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U. S. PRIVATE INVESTMENT IN LATIN AMERICA: SOME QUESTIONS OF NATIONAL POLICY

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PREFACE

This RAND Memorandum was prepared for the Office of the Assistant Secretary of Defense, International Security Affairs (ISA). The study is predicated on the conviction that U.S. private business activity in Latin American countries significantly affects the character of U.S. relations with those countries. The presence and behavior of U.S. owned business firms in Latin America will continue to be one of the major factors shaping the economic, political, and military environment that the United States will encounter in the future.

The Memorandum examines various economic-political side effects of U.S. private investment in foreign countries -- side effects that might adversely influence relations between the host countries and the United States. Presuming that large economic benefits do accrue to host economies from U.S. foreign investment, the study goes on to explore the nature and sources of conflict that can, nevertheless, arise between host countries and U.S. investors and that can lead to the involvement of the U.S. government. From this analysis the study identifies a number of issues that are relevant in formulating future U.S. national policy toward American private investment abroad.

While it makes use of actual events to illustrate the economic-political side effects of U.S. private investment in Latin America, the study is not an analysis of the economic and political environment within any particular country. This is not to say that the structure of the host country's economic system and the nature of prevailing economic and political doctrines are not important in conditioning responses to private investment from abroad; clearly they are. Local Nationalism and Marxism, for example, especially when found in combination, are forces that could not be ignored in a general study of U.S. investment in Latin America. The present study, however, does not attempt to deal with the whole complex of such problems, but rather focuses more specifically on the nature of U.S. investment in relation to typical conflict situations.

A good deal of apprehension has been expressed in the press and elsewhere that U.S. investment in Latin America is declining in the face of increasing economic and political instability, particularly since the rise of Castro. A related study by the same author, The Course of U.S. Private Investment in Latin America Since the Rise of Castro, The RAND Corporation, RM-4091-ISA, May 1964, examines the extent to which this apprehension has been justified in the light of empirical analysis.

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SUMMARY

U.S. private investment in Latin America constitutes a vital economic contribution in that, among other things, it provides external financing and skilled human resources, it stimulates local productive capital formation and the emergence of a local entrepreneurial base, and it demonstrates by persuasive example the advantages of a strong, progressive private sector. The U.S. government, recognizing this contribution, has instituted a number of programs (including investment guarantees, financing, and information) designed to promote the flow of new private investment to friendly, less-developed areas. Other measures are being considered in Washington to promote the flow of private capital as an important if not indispensable ingredient of the total U.S. foreign assistance program.

At the same time, U.S. private investment abroad in some cases gives rise to resentment, hostility, and conflict in host countries, even though the economic benefits from foreign investment to those countries may be large. Employing both historical empiricism and theoretical analysis, this study examines a number of economic-political side effects that can potentially have an adverse effect on relations between these countries and the United States.

This study first explores the role that the large U.S. investment in Cuba may have played in shaping political relations between the United States and Cuba during Castro's rise to power. A critical aspect of the Cuban revolution involved Castro's ability to transfer hatred for Batista, in the eyes of his followers, to hatred for the United States and its business interests. The composition of U.S. investment in Cuba may have played a role in Castro's being able to maintain popular support during his anti-American campaign even though thousands of his earlier followers were becoming bitterly disillusioned. In the minds of his sympathizers, the large concentration of U.S. private investment in public utilities may have created an identification between the Batista regime and the U.S. government, through no fault of the companies themselves. The concentration of

U.S. investment in sugar production may have become identified with Cuba's dependence upon a single major export crop that tied her economic fortunes closely to the behavior of the United States -- a situation that Castro found convenient to exploit in maintaining popular support during his campaign against the United States and foreign "domination."

The study goes on to explore, on theoretical grounds, a number of conflicts that could arise between foreign business enterprises and host countries. The analysis shows how the host government, trying to increase the gains from foreign investment to the economy, may discriminate against extractive, export-oriented industries by imposing higher excise taxes, higher minimum wage laws, and other cost-increasing restrictions. Even though these restrictions may adversely affect output and employment in these industries, the government may feel (perhaps rightly, at least in the short run) that the gains from the restrictions outweigh the losses due to reductions in output and employment. These industries may be subject to discriminatory treatment simply because they do try to operate in an efficient and progressive fashion. Moreover, the foreign owned enterprise, trying to maximize its own welfare, might select a level of output lower than the one the host government would select were it in control. Conflict between the two over output and investment decisions could lead the government to favor expropriation as a means of (hopefully) increasing the net gain to the economy from the investment activity. With respect to foreign investment in general, the personnel policies pursued by foreign firms, the competition with local capital, and the large profit outflows are also potential sources of difficulty. These factors, among others, can give rise to distrust and resentment and produce a climate hostile to private investment that could strain relations between the United States and the host government.

