Protection, Growth and Trade

Essays in International Economics

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The Enclave Approach*

This essay presents a systematic framework for analysing the effects on host country economic welfare of multinational corporations. An approach will be sketched out here which makes use of trade theory, which focuses on the interests of the residents of the countries in which the corporations operate, but which involves a departure from the usual approach.

The Kemp–Jones–Gehrels theory of optimal trade and capital taxes summarized in essay 11 conceives of a country buying and selling both goods and factors from and to the outside world; it concerns itself only with goods and factors that pass across the country's borders, but it does not allow for the multinational corporation as an agency which is apparently both a foreign supplier and buyer and a domestic supplier and buyer of these goods and factors. Furthermore, it does not integrate into the analysis the numerous possible divergences between private and social costs and benefits – that is, domestic distortions of all kinds. The enclave approach can deal with these matters more easily.[1]

We can think of the multinational enterprise as an enclave cutting across national boundaries that is rather like an independent country. This enclave (a) buys and sells factors, (b) buys and sells goods, (c) makes and receives transfers, and (d) creates various external effects. We are interested in the effects of these four types of operations on Our country – which we should think of as any country in which the corporation operates other than its home country. There will be linkages with Our country,

* From John Dunning (ed.) 1974: *Economic Analysis and the Multinational Enterprise*, London: George Allen & Unwin. An expanded version of one section of the original paper.

1. The enclave concept is not new in discussions of foreign investment in the export industries of developing countries. The principal normative analysis of the multinational enterprise is given by Johnson (1970), and in certain respects the approach here is implicit in his paper. The concept of 'development enclaves' is used by Lewis (1976), though with an emphasis on income distribution effects and no use of trade theory concepts. Lewis notes the adverse effects of development enclaves on traditional sectors, a kind of Dutch disease effect (see essays 15 and 16).

namely (a) the corporation raises some capital locally and employs local workers, (b) it buys raw materials locally and sells some of its final products to local consumers, (c) it pays taxes to the local Ministry of Finance, and possibly also receives some subsidies, and (d) it creates a variety of external effects – that is effects that by-pass the market – for example through labour and managerial training, through spreading modern techniques of various kinds and through pollution. The problem is to analyse each of these linkages between the corporation and Our country.

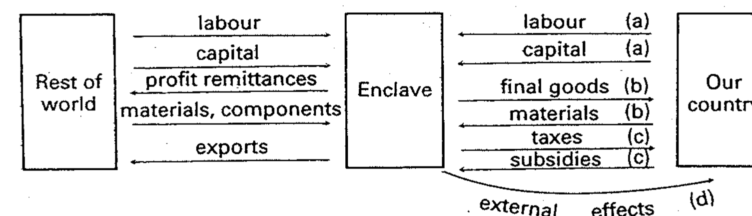

Figure 12.1

These linkages are summarized in figure 12.1. We have a model with three trading units – Our country, the Enclave and Rest of world – between which there are various linkages. The direct linkages in the form of trade, factor and other flows between the Rest of the world and Our country are not shown in the diagram as they are not of immediate interest. In fact, as noted below, the flows between the Enclave and the Rest of the world are also not of interest. The focus is on the flows between the Enclave and Our country. If one wanted to use a two-country model for welfare analysis one should group the Enclave with the Rest of the world, not with Our country, as is usual in trade theory.

Two questions can then be asked. First, does Our country gain from the presence of the corporation on our soil, the alternative being the complete absence of the corporation and of the package of factors, technology and know-how that it brings with it? Second, can taxes, subsidies or restrictions maximize Our country's gain from the presence of the corporation? The first question is the equivalent of the familiar 'gains from trade' question: does a country gain from trade compared with no-trade, and the second is the equivalent of the optimal-trade-intervention question: given various constraints and domestic distortions, what is the optimal structure of tariffs, export taxes, subsidies and so on?

We begin by considering the first question. It is important to stress that if one accepts this approach, one is only interested in trade between the corporation and Our country; thus the corporation's sales to domestic consumers of import-competing products are of interest, but its sales to foreign consumers of export products are not. This is a complete reversal

of the normal approach in international trade theory. Similarly, the corporation's import of capital and knowledge from its mother country is not of interest, but its use of locally-raised capital and labour is.

I The Gains and Losses from Linkages

Consider first linkages (a) and (b) (factor and trade movements). Let us just take two of them. Our country sells labour to the corporation. If the labour supply curve is upward-sloping and the wage rate is equal to the marginal opportunity cost of labour in Our country, there will be no gain on the last man employed, but there will be an intra-marginal gain. If the wage rate exceeds the marginal opportunity cost of labour – as it may well do in many less-developed countries, especially but not only if the labour would otherwise be unemployed – there will be a gain even on the last man employed, and an even greater intra-marginal gain.

