such strong autonomous powers in issues relating to the creation of a common market that the omission is unlikely to restrain them very much in taking cognizance of the existence of these institutions as necessary. Indeed, the idea of a transnational enterprise has begun to take tangible shape inside the Community with the occasional recognition of the existence of "groups" in the decisions of the European Court and in the actions of other Community bodies.[3] The institutions contemplated for the administration of western hemisphere free trade area, on the other hand, are unlikely to possess any analogous degree of autonomy and adaptability, so that the omission in that context is likely to have a much more limiting effect.

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3. D.G. Goyder, EEC Competition Law (New York: Oxford University Press, 1988) pp.385-392.

Assessing the Consequences

There is a widespread conviction among economists that the developing countries of the western hemisphere may have overdone their policies of national protection and import substitution during the 1950s and 1960s, given the limited size of the national markets in which such policies have been applied as well as the stifling effects of such policies in the long run on innovation and growth. The basic justification for a western hemisphere free trade area, therefore, rests on the proposition that its members will allocate their resources more efficiently by increasing the size of the market in which goods and services move freely. At the same time, however, analysts recognize that a free trade agreement among a limited group of countries may divert the participating countries from engaging in an even larger global market. Accordingly, one central idea in the economic literature is that a free trade area can be either trade-creating or trade-diverting--trade-creating when it generates trade between the participating countries that previously had been blocked by protection, but trade-diverting when it rechannels existing trade flows from efficient outsider countries to less efficient insider countries.

The concept of trade creation versus trade diversion, however, is usually recognized as less than adequate for the formulation of national policy--too static in its estimate of costs and benefits, too neglectful of the possibilities of benefitting from economies of scale and scope, too insensitive to the political and social implications of any such arrangement. But it does serve to

underline one critical, if obvious, lesson: When weighing the costs and benefits of a given policy, one has to have a counterfactual world in mind with which to compare the results of the proposed policy.

My counterfactual for this purpose is based on the assumption that in the absence of a western hemisphere free trade area, the trade and investment patterns of the hemisphere will continue roughly in the patterns of 1992. The critical elements of that counterfactual include: an assumption that the countries of the western hemisphere would still pursue a relatively liberal approach to foreign direct investment (albeit one that makes frequent use of TRIMs, TRIPs, and other conditioning requirements); that they would make a relatively restrained use of tariffs, export taxes, and trade licenses (while nevertheless retaining and occasionally exercising the right to restrict both imports and exports of trade, services, and workers); and that they would do little or nothing to harmonize their national regulations bearing on international economic transactions, such as environmental controls, consumer safety, workplace safety, licensing of professions and services, and other regulatory measures. Needless to say, my counterfactual also assumes the existence of separate national currencies and relatively uncoordinated monetary and fiscal policies.

Where do transnational enterprises figure in the assessment? Wherever the rules of the game are to be changed with respect to investment and trade, there is a strong presumption that transnationals will play a major role in the response to those

changes. The existing theory relating to free trade areas offers no hint of the distinctive aspects of their reactions. But my contention in these pages is that the reaction will be distinctive in various respects. The central question, then, is: How does the existence of these transnational affiliates affect one's estimates of the consequences of a western hemisphere free trade area?

Transnational entities have played a key role in the development and industrialization of developing countries, a role that has manifested itself in technology flows, human resource development, investment, and trade.[4] In the western hemisphere, Mexico has represented the outstanding case in which transnationals have played a key role. Over 50 percent of the country's exports of manufactured goods, for instance, comes from US-owned affiliates alone.[5] For the developing countries of the western hemisphere in the aggregate, of course, the relative importance of transnational enterprises in foreign trade has been much lower; but even at that level, US affiliates alone accounted for about 15 percent of the exports of manufactured goods.[6] Moreover, a substantial portion of these transactions were usually undertaken between members of the same network.

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4. For an overall evaluation, see World Investment Report 1992, United Nations, New York, 1992, pp. 163-221.

5. See for instance Foreign Direct Investment and Industrial Restructuring in Mexico, UNCTC Current Studies, No. 18, United Nations, New York, 1992, pp. 45-57.

6. World Investment Report 1992, United Nations, New York, 1992, pp. 200-214.

There have been occasional cases, of course, in which countries have industrialized successfully without much direct participation by transnational enterprises. Japan has graphically demonstrated, for instance, that a national economy can grow successfully without giving any substantial role to foreign-owned subsidiaries; with a sufficient commitment to education and savings, with the existence of strong private incentives and adequate public resources, governments may rely on nationally-owned enterprises to implement successful programs of modernization and expansion. Nevertheless, most countries have been unable or unwilling to follow the Japanese model, and have availed themselves of foreign-owned enterprises to spearhead some critical areas in the development process. Accordingly, the transnational enterprise has become an important institution through which international business is conducted in developing countries.

To assess the role of transnational enterprises in shaping the effects of a free trade area, it is important to know something of the motives of managers in creating and enlarging such networks. Obviously, not all transnational networks are alike. In some, such as those in the raw material industries and in some branches of electronics, a vertical structure is dominant, featuring firms that produce materials and components for processing and sale by affiliated firms in other countries. In others, such as pharmaceuticals, chemicals, banking, and fast foods, a horizontal structure dominates; while the units in the network draw on a common pool of technology or capital and on a common set of trade

names, they engage in very similar processing and selling activities in different markets. In yet others, as in automobile manufacture, horizontal and vertical elements of a transnational structure are combined.[7]

What transnational networks seem to share, however, is a propensity to cluster in industries in which the barriers to entry are high; although the nature of the barriers may vary, the linkage between high barriers and a propensity to form transnational networks is strong. So, for instance, the research and patent strengths of the leading pharmaceutical firms, the economies of scale and the process know-how of the leading chemical firms, and the trade-name and food-processing skills of fast food chains all seem to be intimately related to the presence of transnational networks.[8]

That association tells us something of the motivations of firms when they set up subsidiaries in foreign countries. Most possess some rent-earning capabilities that stem from the existence of these entry barriers. In theory, the enterprises concerned could exploit their rent-earning capabilities by means that did not entail the creation of a transnational network, such as exporting their products or services to independent distributors, or

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7. Alfred D. Chandler, Scale and Scope: The Dynamics of Industrial Capitalism (Cambridge, MA: The Belknap Press, 1990), pp. 28-45 and 141-145; Globalisation of Industrial Activities: Four Case Studies, OECD, Paris, 1992, pp. 29-60.