From this analysis some questions arise about the advisability of a more active U.S. government role in guiding U.S. investment abroad in a manner consistent with long-run national interests, for example, by means of highly selective investment incentive programs. This study notes that such government participation would face a number of problems: (1) it is difficult, if not impossible, to predict the economic-political effects of particular contemplated investments, given our present state of knowledge; (2) serious disagreement can arise about what long-run U.S. national interests really are; and (3) perhaps most important of all, a selective incentive program, by generating delays, uncertainty, and even undue favoritism, would threaten to suppress a most valuable characteristic of private-enterprise decisionmaking -- the ability to identify quickly and to explore aggressively promising new opportunities, and to bring financial and human resources to bear in developing them.

The study points out a basic dilemma. If the level and allocation of U.S. private investment abroad are left to the dictates of market forces (either with or without across-the-board government-administered incentive programs), there is danger that some business activities will operate in a manner contrary to the national interest. But the greater the degree of government-imposed direction, the greater the danger that the most valuable characteristics of private decisionmaking will be suppressed.

CONTENTS

LIST OF FIGURES AND TABLES

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I. INTRODUCTION

The economic impact of U.S. private investment is very large in Latin America.[1] In 1957 U.S. owned enterprises operating in petroleum, manufacturing, agriculture, mining, public utilities, and other industries employed about one million workers; and they spent over $6 billion in the local economies of the host countries to cover materials, labor, and tax payments. Their total sales of $7.9 billion included $4.6 billion in local sales and $3.3 billion in exports to the rest of the world. Manufacturing sales alone, nearly all of which consisted of goods for local consumption, amounted to $2.4 billion in 1957 and rose rapidly to $4.2 billion by 1962. In 1955 the export sales of U.S. owned enterprises accounted for about 30 per cent of total Latin American exports.

GOVERNMENT POLICY AND PROGRAMS

In both government and business circles a good deal of attention is being given to expanding the role of U.S. private investment in meeting the development needs of Latin America. A number of studies under both government and private sponsorship have concluded that U.S. foreign investment makes a very substantial contribution to the economic development of host countries, and that an acceleration in the flow of investment to less-developed areas would further the national interests of the United States. Typically, these reports have gone on to recommend a wide range of measures for U.S. government action in order to stimulate the flow of foreign investment into less-developed areas and to mobilize local capital more effectively for economic development.[2]

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[1] Unless otherwise specified, the term "Latin America" includes the 20 Republics and Western Hemisphere dependencies.

[2] See, for example, Committee for Economic Development, Economic Development Abroad and the Role of American Foreign Investment (Washington, D.C., 1956); R. F. Mikesell, Promoting United States Private Investment Abroad (National Planning Association, Washington, D.C., 1957); Expanding Private Investment for Free World Economic Growth,

The United States government is, of course, already engaged in a number of programs to promote the flow of U.S. capital to friendly less-developed areas and to encourage productive investment by locally owned enterprises. The Agency for International Development administers the specific-risk Investment Guarantee Program designed to cover U.S. investment projects against losses arising from currency inconvertibility; expropriation or confiscation; and war, revolution, or insurrection. AID also administers two extended risk programs to insure against both commercial and political risks: one covers investment in high-priority projects in eligible, less-developed countries for which it can clearly be demonstrated that the investment would not be forthcoming in the absence of the guarantee; the other covers investment in pilot or demonstration housing projects in Latin America.[1]

AID is authorized also to make dollar loans directly to private firms, both U.S. owned and locally owned, for projects of high priority in the host country's development program, but for which dollar financing is not obtainable from other sources on reasonable terms. Dollar loans are also made to intermediate credit institutions for relending to private firms; such loans, now active or recently authorized, total more than $270 million.[2]

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prepared under the direction of Ralph I. Straus, Special Consultant to the Under Secretary of State for Economic Affairs (Washington, D.C., April 1959); The Commerce Committee for the Alliance for Progress, Proposals to Improve the Flow of U.S. Private Investment in Latin America (Washington, D.C., Department of Commerce, 1963).

[1]The guarantee programs are described in more detail in U.S. Agency for International Development, Investment Guaranties Division, Investment Guarantee Handbook (Washington, D.C., 1960), and Agency for International Development, Aids to Business (Overseas Investment), (Washington, D.C., 1963), pp. 19-27. The latter also describes in detail other AID programs. For additional discussion of those programs, including the accumulated dollar figures involved, see 88th Congress, 2nd Session, Joint Economic Committee, Private Investment in Latin America, Hearings, January 1964, pp. 166-184, and Committee on Foreign Affairs, Foreign Assistance Act of 1964, Hearings, March 1964, pp. 46-50.