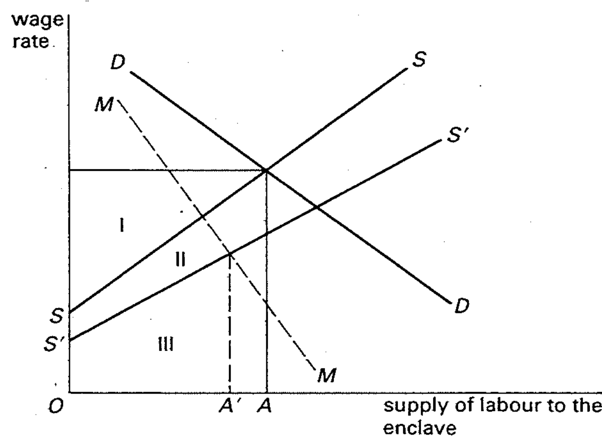

Figure 12.2

This is represented in figure 12.2. *SS* is the supply curve of labour to the corporation and *DD* is the corporation's demand curve for labour. The wage bill paid is the rectangle (I + II + III). If the wage rate was always equal to the marginal social product of labour in Our country (i.e. if it indicated the opportunity cost of labour moving into the corporation) then area (II + III) would represent output lost in Our country (excluding output of the corporation). The net gain to Our country is then area I. If the wage in Our country exceeds its marginal social product (for example if there are diminishing returns, and labour is paid its average rather than its marginal product or if some of the labour is unemployed but has a positive

reservation wage) then we must draw the curve *S'S'* tracing out the marginal social cost of labour separate from *SS*. The gain will then be area (I + II).

Next, Our country buys products produced by the corporation. If these are non-tradable goods, there may well be a gain: the corporation will have increased the supply of these goods, this will have brought down their prices, and this will yield an intra-marginal gain to consumers (consumers' surplus). But the corporation's products are more likely to be traded goods, replacing goods that would otherwise have been imported. If they are sold at the same price as the imports replaced, there will be no gain or loss because of this linkage. But if tariffs or import restrictions make it possible for the price to be higher, there will be a consumer loss on this account. Indeed, this may often be the main source of loss from multinational corporations in countries where high rates of protection are prevalent. This loss would have to be set against the two main sources of gain: the gain through employment of labour and the gain through tax revenue.

One could analyse in a similar way all the other linkages. When the corporation issues shares to local investors, are they paying a price which is equal to or departs from the marginal social product of capital when invested locally? Furthermore, what is the marginal cost to Our country of the demands that the corporation makes on local infrastructure, and how does this compare with the corporation's payments, if any?

The corporation may be highly efficient and make use of the latest and best technology. It may make big profits and export vast amounts of goods from its local subsidiary to other countries. But all of this is of no interest in this approach, other than as an indication of the taxable potential of the corporation and hence the opportunity it presents of being squeezed. It has to be remembered that often the linkage through taxation of multinationals is likely to be the most important one. We should not be interested in growth of geographical GNP or in the flow of trade as usually understood, especially as trade flows may be valued by transfer prices designed to minimize tax payments. We should be interested only in the taxes paid by the corporation and in the valuation of the various linkages, including those that bypass the market completely. We may also wish to take into account the income distribution effects in Our country by attaching distributional weights to the income gains and losses of different sections of the population, as suggested by the method of Meade (1955).

II Optimal Taxation

Finally, let us consider briefly our second question. What would be the optimal intervention by the government of Our country in the latter's goods and factor trade with the corporation so as to maximize Our country's benefits? This is quite an intricate subject, and it is only possible

here to indicate lines of approach, ignoring necessary qualifications. We shall consider three possible cases.

First, suppose the corporation cannot be taxed directly through profits tax. This is equivalent to the situation between independent countries, where one country cannot tax another country directly. Our country might then exercise any monopsony or monopoly power it has in its purchase (or sale) of goods and factors from (to) the corporation. This is the equivalent of the usual optimal tariff-export tax argument. The corporation's elasticities of demand for or supply of goods and factors will be relevant in determining appropriate rates of tax, as well as the degree of private monopoly already existing among Our country's suppliers and buyers.

In figure 12.2 the optimal tax will be derived by drawing the marginal curve *MM* to the *DD* curve. If *S'S'* represents the social marginal cost curve to Our country the tax would be such as to reduce labour services purchased from *OA* to *OA'*. Of course, if *SS* were the marginal social cost curve the tax would need to be higher. A tax would reduce the wage paid to workers but raise revenue that could be redistributed to them. Alternatively, labour supply might be restricted by regulations, in which case the wage paid would rise. Next, at the other extreme, suppose that it is possible to charge and collect any rate of profits tax desired. The previous policy, which was designed to redistribute income from the corporation to Our country by manipulating trading prices, will then be second best. First-best policy will be to aim at maximizing geographic product and then impose the optimal profits tax. If one thinks of the corporation as an indivisible operation that either stays in the country or does not, the optimal profits tax will be the highest rate of tax compatible with the corporation not going away as a result. The maximization of geographic product may involve taxes and subsidies designed to correct distortions but not designed to improve the terms of trade of Our country relative to the corporation.

A third possibility is that there is a positive rate of profits tax which cannot be varied. It may be equal to the rate of tax in the corporation's home country since a lower rate would simply cause the home country's treasury to scoop up the difference (given the usual arrangements whereby host-country tax paid by a subsidiary is deducted from tax payable in the home country), and since a higher rate would lead to evasion of Our country's tax through transfer pricing. In that case it will again be optimal for Our country to seek to improve its terms of trade through restricting or taxing the demand for (or supply of) goods and factors by (to) the corporation. But the optimal rates of tax will be lower than in the first of our three cases where the profits tax was assumed to be zero.

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