8. Peter J. Buckley and Mark Casson, The Future of the Multinational Enterprise (New York: Holmes & Meier, 1976), pp. 32-65.

importing their required components from independent suppliers, or licensing their patents, technology, or trade names to local enterprises. Firms that have failed to take up such options, we can assume, have concluded that exports to independent distributors, imports from independent suppliers, and licensing to independent producers were inferior ways to exploit their rent-earning strengths.

In many instances, the reasons for that conclusion are obvious. A marketing strategy based on exports to independent foreign distributors or licensing of independent producers may or may not prove efficient in terms of the costs of production and delivery; but, even when it is efficient in a narrow short-run perspective, it deprives the exporter of various advantages of internalization, such as close observation of the foreign market and sensitive adaptation to its distinctive needs. Besides, the exporter is always exposed to the threat of import restrictions imposed by foreign governments, especially at the point at which a large local market for the firm's product has developed and other firms have begun to acquire the technology required for production. Firms that are considering whether to acquire their needed imports from independent foreign sellers face the same kind of choice; although an independent source may seem economic in the short run, it may reduce the opportunity and increase the risks for the achievement of adequate quality control and just-in-time delivery.

Licensing independent foreign firms in order to exploit a technological asset also has its serious drawbacks, entailing high

transaction costs and major uncertainties between the contracting parties. The transaction costs are high for a variety of reasons, including the difficulty of both sides in securing the information needed for a rational decision; the licensee cannot know whether the technology is worth the price until after the license has been issued, and the licensor cannot know how the licensee will use the information until after it has been released.

But in industries in which competitors are large and few in number, there are other reasons for maintaining a transnational structure as well. In such situations, competition in the marketplace is not an impersonal battle among anonymous adversaries.[9] Each participant must anticipate that others in the market are engaged in a long-term campaign aimed expressly at weakening the participant's capacity to attack or defend. Each will expect that its rivals will deny it access to markets or access to raw materials and components whenever such denial would weaken its competitive power. As a result, there will be a tendency on the part of each participant to develop self-contained vertically integrated structures, a tendency to match the moves of adversaries into new markets or new sources of supply, and a tendency to strive for maintaining global market share.

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9. Richard Caves, American Industry: Structure, Conduct, Performance, 5th ed. (Englewood Cliffs, NJ: Prentice Hall, 1982), pp. 40-44. Frederick T. Knickerbocker, Oligopolistic Reaction and Multinational Enterprise (Cambridge, MA: Division of Research, Graduate School of Business Administration, Harvard University, 1973).

Picture a world, then, in which a considerable part of the goods and services crossing international borders represents the transactions of enterprises that are units in a transnational enterprise. As units in the enterprise, the firms involved draw some of their resources from a common pool, including in many instances resources that are intangible and distinctive, such as data banks, software systems, technology, and managerial expertise. By and large, these enterprises operate in markets in which barriers to the entry of competitors are relatively high. Rivalry exists among those that have surmounted the barrier; indeed, the rivalry is often severe. But it is a rivalry among the few, not the kind of rivalry encountered in an impersonal market made up of many buyers and sellers. How, then, are the enterprises concerned likely to respond to the creation of a free trade area in the western hemisphere? And how are governments likely to react to those responses?

Enterprise Responses

Although economists have had a great deal to say about the trade effects of the creation of a free trade area, generalizations about the effects of such an area on the shape and spread of transnational enterprises have been much less common. Of late, however, some have been hurrying to make up for this oversight, producing some useful guidelines for an exploration of such effects.[10]

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10. For a review of some of the effects of the US-Canada free trade agreement on the locational decisions of transnational enterprises, see "Regional Economic Integration and Transnational

To track the responses of enterprises to the creation of a free trade area in the western hemisphere, it helps to distinguish between two kinds of firm strategies: those that see the creation of the free trade area as a signal for altering their strategies for market penetration; and those that see it as a opportunity for acquiring or providing resources at lower cost.

Serving the market. For enterprises interested primarily in penetrating markets, another set of distinctions is useful. Some firms already marketing their products in a number of member countries of the proposed free trade area will see the establishment of the area as a signal for reconsidering whether their existing logistical networks need to be reshaped; other firms, producing and selling in only a single country of the area, will consider whether the creation of the area offers new opportunities or threats. It is useful to track the consequences for each of these groups separately.

Among those already marketing their products or services in a number of countries in the area, US-based producers will figure prominently. Practically all major US-based exporters of goods or services have found it expedient, under the conditions that have existed in the western hemisphere, to set up producing subsidiaries in a number of the national markets in which their customers are located, with special emphasis on the relatively large markets of

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Corporations in the 1990s: Europe 1992, North America, and Developing Countries," UNCTC Current Studies, no. 15, United Nations, New York, pp. 31-34. A number of other studies of this important subject are currently in progress.

Mexico, Brazil, and Argentina. The present distribution of the producing facilities of such enterprises in the western hemisphere has been heavily influenced by the national import-substituting policies that were characteristic in the area until the mid-1980s. These policies tended to generate relatively small plants that were tilted toward the last stages of processing in the products they offered to the local market, such as automobiles and consumer electronics; such plants tended to rely heavily on imports for those components in which scale economies or tight quality control were important.[11]

With the introduction of a free trade area, these firms would still face numerous national differences, including currency differences, fiscal differences, and internal regulatory differences. But the creation of a free trade area will mean that the role played by tariffs and quotas, existing or prospective, will figure less importantly in the plans of these enterprises. For relatively large markets, such as Mexico and Brazil, the possibility of generating domestic facilities for such components has been greater than for smaller markets such as Ecuador and Peru. Moreover, in these larger markets, the follow-the-leader phenomenon has been most in evidence, a pattern in which global competitors sought to maintain their respective market shares by following

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11. For a discussion of consumer electronics, see Richard Newfarmer, ed., "International Oligopoly in the Electrical Industry" in Profits, Poverty, and Progress (Notre Dame: University of Notre Dame Press, 1985) pp. 113-149. For a discussion of automobiles, see Douglas C. Bennett and Kenneth E. Sharpe, "The World Automobile Industry and Its Implications" in same, pp. 193-226.

their rivals into any major market. By and large, the pattern tended to create surplus capacity, as producers relied upon the protection of the market to shield their undersized plants.

For these US firms, the immediate effects of reducing existing trade barriers and of altering expectations about future trade barriers will not be spectacular; too many factors will continue to distinguish national markets from one another. But eventually a considerable number are sure to reconsider their strategies in serving the various national markets of the area. And, wherever scale economies are not being fully exploited in their existing plants, these enterprises are likely to move in the direction of consolidating their production in a smaller number of larger plants.