[2]Private Investment in Latin America, Hearings, op. cit., p. 176. The Social Progress Trust Fund administered by the Inter-American Development Bank, has made loans to private firms or to intermediate credit institutions totaling more than $50 million.

AID is authorized to participate with private firms in financing surveys of investment opportunities. Its participation, limited to 50 per cent of the cost of the survey, is designed to encourage potential investors to explore the feasibility of contemplated investment projects that will contribute to AID objectives in the less-developed countries. Only if the investment is not made, on the basis of the survey, would AID reimburse the sponsor for up to 50 per cent of the cost of the survey.

AID program loans have been used to promote private enterprise by providing development imports for the private sector. In Colombia, furthermore, a large proportion of the local currency proceeds of one program loan is being channeled into a private investment fund. The equivalent of over $18 million has so far been lent by the fund to Colombian businessmen.[1]

AID also provides local currency "Cooley" loans out of counterpart currencies accumulated from the sale of surplus agricultural commodities under the PL 480 program. From the beginning of the program through June 30, 1963, about $156 million was lent to U.S. and local private borrowers under the Cooley program. The bulk of this amount, however, has been channeled to the Near East and Southeast Asia. Loans in Latin America have amounted to about $20 million or 13 per cent of the total.[2]

The Export-Import Bank has been very active in the Latin American field for many years. It provides direct dollar loans for the purchase of U.S. goods and services, guarantees and insurance on export transactions, and medium-term (1-5 years) exporter credits. Within the U.S. economic assistance program, Export-Import Bank long-term loans have represented over one-half of the total obligations and loans made by government agencies to Latin America from Fiscal Year

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[1] _Ibid._, p. 458.

[2] AID files.

1946 through Fiscal Year 1962.[1] Of the total dollar credits and guarantees of the Export-Import Bank outstanding at the end of 1958, about 23 per cent consisted of loans and guarantees directly to private enterprise (both local and foreign) and to governments for relending to private enterprises.[2]

The Department of Commerce analyzes and publicizes specific investment opportunities in less-developed countries. It also provides general information, guidance, and advice for investors interested in overseas operations.[3]

Besides these current government activities, consideration is being devoted to means by which the government might further promote and guide U.S. private investment. A presidential recommendation now before Congress specifies that U.S. companies making new investment in eligible less-developed countries would be allowed to deduct 30 per cent of the cost of the investment from their federal tax bill on income wherever earned.[4]

PRIVATE INVESTMENT AND U.S. NATIONAL INTERESTS

In appraising the future role of U.S. private investment in Latin America, we must consider both the favorable and unfavorable aspects

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[1] The grand total amounts to $6.17 billion of which Export-Import Bank loans comprise $3.37 billion. AID Statistics and Reports Division, U.S. Foreign Assistance, Obligations and Loan Authorizations, July 1, 1945-June 30, 1962 (revised), p. 2.

[2] Expanding Private Investment for Free World Economic Growth, op. cit., p. 55.

[3] Among other publications, the Department of Commerce has, through the years, disseminated a number of reports on specific countries, entitled "Investing in...[country[." In general, these are excellent over-all surveys of the operations and regulations of local government, the industrial structure, international trade and finance, and other factors of concern to potential foreign investors in the country in question. Specific investment opportunities are publicized in Foreign Commerce Weekly, published by the Department of Commerce.

[4] 88th Congress, 2nd session, President's Recommendation Relative to Foreign Assistance, Document No. 250, March 19, 1964.

of U.S. business activities, viewed in terms of U.S. national interests. On the favorable side, U.S. private investment is a valuable, if not indispensable ingredient of the total foreign assistance program. Besides supplying external financial resources to supplement local savings in productive capital formation, it contributes technical, management, and entrepreneurial skills that are frequently in critically short supply in less-developed economies. By supplying technical and organizational knowledge, along with financial and human resources, these investment activities serve as a medium by which new advanced technology is transferred into, and successfully absorbed by, the host countries. Moreover, U.S. foreign business enterprises provide vocational and managerial training activities for local employees, thereby contributing to a pool of skilled local labor upon which the entire economy may draw. By purchasing goods and services from the local firms as inputs into their own production processes these enterprises encourage the establishment and expansion of locally owned business. Some observers have emphasized that U.S. private investors, in contrast to slow-moving government-to-government aid activities, can quickly identify and explore promising new opportunities, and promptly supply the financial and human resources required to translate them into going ventures.

We now have a voluminous literature on the contributions of U.S. private enterprise to less-developed countries. A large number of case studies of specific companies abroad has been compiled by the National Planning Association. Together these studies contain a massive number of specific examples showing how, in fact, these firms have trained local labor in vital industrial skills, stimulated the growth of local enterprise, encouraged modern merchandising practices, promoted technological progress, and engaged in other activities that have increased productivity in the host countries.[1] The Department

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[1]National Planning Association, Case Studies of Business Performance Abroad: Sears, Roebuck de Mexico, S.A., 1953; Casa Grace in Peru, 19[illegible]4; The Philippine-American Life Insurance Company,

of Commerce has published several reports, based on comprehensive surveys of U.S. business activities abroad, that shed light on the economic importance of U.S. private investment in host countries. Among other things, the reports show for various industries the level and composition of local payments made by U.S. enterprises, the levels of their foreign and domestic sales, and the contribution of foreign exchange to host countries.[1]

On the unfavorable side, some private investment activities generate resentment, distrust, and conflict in host countries. Even though economic benefits accruing to the host economy may be large from a particular foreign enterprise, serious conflict between the host government and the enterprise can arise over the distribution of the total benefits between the two. The government may impose higher taxes and more restrictive labor regulations in an attempt to increase its own share. The enterprise may complain about the onerous tax and labor laws and threaten to reduce production or pull out altogether. The government may counterthreaten to expropriate and perhaps actually carry out the threat. Extremist, anti-American political groups frequently attack the presence and nature of foreign enterprise in their countries; their accusations of foreign domination and economic exploitation represented by the enterprises, however wildly untrue the accusations are, may at times nevertheless be effective in gaining popular support.

Conflict between host governments and U.S. owned firms can involve the U.S. government as well. If, for example, the host

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1955; The Creole Petroleum Corporation in Venezuela, 1955; The Firestone Operations in Liberia, 1956; Stanvac in Indonesia, 1957; The United Fruit Company in Latin America, 1958; TWA's Services to Ethiopia, 1959; The General Electric Company in Brazil, 1961; Aluminium Limited in India, 1962. See also Simon Rottenberg, How U.S. Business Firms Promote Technological Progress (National Planning Association, Washington, D.C., 1957).

[1] U.S. Department of Commerce, Office of Business Economics, U.S. Investments in the Latin American Economy, 1957; Foreign Investments of the United States, A Supplement to the Survey of Current Business, 1950; and U.S. Business Investments in Foreign Countries, 1960. The results of less detailed annual surveys appear in the Survey of Current Business, usually in the fall of each year.

government expropriates a private U.S. enterprise without reasonable and prompt compensation, the U.S. government is obliged under present law to halt its own aid program to the country. If the investment "climate" suddenly turns poor in a country, because of the hostility of a new regime to the private sector in general and to foreign capital in particular, the U.S. government must decide whether and by what means to modify its own foreign policy, especially aid policy, toward that country.

How should the U.S. government promote and guide private investment to reduce or minimize these negative side effects and at the same time preserve the valuable contribution that private investment can make to economic development? For example, should future tax legislation designed to promote private investment in foreign countries provide across-the-board tax incentives for <u>all</u> kinds of investment or should it apply on only a selective basis to investment whose <u>combination</u> of anticipated economic and political effects is judged to work consistently with U.S. national interests? To what extent should the government use moral suasion and stronger measures to encourage existing U.S. firms in Latin America to behave in a manner that enhances their over-all political (as well as economic) impact in host countries?

For several reasons these questions do not admit of simple answers; on the contrary, they raise a whole set of enormously complicated issues. In the first place, there is the problem of defining U.S. national interests. Rather than becoming embroiled in an extended discourse on this complex issue, only the following will be noted: in this study we shall conceive of U.S. national interests in Latin America as being primarily concerned with the emergence of stable political regimes, responsive to the will of the governed, and friendly to the United States. The factor of economic development relates to U.S. national interests insofar as it provides a necessary (though not sufficient) condition for the emergence of such regimes.

Second, even though a voluminous literature is available on economic aspects of U.S. investment abroad, we have little basis today for deciding which particular investment activities, in particular countries, generate the greatest positive economic benefits. While private investment may in general contribute a good deal to economic development, some activities undoubtedly contribute much more than others. A major problem, among many others, is that it is difficult to determine the "opportunity" costs of local resources employed by particular U.S. firms. As noted earlier, the Department of Commerce has collected data on the payments of U.S. owned firms to local labor, materials, tax obligations, and so forth. But such data do not disclose the net gain (as distinguished from the gross contribution) of the investment to the host economy. While a particular firm may have a local wage bill of x dollars, the extent to which this represents a net gain depends on what would have happened to the labor resources had the investment not been made. If the labor would otherwise have been unemployed, then this x dollar payment would approximate the net gain; but if the labor would have been employed, though likely in less productive pursuits, the net gain would reflect only the difference between the x dollar payment and the positive value to the host economy of the resources in those alternative pursuits. In the real world it would be a formidable task, if not an impossible one, to determine this opportunity cost with any tolerable degree of precision. Foreign investment frequently generates benefits in the form of labor training, stimulation of local enterprise, adoption of new technology, and so on. But these benefits, too, undoubtedly vary a good deal in size from one activity to another, and one would be hard pressed to place a dollar sign on either the aggregate benefits, or the differences in benefit among various investments. Then, too, the problem of displacement of local capital arises: to the extent that foreign capital displaces local capital in particular activities, the reduction in productivity suffered by the local capital when shifted to an alternative pursuit would have to be subtracted from the gross contribution of foreign capital to derive net gain. Again, it would be difficult to determine the extent to which such displacement does take place, if at all, or the value of the productivity loss of local capital suffered as a consequence.[1]