This response, like practically every other associated with the transnational enterprise, is likely to be more rapid and more pronounced than the reactions that would exist in a world populated only by national enterprises. For one thing, the response of a transnational firm to a change in the structure of its markets, such as the liquidation of a subsidiary and the transfer of its function to another facility, is likely to represent only a marginal adjustment in the structure of the network; by contrast, the adjustment of national enterprises to such events, such as the liquidation of the home facility in the face of competition from another supplier in the free trade area, is likely to be an event of profound significance for its owners and managers.

Contributing to the relatively hesitant reaction of national producers are a number of other factors. Such producers are commonly tied to a given location by considerations of history and inertia, such as the family's elevated position in a given locality, and its inside track in the politics of its home country. Besides, the capacity of national enterprises to scan the alternative possibilities in the various countries of the free trade area and its sense of assurance regarding the reliability of the information it receives are likely to be far weaker than the analogous reactions of a seasoned transnational enterprise.

In addition, because the incremental expansion of existing plants is usually less costly than the establishment of a new greenfield venture, transnational enterprises will find it easier to respond to the changed conditions created by the free trade area than would national firms. And because the characteristic follow-the-leader instinct of transnational firms in setting up production facilities has been more fully in evidence in large markets than in small, plants in the larger countries are likely to attract a disproportionate share of the relocated production.

Moreover, short-run responses such as these can easily have long-run locational effects. Up to a point, consolidation in a given area encourages more consolidation in that area. Existing agglomerations often exercise an attractive force, inasmuch as they may provide external facilities such as reliable utilities, transportation, and repair services; so the immediate effects of

any free trade agreement in shifting the location of production can prove to have somewhat more lasting significance.

Unlike the units in a transnational network, therefore, firms whose activities have been confined to one country in the prospective free trade area are likely to see the development of a free trade area as creating more threats than opportunities. For them, a major question in the short run will be whether the existing transnationals in the area will succeed in driving them out of business. Their responses over the longer term, to be sure, may prove quite different from their earliest reactions; linked more closely to foreign markets by the new free trade arrangements, some may discover new opportunities for export or may develop producing and marketing subsidiaries of their own in other countries of the area. But the earliest reactions of these national enterprises are likely to be dominated by concerns over new threats rather than by perceptions of new opportunities.

Not all transnational enterprises, however, are headquartered in the United States. Even without the stimulus of a free trade area, some firms headquartered in the developing countries of the western hemisphere, such as Mexico and Brazil, have already taken to establishing subsidiaries in other parts of the western hemisphere and elsewhere, as the home location has proved uneconomic for serving foreign markets.[12] Like the national firms

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12. Louis T. Wells, Jr. "Foreign Investors from the Third World," in Krishna Kumar, and Maxwell G. McLeod, eds. Multinationals from Developing Countries (Lexington, MA: Lexington Books, 1981) pp. 23-36.

that heretofore had not ventured into foreign countries, these firms could accelerate the spread of their networks into other parts of the western hemisphere in response to the creation of a free trade area. On the other hand, these firms could respond like some of the veteran transnationals, consolidating their existing facilities in fewer locations in the short run, as their fear of import restrictions in the area declines; and as long as that reaction predominates, it could produce a more concentrated pattern of production in the area.

The impact of a free trade agreement on the behavior of firms that heretofore have done no marketing in the region deserves special consideration. The consummation of a free trade area agreement will have some of these outside firms considering whether to establish a production facility in the region for the first time; already, for example, one sees a heightened interest on the part of Japanese firms in availing themselves of the more open trading conditions of the western hemisphere. However, unfamiliar with the advantages and drawbacks of alternative locations, these firms may show an especially strong propensity to locate in existing agglomerations, that is, in the United States or in the larger industrializing countries such as Mexico and Brazil.[13]

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13. Anthony Blackbourn, "The Spatial Behavior of American Firms in Western Europe," Spatial Perspectives on Industrial Organization and Decision Making (New York: Wiley, 1974) pp 245-264. See also, Cletus C. Cockburn et al., "State Characteristics and the Location of Foreign Direct Investment within the United States," Review of Economics and Statistics LXXIII, no. 4, (November 1991) pp. 675-683.

But the agglomerative tendency has its limits. To the extent that some factors of production are immobile, such as land and infrastructure, the continued growth of the existing poles will eventually generate its own limits; at some point soon, the increasing costs of production at these locations will eventually have new entrants looking in other areas, just as they have done in their progression through the various southeast Asian countries during the past few decades.[14] So while the agglomerative urge may figure importantly in the early reactions of enterprises to a free trade area, it cannot be expected to persist forever.

Indeed, as one observes the shifting patterns of industrial location inside each of the large national markets of the western hemisphere, one can readily see how existing agglomerations eventually repel rather than attract new enterprises. For instance, automobile producers from Japan appear to prefer Canada, Mexico, or the US southeast to traditional US midwest locations; in Mexico, the capital city is losing industrial jobs to other locations, especially to the north; and in Brazil, Sao Paulo is suffering similarly from a surfeit of industrial enterprises. There are strong reasons, therefore, for expecting the early lead of the larger economies to be diluted in time.

A second consideration leading to the eventual dispersion of productive facilities is based on some simple principles of location. In a footloose industry whose production facilities

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14. Sanjaya Lall, "Direct Foreign Investment in South-East Asia by the NIEs: Trends and Prospects," Banca Nazionale del Lavoro Quarterly Review, no. 179 (December 1991), pp. 463-480.

enjoy economies of scale and whose delivery costs are significant, the minimization of total delivered costs leads to a dispersed production pattern throughout the market.[15]

In any event, in the short run, one should probably expect the larger national economies in the region including the United States to benefit from the redistribution more than the smaller ones, as relocation decisions favor the larger economies. In the longer run, all members of the free trade area could conceivably benefit from these various reshuffles in location, as the drive for lower labor costs overcomes the drive for scale and the advantages of agglomerations. Besides, if some modicum of price competition persists in spite of the oligopolistic structure of the industries concerned, some of the benefits of increased efficiency associated with the reshuffling of facilities could be passed on to workers and consumers throughout the free trade area.

Sourcing for low cost. I observed earlier that many transnational networks were created as vertical structures, with some units devoted primarily to producing materials and components for export to other units in the network. In the present context, the relevant question is whether the membership of such units in a transnational network will in any significant way affect their responses to the creation of a free trade area.