Third, in contrast to the voluminous literature on the positive economic contributions, little systematic research has been directed to the political impact of private foreign investment or to the manner in which political and economic factors interact. The nature of conflicts that arise between U.S. business enterprises and host governments has been briefly treated.[2] Repeated reference is made in the literature to the fact that in some industries in some host countries, U.S. investment activity creates resentment, hostility, and distrust. And there is a huge literature, frequently extremely left wing, that lambasts U.S. private capital for a variety of economic and political reasons. But we have little knowledge of the political significance or sources of local unfavorable attitudes -- whether they arise from misinformation and ignorance concerning the benefits of U.S. private investment, whether they reflect a basic clash in economic and political ideology, or whether they stem from a genuine conflict in economic interests between foreign investors and the host country.

To consider an example of this gap in our knowledge, opinion surveys have examined local public attitudes toward foreign investment in a number of Latin American countries. The United States

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[1]Anthony Y. C. Koo has analyzed the Department of Commerce data in an attempt to discriminate among industries with respect to their relative economic contribution to host economies. See "A Short-Run Measure of the Relative Economic Contribution of Direct Foreign Investment," Review of Economics and Statistics, August 1961, pp. 269-276.

[2]Bernard Goodman, "The Political Economy of Private International Investment," Economic Development and Cultural Change, April 1957, pp. 263-276; Irving Brecher and S. S. Reisman, Canada-United States Economic Relations (Ottowa, Royal Commission on Canada's Economic Prospects, 1957); John Lindeman and Donald Armstrong, Policies and Practices of United States Subsidiaries in Canada (Ottowa, Canadian American Committee, 1961); Donald A. Wells, "Economic Analysis of Attitudes of Host Countries Toward Direct Private Investment in U.S. Private and Government Investment Abroad, R. F. Mikesell (ed.) (Eugene, University of Oregon Books, 1961), pp. 483-507.

Information Agency has collected data on attitudes toward expropriation in selected countries, shown in Table 1. In the upper half of the table, the percentage of respondents favoring expropriation of locally owned property is in every case lower than the percentage favoring expropriation of foreign property, while the percentage opposing expropriation is in every case higher. The data disclose that attitudes towards foreign investment vary considerably from one country to another. In Mexico, Peru, and Uruguay the percentage favoring expropriation is roughly equal to that opposing, while in the other countries the percentage favoring is substantially less than that opposing. USIA also asked those favoring expropriation whether the former owners should be paid in full, in part, or not at all. The responses, in the lower half of Table 1, indicate that in every country the percentage who feel that foreign owners should be paid in full is smaller than the percentage who feel that domestic owners should paid in full. Again, this implies that respondents are less favorably disposed to foreign than to local ownership.

To consider another example, Table 2 summarizes a survey conducted in 1958 in six Latin American capital cities. A disturbing aspect of this table is that in every country except Argentina the younger respondents -- those under 35 years old -- were less favorably inclined toward U.S. investment than the older ones. It is well known that much of the political extremism in Latin America exists among the younger groups, especially among urban students: students were involved in the Lima and Caracas riots during the Nixon tour in 1958; students were initially involved in the flag riots in Panama in January 1964 (and in the 1959 and 1958 riots); and students were heavily involved in anti-American demonstrations in Venezuela prior to the presidential elections in 1963.[1]

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[1] Of course, many surveys have been conducted in addition to those mentioned above. For an illuminating summary see Elmo C. Wilson, "Current Latin American Attitudes and Motivations Affecting the Climate for U.S. Business in Latin America," New York, International Research Associates, 1963 (mimeo.), p. 5.

Table 1

ATTITUDES TOWARD EXPROPRIATION OF DOMESTICALLY OWNED AND FOREIGN OWNED PROPERTY, EARLY 1961[a]

Country	Number of Cases	Government Expropriation of Private Property of Persons in Country Surveyed[b]		Government Expropriation of Property of Foreigners[b]	
		Favor (per cent)	Oppose (per cent)	Favor (per cent)	Oppose (per cent)
Brazil	1593	6	74	16	57
Mexico	1106	22	71	50	40
Argentina	2000	23	55	25	50
Colombia	700	19	75	27	66
Peru	703	26	57	39	39
Venezuela	700	11	84	22	69
Uruguay	516	32	45	38	40

Country	Should be Paid in Full		Should be Paid in Part or Not at All	
	Domestic Owners (per cent)	Foreign Owners (per cent)	Domestic Owners (per cent)	Foreign Owners (per cent)
Brazil	60	36	40	64
Mexico	40	20	60	80
Argentina	62	48	38	52
Colombia	32	22	68	78
Peru	38	24	63	76
Venezuela	60	41	40	54
Uruguay	56	46	44	54

Notes:

[a]Survey covers "urban areas" of countries sampled.

[b]The percentages in each category of response do not add to 100 since a fairly large percentage of interviewees expressed no opinion.

Source:

United States Information Agency, The Climate of Opinion in Latin America for the Alliance for Progress (mimeo.), No. LA-1 (Washington, D.C., August 1961), pp. 6 and 8.

Table 2

ATTITUDES OF THE PUBLIC IN SELECTED SOUTH AMERICAN CITIES, 1958

Question: v do you feel about U.S. companies investing in business this country?

Answer: (a) On the whole, I would welcome more such investments.
(b) I believe there is about the right amount now.
(c) I think it should be eliminated altogether.
(d) I would prefer it if there were less such investment.

City Surveyed and Age of Respondent	Number of Respondents	Would be Welcome (per cent)	Enough, Less, or Eliminated (per cent)
Caracas, Venezuela			
18-34 years	156	31	63
35 years and older	94	35	54
Total	250	33	60
Mexico City, Mexico			
18-34 years	130	45	49
35 years and older	120	52	43
Total	250	49	45
Buenos Aires, Argentina			
18-34 years	103	71	20
35 years and older	147	67	27
Total	250	69	24
Lima, Peru			
18-34 years	124	52	42
35 years and older	126	64	31
Total	250	59	36
Bogata, Colombia			
18-34 years	105	67	22
35 years and older	145	77	14
Total	250	72	18
Montevideo, Uruguay			
18-34 years	125	19	71
35 years and older	177	38	48
Total	302	34	52

Source:

International Research Associates, Inc., A Survey of Latin American Public Opinion (conducted for Life, New York), 1958, p. 11.

Aside from the issue as to how reliable such polls are in reflecting public opinion, a basic question left unanswered in these surveys is how significant these attitudes are in terms of U.S. national interests.

Does it make much difference whether private investment goes into an area where large segments of the public express unfavorable attitudes? Is it not possible that the positive economic benefits far outweigh the significance of local public opinion? Can hostile attitudes be effectively exploited by anti-American, nationalistic political elements in gaining popular support for themselves? Again, the difficulty is that we do not have an adequate understanding of the sources or the character of adverse attitudes expressed in opinion polls, or elsewhere, nor do we have a sound notion of the mechanisms by which such attitudes get translated, if at all, into political action.

SCOPE OF THIS STUDY

This study examines a number of economic-political side effects that might have adverse effects on relations between host countries and the United States; and it raises a number of issues that are relevant in formulating future national policy toward U.S. private investment. Given this focal point, the study makes no attempt to be "well-rounded" in covering all major factors that one would need to consider in an over-all appraisal of the future of foreign investment and its relation to U.S. national policy. In particular, it makes no attempt to follow the lead of so many studies in the past in identifying and evaluating the many economic benefits of private investment enjoyed by host economies. Rather it presumes that such benefits do exist -- but then goes on to explore the nature and sources of conflict that can, nevertheless, arise between host countries and U.S. investors.

More specifically, the examination in Section II is concerned with the relationships between U.S. owned enterprises in Cuba and the Castro regime during its early years in power. Drawing from newspaper accounts and other secondary sources, it seeks to shed light on such questions as: What was Castro's professed attitude toward U.S. investment in Cuba before he came to power? What was the role of U.S. business enterprise in shaping events after he came to power? Especially, to what extent may the presence and composition of U.S. business enterprise in Cuba have played a role in affecting relations between the United States government and Cuba? Though the study by no means provides clear-cut definitive answers to these questions, focusing the analysis in this manner is useful in identifying issues relevant to appraising private investment and U.S. national interests in other countries.