We may begin that inquiry by considering the responses to a free trade area on the part of a small subset of firms, namely, raw

15. Edgar M. Hoover, Location Theory and the Shoe and Leather Industry (Cambridge, MA: Harvard University Press, 1937) pp. 34-59.

materials producers with exportable supplies; these include, for instance, the oil, aluminum, and iron ore exporters of Venezuela, the oil exporters of Ecuador and Mexico, and the copper exporters of Peru, along with a number of US-based entities producing in the United States and elsewhere in the prospective free trade area. In the past few decades, many of these firms went through major transformations. Privately owned firms based in the advanced industrialized countries lost some of their raw material sources through nationalizations, while state-owned producers in the developing countries expanded such holdings; the result over all was a considerable decline during the 1970s in the vertical structure of firms in these industries.

By the 1990s, however, the leading state-owned and privately owned firms in some of the raw materials industries were beginning to rediscover the advantages of a vertically integrated structure. These were firms, by and large, whose operations entailed very high fixed costs, giving them an especially large stake in stability of output and prices. Exporters of raw materials, therefore, saw some advantages in tying downstream customers by links of ownership and control, thereby removing one element of uncertainty in their sales volumes and at the same time sharing in the profits of products with greater price stability. Concurrently, processors and distributors without their own raw material sources saw increased reasons for acquiring such sources in the face of their new competition from upstream.

Even before the quickening interest in a free trade area in the western hemisphere had been apparent, state-owned and privately owned firms in some of the raw materials industries were already in process of strengthening their vertical links, encouraged by a widespread relaxation of the restraints that had previously existed in many countries on foreign direct investment in the raw materials industries.[16] The prospect was that the trend would feed on itself, inasmuch as any remaining unintegrated enterprise in a given product market would have to face increasing threats to its access to markets or materials. And the development of a free trade area could be expected to expand and accelerate the trend.

The direction of the trend, however, is more evident than its strength. If Venezuelan and Mexican companies prove to have a competitive advantage in petroleum and petrochemicals inside the free trade area, as may well be the case, will they be permitted to establish downstream processing and distributing facilities in Brazil and Argentina? Or will they be blocked by forces at home or in the prospective host country from establishing such downstream facilities? Other products such as steel and aluminum will likely raise the same issues. Mexico's apparent resistance to including oil within the scope of its free trade agreements with the United States and Canada, and the resistance of the US government to having foreign-owned firms take over facilities in advanced electronics production suggest there may be limits to the tolerance

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16. Melissa H. Birch, "Changing Patterns of Foreign Direct Investment in Latin America," The Quarterly Review of Economics and Business, vol. 31, no. 3 (Autumn 1991), pp. 141-158.

of western hemisphere countries for foreign ownership of some of their key industries. But perhaps such positions will bend with time.

A somewhat different set of issues is raised by the effects of a free trade area on the locational decisions of those transnationals that have been producing materials and components in low-wage areas in the western hemisphere, typically for further processing, assembly, and sale in the United States. Although most of the manufacturing units of transnational enterprises in the developing countries of the western hemisphere market their products primarily in the countries in which they are located, a significant minority are engaged in manufacturing for the transnational network as a whole. The most prominent cluster of such transnational units is found in the free trade zone on the northern border of Mexico, especially in the manufacture of automobile components; but transnational units engaged in such activities appear in other western hemisphere countries as well.

Finally, there are the cases of transnational firms that may see the creation of a free trade area as a reason for shifting their existing or planned production from locations outside the area, such as Asia, to locations within the area; some transnationals headquartered in Japan, Korea, and Taiwan, for instance, are likely to respond in this way. Whereas many of the reaction patterns described earlier could be classified as trade-creating in character, this form of reaction could easily include cases of trade diversion, that is, shifts to a less efficient

production source generated by a fear of being excluded from the area.

It is difficult to draw sweeping conclusions, equally valid for all industries and all industrial processes, regarding the locational drift of the units in transnational networks searching for a low cost production source. But because of the dominance of US-based transnationals in the area, some generalizations seem more plausible than others. As I observed earlier, the present logistical pattern of many transnational enterprises is one that reaches out to various foreign sources for components and materials, while leaving the final critical processing in the country where the largest share of the product is to be marketed. In the western hemisphere, the US market usually is the final destination for the largest part of such output, although some of the output of the US facilities may be returned in a finished state to the rest of the western hemisphere.

If the creation of a free trade area has any effect on these procurement patterns over the long run, it will be to loosen the ties of US-based firms to production in the United States. With the promise of easier movement of goods and services among members of the free trade area, the long-run tendency should be for US producers to look more readily at non-US locations as possible least-cost sources for their production activities. Moreover, in that kind of search, as I suggested earlier, the pull toward existing agglomerations ought to decline over time. The capacity of producers to ferret out low-cost sources should grow and their

sense of uncertainty in penetrating new areas should decline, offering added promise of the dispersion of economic activity.

Aggregate tendencies. If one were attempting to draw large conclusions regarding the aggregate effects of the transnational form of organization in the responses of enterprises to the creation of a free trade area, it would be necessary to weight the various elements described above according to their relative importance, and necessary further to distinguish short-term from long-term effects. In the absence of a hard quantitative exercise that attempts such a synthesis, let me suggest some overall impressions based on a qualitative sense of the critical factors in the mix.

The short-run effects of the transnational factor in a free trade area, as I see it, will be to encourage some marginal shifts in production facilities that tend to favor the larger countries and tend to add to existing agglomerations, shifts that may increase consumer surpluses throughout the free trade area and producer surpluses in the advantaged countries. The longer run effects of the transnational element, however, are likely to weigh in the direction of dispersing economic activity more evenly through the free trade area.

Inside the Transnational

The transnational structure of many enterprises in the free trade area, however, will influence not only the locational patterns of productive activity in the area but also the nature of the issues that will engage public authorities in the operations of

these enterprises. Some of these issues will be dealt with unilaterally by governments in the various national jurisdictions; but some could be dealt with far more effectively if the governments negotiating the terms of the free trade area took explicit cognizance of their existence at the time of the formation of the area.

The fundamental characteristic that distinguishes enterprises in a transnational network from those that are only national in scope is that no unit in the transnational network can realistically be viewed as standing alone; each such unit responds in some degree to the fact that it is part of a larger structure to whose overall performance it is expected to contribute. The nature of the link between the unit and the network, it is true, varies widely. At one extreme, a unit may appear to operate almost as if it were a portfolio investment, a free-standing business that merely contributes some portion of its profits to the parent. But that is the exceptional case, much rarer today than it was, say, four or five decades ago. In most instances, the operations of each unit are linked much more intimately to the strategies, resources, and needs of the transnational entity as a whole; in a transnational structure such as Siemens, Toyota, or General Electric, for instance, each unit of the structure is to some extent influenced by its membership in the structure.[17]

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17. See Michael Gould, "Strategic Control in the Decentralized Firm," Sloan Management Review, vol. 32, no. 2 (Winter 1991), p. 69; also Anant R. Neganghi, "External and Internal Functioning of American, German, and Japanese Multinational Corporations: Decisionmaking and Policy Issues," in Mark Casson, ed.,

Moreover, the ties that link each unit to its network cannot be monitored merely by observing the financial flows that cross international borders. At the time of establishment of the unit in the network, it is true, some cross-border financial flows will ordinarily signal the event; but even such a signal is not altogether assured. Both the original acquisition and the subsequent financing of the subsidiary may be financed from sources inside the host country.[18]

In addition, the books of the unit itself will not necessarily reflect the capital endowment provided by the entity to which it belongs. While some of the structure's endowment to the subsidiary may take the form of financial assets, the most critical elements are likely to be other intangibles that normally accrue to any member of the network: access to a pool of technology or managerial skills, to a trade name, or to an enhanced capacity to borrow from outsiders. In theory, some of these intangibles assigned to the subsidiary will have an economic cost for the rest of the network, such as the opportunity cost to the parent of assigning a patent to the subsidiary; but the values that are placed on the subsidiary's

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Multinational Corporations (Brookfield, VT: Edward Elgar, 1990), pp. 557-578.

18. For example, foreign-owned subsidiaries in the United States reported that as of the 1989 year end, even after excluding retained earnings, 73 percent of their financing had come from US sources. Foreign Direct Investment in the United States: Operations of U.S. Affiliates of Foreign Companies Preliminary 1989 Estimates, U.S. Department of Commerce, August 1991, Washington DC, Table C-1.

books to signal such assignments are unlikely to have even a remote relationship to their theoretical values.

Part of the reason for such a gap will be found in the accounting practices of the network itself and part in the accounting requirements of the national jurisdiction in which the unit operates. Sometimes, too, the evaluation is likely to be influenced by the existence of a joint venture partner in the unit. Such partners are commonly taken on for their ability to lubricate relationships with local authorities and local labor organizations; and in order to justify the equity assigned to such partners, it is often necessary to understate the real value of the capital contribution of the foreigner or to overstate that of the local partner.

In any event, the managers of any network are likely to look on the role of the local subsidiary through very different eyes than do the local authorities. The managers will see the subsidiary as a unit in a system that responds to a global strategy, whereas the local authorities will be concerned with the contribution of the unit to the national economy. As a unit in a system, the subsidiary will be expected to add to the system's earnings by its ability to tap the rent-generating assets of the system such as a pool of technology or a trade name. In the rivalistic setting of an oligopoly, a unit in a system may also earn its way for the system in a number of ways that will not be apparent from a perusal of its financial statements: for instance, by reducing the rent that a global rival would otherwise acquire in

its sales to the local market, by inhibiting such a rival from following an aggressive strategy in global competition, or by acquiring information and experience in the local market to be shared with other units in the network.

From time to time, the differences between the managers' perceptions of the functions of their foreign subsidiaries and their host governments' perceptions of those functions are bound to surface, constituting a source of stress between them. The forms in which these problems arise, however, are quite varied, a subject I explore below.

Issues for Governments

The unitary enterprise. Underlying many of the issues that governments must confront in their dealings with the units of a transnational enterprise is the struggle between the concept of the unit as an entity in a larger business structure and the concept of the unit as an autonomous actor within the government's jurisdiction. The validity of the two rival concepts varies from one case to the next; but the introduction of a free trade area promises to strengthen the unitary nature of most transnational enterprises and reduce the role of autonomous units. Meanwhile, it can be expected that governments will continue to deal with each unit in their jurisdiction as if it were autonomous, except in the occasional case when it suits a government's interests to make the opposite assumption.

Once governments are prepared to acknowledge that they are dealing in most cases with entities that can only be understood as

segments of a larger system, that recognition is bound to raise questions regarding the rights and obligations of the larger system in the free trade area. As long as the existence of transnational networks is ignored, that question will not be directly addressed. Instead, if precedent is followed, the negotiations over a western hemisphere free trade area may attempt to define the rights and obligations associated with foreign direct investment as if each unit in any transnational structure were a free-standing entity.

I shall not attempt to explore fully the implications of recognizing the existence of transnational networks in a redefinition of the rights and obligations of foreign interests; any such effort could take us too far afield. But even for the narrower purposes pursued here, there is an evident need to develop a set of agreed criteria by which enterprises can be identified as units in a transnational structure as distinguished from free-standing business entities. As I shall presently seek to demonstrate, that need exists over a broad range of governmental decisions.

The taxation issue. The problem is nowhere more evident than in the field of taxation. There is a long history of disputes over the appropriate taxation of the profits of units in a transnational network. Most governments recognize the dangers of imposing double taxation on the same dollar of profits -- once by the country in which the taxpaying unit is domiciled and once again by the country in which its owners reside; such practices, pursued in uninhibited fashion, can produce a lose-lose outcome for all the taxing

authorities concerned by eventually killing the profit-generating enterprise. The problem, however, is to produce an equitable division of profits for taxing purposes among the countries concerned.[19] Given the nature of the operations of transnational networks, defining such an equitable division in individual cases proves extraordinarily difficult.

One source of the difficulty is in defining the costs to any taxpaying unit of resources acquired from another unit in the network. Wherever the taxing authorities have expressed some reservations about the transfer price reported by the taxpayer, the standard approach has been to substitute a figure purporting to represent the arm's length price for such resources. But when the resource is unique, as in the case of tailor-made components or technological information, the yardstick represented by an arm's length price can be quite meaningless; for many such products and services, no public market exists on which to base such a price. In that case, some authorities attempt to substitute cost for price; but when the marginal cost of transferring the product or service is only a tiny fraction of the total cost of generating it, the cost criterion simply invites a passionate dispute between the national taxing authority and the enterprise as to the appropriate transfer price. Small wonder that, where the international transfer of intangibles is concerned, some developing countries have simply fixed the fees paid by subsidiaries to their affiliates

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19. Organization for Economic Cooperation and Development, Taxing Profits in a Global Economy: Domestic and International Issues (Paris, 1991) pp. 35-42.

in a transnational network at some arbitrary percentage of subsidiary sales; nor is it surprising that the arbitrary percentage has sometimes been fixed at zero.

Apart from struggling over the transfer prices of goods and services among units in a transnational network, taxing authorities have also questioned from time to time whether the sales attributed to a unit of a transnational structure in their jurisdiction appropriately represented reality. Various tendencies in modern industry have contributed to uncertainties over that issue. One has been the occasional emergence of sales involving the cooperative efforts of more than one unit in a transnational network, such as the sale of a supercomputer or a nuclear plant, the sale of services by a financial intermediary in an offering of an international bond issue, or the sale of services by a management adviser in the preparation of a global marketing study; because such undertakings usually involve not only the local unit of a transnational network but also some of its affiliates located in foreign countries, it is not always clear where the sale of the goods or services has arisen. A second tendency complicating the question of the sale's venue has been the growth of transactions between transnational networks, such as a contract for services between a transnational fast-food company and a transnational advertising agency.