In Section III, the study considers, in theoretical terms, a number of conflicts that might arise between foreign business enterprise and host countries. The special problems posed by extractive, export-oriented industries are treated in terms of the <u>distribution</u> of total benefits among the host country, private foreign investors, and foreign consumers -- a source of conflict that can lead to threatened and actual expropriation, and involvement of the U.S. government as well. The study then treats certain more general problems arising out of (1) the disparity between outflows of remitted profit back to the United States, and inflows of new private investment into the host country; (2) competition between foreign capital and local capital; and (3) personnel policies of U.S. owned firms. Section III concludes with a very brief summary of some U.S. government and business activities designed to enhance the economic-political effects of private investment in Latin America.

Finally, Section IV bring together strands of analysis from the earlier sections to present briefly an overview of problems facing the U.S. government in promoting and guiding private investment in the future.

II. ECONOMIC-POLITICAL INTERACTIONS AND U.S. NATIONAL INTERESTS: THE CASE OF CUBA

In this section we shall consider the case of Cuba where U.S. private investment has historically been very large relative to that in other Latin American countries. The purpose is to explore the role that the large volume of U.S. investment may have played in helping to shape political relations between the United States and Cuba during Fidel Castro's early years in power. Because of the extreme nature of this case, it cannot be used to generalize about the economic-political consequences of private investment in the rest of Latin America. Nevertheless, this inquiry will serve to identify several issues of general relevance to considering relationships between private investment and U.S. national interests in other countries.

THE RISE OF CASTRO

When Castro came to power in 1959, the total book value of U.S. business enterprises in Cuba was greater than in any other Latin American country except Venezuela. Table 3 indicates that on a *per capita* basis, the book value of U.S. enterprises in Cuba was over three times the value for the rest of Latin America considered as a whole. Only in Venezuela and Panama was per capita investment larger. With respect to direct investment flows and undistributed earnings[1] during the 10-year period 1950-1959, Cuba received over twice as much per capita as the average for the other countries, as shown in Table 4. Moreover, U.S. owned firms were especially prominent in certain industries. According to a Department of Commerce survey completed in 1956:

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[1]Direct investment flow is loosely defined to include the flow of equity and loan investments from U.S. residents to foreign firms controlled by U.S. interests. The book value of direct investment enterprises includes the U.S. ownership of equity capital, loan capital, branch accounts, and intercompany accounts in foreign firms controlled by U.S. interests. For more precise definitions and a treatment of methodology, see U.S Department of Commerce, *U.S. Business Investments in Foreign Countries* (Washington, D.C., 1960), pp. 76-85.

Table 3

BOOK VALUE -- U.S. DIRECT INVESTMENT ENTERPRISES IN CUBA AND OTHER LATIN AMERICAN COUNTRIES, 1959

Industry	Cuba		Other Latin America[a]	
	Millions of Dollars	Dollars Per Capita[b]	Millions of Dollars	Dollars Per Capita[b]
Petroleum	147	22	2715	15
Manufacturing	111	17	1285	7
Trade	44	7	592	3
Public utilities	313	47	790	4
Mining and smelting	-[c]	-[c]	1254	7
Other (primarily agriculture)	341	51	527	3
Total	956	143	7163	39

Notes:

[a]Excludes Western Hemisphere dependencies.

[b]Population figures for 1959 used in per capita computations.

[c]Not available separately; included in "other" industries.

Sources:

U.S. Department of Commerce, U.S. Balance of Payments, Statistical Supplement (Washington, D.C., Revised Edition, 1963), pp. 178-207; and United Nations, Boletin Economico de America Latina (New York, November 1960), p. 8.

Table 4

CUMULATIVE NET DIRECT INVESTMENT AND UNDISTRIBUTED CORPORATE EARNINGS, CUBA AND OTHER LATIN AMERICAN COUNTRIES, 1950-1959

Industry	Cuba		Other Latin America[a]	
	Millions of Dollars	Dollars Per Capita[b]	Millions of Dollars	Dollars Per Capita[b]
Petroleum	115	19	1720	10
Manufacturing	56	9	1250	7
Trade	26	4	494	3
Other	202	33	359	2
Mining and smelting	-[c]	-[c]	759	4
Total	399	65	4582	26

Notes:

[a]Excludes Western Hemisphere dependencies.

[b]Population figures for 1950 used in per capita computations.

[c]Not available separately; included in "other" industries.

Sources:

U.S. Department of Commerce, U.S. Balance of Payments, Statistical Supplement (Washington, D.C., Revised Edition, 1963), p. 207; and United Nations, Boletin Economico de America Latina (New York, November 1960), p. 8.