So far, the struggles over such issues have been arcane, a struggle among lawyers and accountants. Occasionally, the problems have surfaced, as when the US taxing authorities have sought to

codify their treatment of licensing fees from foreign subsidiaries or when the United Kingdom has protested California's rules for estimating the taxable income of transnational units located in its jurisdiction. But for the most part, the problems have been addressed in complex bilateral treaties implemented by lawyers and accountants and based on principles unrelated to modern realities, including notably the principles of arm's-length transfer pricing and the unambiguous allocation of every sale to a national jurisdiction.

The beginnings of a solution to that problem is to recognize reality: Where relations between the units of a transnational enterprise are such as to make the allocation of sales or expenses grossly arbitrary, the division of taxable income between the taxing jurisdictions should proceed from a candid recognition of that fact. Various systems of taxation already in existence take cognizance of such problems, such as the systems that most states in the United States have adopted for identifying the portion of US-generated income falling within their jurisdiction, and the so-called unitary system used by California and a few other states for determining the share of the global income of transnational entities taxable in their jurisdiction. The prime difficulty with such systems is their unilateral character, which allows each jurisdiction to choose the system that most favors it. A system jointly adopted by all members of the prospective free trade area would go some way toward reducing the risks of unilateral adoption.

The national origin issue. In every negotiation over a free trade area, the definition of the national origin of products and services becomes a central issue for discussion and resolution. The reason is obvious: Although the parties may intend that the products and services originating in the territories of their partners should move freely across national borders inside the area, they are not inclined to extend that privilege to products and services originating outside the area that are being transshipped through the territories of their partners. And in the case of free trade areas as distinguished from customs unions, transshipment can be especially common because each of the parties retains the right to determine the level of tariffs and other restrictions maintained against the products and services of third parties.

But how does one determine the country in which a product or service "originates"? Where components and materials are being imported from outside the area to create a given product or service, how much additional processing in a member country is needed to establish that country as the originating source?[20] The usual rule in such cases is that if the added processing has the effect of changing the tariff classification of a product, it is to be regarded as originating in the country in which the processing takes place. But over the course of time, various free trade areas and customs unions have tacked on qualifications aimed

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20. John H. Jackson, The World Trading System (Cambridge, MA: The MIT Press, 1989), pp. 142-143 and 191.

at protecting specific industries. For some products, minimum value-added criteria have been superimposed on the tariff-classification principle; so, automobiles in the European Community and in the US-Canada free trade area must satisfy specific value-added criteria before they can qualify as products originating inside their respective areas.

Requirements such as these generate complex games between enterprises and governments, games that transnational networks can usually play more effectively than national enterprises. The tariff-classification principle leads the transnational network to bring in a product in disassembled form, and to assemble it in a network unit located inside the area; but the country to which the vehicle is ultimately destined then has the option of redefining its tariff classifications so that mere assembly does not serve to change the classification of the product. Moreover, the value-added requirement leads the network to set its transfer prices in a pattern that maximizes the value added inside the area; and, in return, the country for which the product is destined recalculates and adjusts the value-added totals by using higher transfer prices or by disallowing certain categories of costs incurred inside the free trade area.

Because most of these decisions can be justified by a thin patina of rationality or because the rules on which they are based are inescapably arbitrary, cases such as these fester. If transnational enterprises play an increasing role in the prospective free trade area, such cases will grow in number and

will be played out with increasing sophistication on both sides. In the end, arbitrary criteria are likely to prove inescapable, as participants in the free trade area seek to create a Chinese wall against products and services generated outside the area.

This is an issue that has already received inordinate attention from negotiators in the NAFTA context. The outcome in that context has been to allow national authorities in some products, such as automobiles, to track back component materials and subassemblies in order to challenge the claim that some specified value-added minimum had been reached. The logistical patterns of large transnational enterprises, however, are so diverse that this process in most instances will produce a wide range of possible results, none more defensible than the other. That approach, therefore, is likely to intensify the by-play between national authorities and the units of transnational networks, creating a running battle without end.

As in the case of the division of taxable profits, one of the criteria by which to judge any proposed agreement for determining the origin of products is whether it will provoke dispute. There are numerous signs in the NAFTA text that its drafters anticipate an endless succession of headaches in the application of the treaty's rules of origin. This expectation is more than justified, inasmuch as the question of origin will be determined in the first instance by the decisions of national authorities, and that these authorities will be drawing on data whose interpretation can be the subject of endless dispute.

This is one area, therefore, in which the NAFTA precedent could be a source of future mischief. Yet, once one departs from the simple criterion of a changed tariff classification as a basis for determining national origin, it is not easy to suggest an alternative that fully deals with the ambiguities. One possibility is that binding determinations should be made in the first instance by an international authority rather than by national authorities. Otherwise, one is left with the wistful hope that the inevitable disputes that these provisions will generate will eventually produce a body of case law that serves to create effective precedents.

Subsidies and dumping. It is a small step from transfer pricing and national origin issues to problems arising over the application of anti-subsidy and anti-dumping duties inside the free trade area. Once again, we are obliged to confront the fact that the existence of transnational networks promises to exacerbate issues involving the anti-subsidy and anti-dumping policies of the member countries.

The added difficulties that transnational networks bring to such issues stem partly from the fact that they produce their goods and services through the cooperation of many affiliated plants operating in a number of different countries. Where dumping is alleged, many of the costs of the enterprise, having been built up from transactions among affiliated enterprises, cannot be assessed with any degree of credibility. And even if they can, the disposition of countries such as the United States to calculate

costs by arbitrary (and sometimes bizarre) formulas means that the standard for a determination of dumping is often hard to defend.

Where public subsidies are alleged, similar problems arise. The fact that the units of a transnational network operate in many countries means that the behavior of many governments may be under scrutiny. Subsidies provided by a government in any one of those countries can potentially lay the basis for an anti-subsidy levy.

The linkages that exist in transnational networks have taken on added importance with the gradual extension in various countries, including notably the United States and the European Community, of their national anti-subsidy and anti-dumping measures, pushing their application well beyond the limits contemplated in the General Agreement on Tariffs and Trade.[21] One such extension involves applying countervailing measures against the subsidies of foreign governments and the dumping practices of exporters even if the alleged practices apply only to an imported component of a product rather than to the product itself. Another elaboration practiced by the United States in effect applies its finding of the existence of dumping to all of the facilities of an offending enterprise, irrespective of the country in which the offending facility is located; and, in the same spirit, imposes its anti-dumping duties on variants of the offending products as well as on the original product in the dock.

Once more, the creation of a new free trade area creates a stage in which transnational enterprises are constantly engaged in

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21. Ibid, pp. 217-273.

jousting with national authorities, in a process that is unsettling to the durability of the free trade area. Patently, the existing rules for applying anti-subsidy and anti-dumping duties are obsolescent in a world dominated by transnational enterprises. Here, several mitigating lines of response are possible.

One line would ape the "solution" embodied in the US-Canada free trade agreement: to accept the existing national statutes on subsidies and dumping as given, while providing a procedure for ensuring that they are fairly applied in accordance with their terms. In the US-Canada case, that procedure entails the creation of a binational court to which aggrieved parties can appeal the decisions of the administrative agencies in the two countries charged with the application of the relevant statutes. Somewhat similar provisions are also a part of the NAFTA accord. But one is entitled to some strong doubts whether the same approach can be used for a considerable number of countries, each with its own laws on the application of countervailing duties and its own administrative and judicial procedures for the implementation of those laws.

Another approach, more ambitious in nature, would be to try to build on the efforts of the contracting parties to the General Agreement on Tariffs and Trade, by attempting to define and limit the conditions under which countervailing duties can be applied, If these efforts proved successful, it might then be possible to incorporate the results in the NAFTA process.

Still another approach would be to deal with subsidies and dumping in international trade as one would deal with an anti-competitive business practice, basing findings and remedies on competition law rather than on trade law. In that case, the experience of the European Community is especially instructive. The Community's approach to the dumping practices of outside firms proves to be sharply different from its approach to the dumping practices of firms inside the Community. Outside firms accused of dumping in the Community's markets are threatened with dumping duties; and, if they wish to avoid such duties, they are usually invited to subscribe to a mutually agreed minimum sale price for their exports. That approach may discourage predatory behavior on the part of foreign firms; but it also encourages the formation of export cartels and paves the way to tacit price agreements between the foreigners and the domestic suppliers of the product.

Meanwhile, when dealing with predatory behavior inside the common market, the European Community follows an altogether different approach, presumably aimed at maintaining the advantages of open market competition. There is always a possibility that enterprises inside a common market may be engaged in predatory behavior, relying either on their own resources or on support from their national governments. But as the case of the European Community demonstrates, governments may be persuaded to agree to cut off their objectionable subsidies and enterprises may be required to desist from their predatory practices. In the case of the Community, the selection of cases and the fashioning of

remedies resides largely in the institutions of the Community itself; but in the case of a western hemisphere free trade area, as in the US-Canada free trade agreement, one could envisage the application of the agreed principles resting in national institutions, subject to appeal to a multinational tribunal. In any case, the remedy would no longer lie in restrictions at the border such as countervailing duties and minimum prices, both of which are conducive to stifling the development of competition and defeating the purposes of the common market.

Incentives and TRIMs. In the competitive struggles among countries for resources and growth, governments see transnational enterprises as a major target, to be wooed with carrots and threatened with sticks. In the carrot category are offers of tax exemptions and subsidies, and in the stick category so-called trade-related investment measures, or TRIMs.

It is easy to understand the reason why governments offer tax exemptions or subsidies when transnational enterprises are searching for a location in which to produce some needed material or component at the lowest possible cost. Notwithstanding that most studies conclude that such subsidies have only a little influence on the locational decisions of transnational enterprises, it is understandable that governments should regard the granting of such subsidies as a useful competitive tool.[22] It is a little less

22. Governments are essentially stuck in a "prisoner's dilemma" wherein they must provide subsidies, considering that other governments will provide similar subsidies, or accept the possibility of incurring a competitive handicap in attracting foreign investors. See Edward M. Graham and Paul R. Krugman

obvious why governments should feel the need to offer subsidies to transnational enterprises in those cases in which the enterprise is seeking to improve its access to the markets of the country through the establishment of a local subsidiary. But subsidies are frequently offered; and the explanation for such offers in many instances is that they originate in sub-national units, such as the states or cities of the United States, which see themselves in competition with other localities for the proposed new facility.[23] In any event, the competition among governments through offers of subsidy and tax exemption represents an activity that will not diminish--indeed, one that may well increase--as enterprises respond to the emergence of a free trade area.

The use of TRIMs, on the other hand, may be very differently affected by the development of such an area. TRIMs--trade-related investment measures--take the form of a government's demands upon a local enterprise to reshape its activities on behalf of the economy, whether through an increase in exports, a decline in imports, an expansion of research or training programs, or some other measure; punishments and rewards usually take the form of modifying the access of the enterprise to the local market.[24]

Foreign Direct Investment in the United States (Washington D.C.: Institute for International Economics, 1989) pp. 105-106.

23. Paul Kantor with Stephen David, The Dependent City: The Changing Political Economy of Urban America (Glenview, Ill: Scott, Foresman, 1988) pp. 226-238.

24. See for instance, Commission on Transnational Corporations, Trade-Related Aspects of Intellectual Property Rights and Trade-Related Investment Measures, United Nations, New York, E/C. 10/1990/13, pp. 12-22.

Characteristically, the local subsidiary of a transnational enterprise is a prime target for governmental demands in the form of TRIMs, inasmuch as such enterprises are in a position to respond to such pressures simply by reshuffling their activities among the units of the transnational network.

With the development of a free trade area, however, the power of governments to punish or reward the local unit of a transnational enterprise will presumably decline; the boundaries of the national market will be more permeable, at least to enterprises located in other countries of the area, and the ability of the government to distribute quotas of the national market to enterprises in its jurisdiction will be reduced.

The incidental result of the creation of a free trade area, therefore, will be to alter the existing balance between two sets of national policies that governments use in their tug-of-war to capture shares of the activities of existing transnational networks, namely, the offer of subsidies and the imposition of TRIMs. Therein lie some potent grounds for future disputes, whose destructive potential might be reduced by addressing them at the outset.

Any realistic response to this problem is likely to be nuanced and complex. As the provisions of NAFTA confirm, outright prohibitions against the use of TRIMs and subsidies to attract or restrain foreign direct investment are quite unlikely. But there is by now considerable experience in international circles on which one can draw for a possible agreement on the limits to be applied.

Once again, negotiations in the GATT have helped to define the positions of various countries with regard to these practices, even though the negotiations themselves have been inconclusive. In addition, the experience of the European Community with respect to state aids offers a basis for the development of proposals in that area.

Restrictive business practices. As long as governments impose significant restrictions at their borders on the international sale of goods and services, the issue of restrictive business practices is likely to have only a muted influence on the patterns of such trade. With the opening of borders, however, enterprises in some industries may find themselves obliged to fall back on enterprise agreements in order to keep competition in check. When that happens, the existence of transnational enterprises will inject a number of distinctive elements in the problem of dealing with such practices.

History strongly suggests that when a few transnational enterprises are in a position to dominate the world market for a product or service, the capacity of any single government to deal with restrictive business practices in that market is relatively limited. If agreements exist among such enterprises that limit competition, they will in all likelihood have been consummated beyond the reach of some concerned governments; and if effective remedies are to be applied, they will almost certainly be aimed at the behavior of these enterprises in more than a single national jurisdiction. As a consequence, the US government has sometimes

tried to reach outside its national jurisdiction in order to undertake effective investigations and fashion effective remedies. But for understandable reasons, other governments have usually resisted such unilateral efforts; indeed, in response to various US efforts to reach into other jurisdictions in order to deal with such cases, a number of countries have enacted laws prohibiting enterprises in their respective jurisdictions from responding to the subpoenas of foreign authorities.[25]

Fortunately, countries have slowly come to recognize the jurisdictional issue in antitrust cases as a problem of increasing importance, a recognition signalled in 1991 by an agreement between the United States and the European Community to cooperate in the enforcement of their respective antitrust laws.[26] Some weak and tentative provisions in NAFTA also reflect some official concern on the subject. But such provisions in their present form lack the substance and the administrative apparatus to play much of a role in the future.

Of particular importance in any free trade area are the provisions for dealing with cases involving the practices of firms with "dominant positions," a concept incorporated in the treaty of

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25. Some of the states that have adopted "defensive legislation" against US attempts to expand its antitrust jurisdiction are Australia, Belgium, Canada, Denmark, Finland, France, Germany, Great Britain, India, the Netherlands, and New Zealand. See A. H. Hermann, Conflicts of National Laws with International Business Activity: Issues of Extraterritoriality (London: British-North American Committee, 1982) p. 59.

26. "U.S./EC Agreement on Antitrust Cooperation and Coordination, September 23, 1991," Bureau of National Affairs, Antitrust & Trade Regulation Report, vol 61, p. 382, Sept. 26, 1991

the European Community. Even in the absence of restrictive agreements, enterprises with monopoly power can engage in predatory actions aimed at suppressing competition, including such practices as dumping, maintaining blacklists, and engaging in discriminatory pricing among buyers. The fear of such practices, when added to the fear of monopoly rents, has prompted the United States, the European Community, and others to exercise some control over mergers in their respective jurisdictions. But when the threat of monopoly stems from a transnational enterprise, there are limits to the powers of a single country in containing the threat.[27]

The provisions for cooperation on such matters incorporated in NAFTA represent a first cautious step for dealing with the problem. Before such measures can be expected to produce significant results, however, they will need a much more effective set of commitments accompanied by suitable provisions for their implementation. These commitments could range from agreements among governments to facilitate the application of national statutes regarding restrictive business practices, to agreements for the joint application of agreed measures against such practices. In this case, too, past international experience offers some guides, ranging from a relevant chapter of the still-born Charter for an International Trade Organization to the experience of the European Community.

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27. For an interesting discussion of the growth of such possibilities in technologically advanced industries, see <u>Technology and the Economy: The Key Relationships</u> (Paris: OECD, 1992) p. 209 <u>passim</u>.

The Direction of Policy

In this review of the policies relating to transnational enterprises operating in a free trade area, one can discern references to two distinctive bodies of policy, each drawing on different traditions and different institutional approaches. One is foreign trade policy, with its emphasis on governmental restrictions imposed at the border, including tariffs, quotas, countervailing duties, and the like; the other, competition policy, with an emphasis on predatory and discriminatory behavior and on anti-competitive private agreements. My basic proposition is that as agreements to dismantle governmental border restrictions gain strength, the ability of governments to deal effectively with the trade issues that remain is impaired; but many of the legitimate preoccupations of governments, such as the injury done by monopoly, dumping, and discrimination, can still be addressed as problems in competition policy.

The importance of competition policy is heightened if transnational enterprises are expected to play a large role in the new area; for in cases involving such networks, the strategy of the network as a whole should provide the relevant basis for policy. In concrete terms, this generalization suggests that governments negotiating over the terms of a free trade agreement should be thinking less of their reserve powers to handle subsidies, dumping, and the national origin of products than of their powers to handle restrictive private agreements, predation, and monopoly. The shift

in emphasis that I have suggested here, however, is likely to face two major roadblocks.

One is the understandable reluctance of the enterprises themselves to see their internal policies and agreements with other enterprises given a more prominent position in intergovernmental agreements than they now occupy; the prospect that this shift in emphasis may entail a lesser use of countervailing duties, anti-subsidy levies, challenges to the national origin of products, and similar devices that hamper trade may seem to enterprises either implausible or inadequate as a trade-off.

Another roadblock, however, may be less obvious, yet more powerful: the fact that in key countries competition policy is ordinarily applied through quasi-judicial procedures rather than through administrative processes, so that in any national administration two very different bureaucratic cultures and two very different sets of bureaucratic institutions are involved. There have been times when that fact has not prevented the coupling of trade policy and competition policy in a single document; the ITO Charter and the Rome Treaty creating the European Economic Community, both drafted in an era of heroic institutional innovation in international relations, represented two such outstanding cases.

As a rule, however, the bureaucratic line between trade policy and competition policy increases the difficulties of having governments consider them in tandem. In the United States, for instance, the formulation and administration of competition policy

is the responsibility of the Department of Justice and the Federal Trade Commission, which have little or no influence in the formulation and execution of trade policy. In the European Community, the Commission exercises extraordinary powers over the execution of competition policy, unchecked by the Council of Ministers, which ordinarily exercises a definitive role over trade policy. And in the various member countries of the European Community that have promulgated laws to prevent anticompetitive practices, the application of the laws is similarly separated from the trade policy field. It is hardly surprising, therefore, that provisions for dealing with monopolies and restrictive business practices occupy a minor place in contemporary projects for the creation of free trade areas.

Despite the roadblocks, however, governments are likely in the end to be pushed to the recognition that in a world in which transnational enterprises play a prominent role, the traditional tools of trade policy will need substantial modification if they are to serve their asserted purposes. In the search for a response that preserves the objective of freer trade while limiting the risks of predatory and destructive practices, governments will eventually find themselves obliged to borrow from the field of competition policy.