> The only foreign investments of importance are those of the United States. American participation exceeds 90 per cent of telephone and electric services, about 50 per cent in public service railways, and roughly 40 per cent in raw sugar production. The Cuban branches of United States banks are intrusted with almost one-fourth of all bank deposits. This intimate economic relationship is so much the outgrowth of mutually helpful association that many of the problems that have plagued less close relationships in other areas have largely been avoided in Cuba.[1]

U.S. investment in Cuba was far greater, both in total dollar and per capita terms, than was typical in the rest of Latin America. Moreover, Cuba enjoyed one of the highest per capita incomes in Latin America. Yet, Cuba is today a member of the Soviet Bloc. Questions immediately arise about the relationships between U.S. investment and this revolutionary and tragic turn of events. What was Castro's professed attitude toward U.S. business enterprise in Cuba before he came to power? What was the role of U.S. business enterprise in shaping events after he came to power? More specifically, to what extent may the presence and composition of U.S. investment have given rise to distrust and resentment toward the United States that he was able to exploit? How did the presence of U.S. business enterprise affect the bargaining positions of Cuba and the United States during the crucial days of 1959 and 1960 when Cuba was moving rapidly toward the Soviet Bloc?

CUBA AND THE UNITED STATES: 1959-1960

At the time that Castro came to power, after Batista fled Cuba on New Year's Day 1959, the U.S. business community had little basis for regarding the turn of event with grave misgivings. Castro had not expressed open hostility either to the United States government or to private business interests. On the contrary, during the preceding two years, while he was leading the rebel forces against the Batista regime, Castro had gone to great lengths to gain sympathy and support from the United States. The considerate treatment of Americans

[1] U.S. Department of Commerce, Bureau of Foreign Commerce, Investment in Cuba (Washington, D.C., 1956), p. 10.

who came into contact with the rebels, the frequent disclaimers of Communist association, and the public pronouncements about democracy, social justice, and economic reform couched in terms of Western tradition, all served to demonstrate a friendly attitude toward the United States. According to one press account of January 8, 1959:

> American Ambassador Earl Smith describes the rebels as "friendly and courteous," surprisingly capable in preserving order among the populace and exhibiting not the slightest anti-American sentiment. An American banker confesses: "The way their troops have behaved so far certainly throws dust on the fear that they are a bunch of Communists." Another Yankee businessman exclaims, "They're just nice kids."[1]

At the same time, the business community did have some reason to feel uneasy and annoyed. Among other things Castro had earlier proclaimed, in 1953, that under "revolutionary law" (1) workers would have "the right to share in thirty per cent of the profits of all the large industrial, commercial, and mining companies, including sugar mills," and (2) the telephone and electric utilities would be nationalized with "return to the people of the unlawful excess that they have been charged in their rates."[2] The Manifesto of the July 26th movement had condemned colonial mentality and the domination of Cuba by foreign economic interests.[3] Moreover, the rioting, sabotage, and labor strikes during the campaign against Batista had worked to the detriment, at least in the short run, of some business interests. Ruby Hart Phillips reported in 1957:

> American businessmen told me that I was contributing to the ruin of the economy by stories of the rebellion. Both American and Cuban businessmen were annoyed. With Cuba

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[1] Wall Street Journal, January 8, 1959.

[2] These statements are from Castro's "History Will Absolve Me" speech (October 6, 1953), as quoted in Jules Dubois, Fidel Castro, Rebel -- Liberator or Dictator? (Indianapolis, Bobbs Merrill, 1959), pp. 70-71.

[3] The Manifesto is reproduced in Enrique Gonzalez Pedrero, La Revolucion Cubana (Mexico City, Escuela National de Ciencias Politicas y Sociales, 1959). See p. 89 for the relevant passage referred to here.

> as prosperous and money so plentiful, they couldn't understand why anyone would support a revolution. They wanted Batista to crush the Fidel Castro rebellion so they could "get on with business."[1]

In any event, U.S. investors perceived no compelling reason to retrench or pull out of Cuba. Although Castro had left-wing leanings, to be sure, it was not clear that they posed any serious threat to the conduct of business as usual. During 1959, companies went ahead with their investment plans; ironically U.S. net direct investment of $63 million during that year was even larger than it had been in most of the years since World War II.

Even before the end of 1959 it became apparent that Castro was more hostile towards private investment than was believed earlier. The Cuban government installed "intervenors" to oversee the operations of several large U.S. owned companies including the Cuban Telephone Company and the Compañía Cubana de Electricidad.[2] Reductions in telephone and electricity rates and extensions of service were quickly ordered. After passing the Agrarian Reform Law, the Government seized lands producing tobacco, rice, and coffee -- including large plantations owned by Americans and Cubans. The 20-year 4-1/2 per cent bonds offered in payment came under protest by the U.S. government as not being "prompt, adequate, and effective compensation."[3] Under new mining and petroleum laws most of the existing claims were canceled, additional taxes were imposed and foreign mineral companies began closing down.

Castro's public statements became increasingly bitter about "foreign vested interests" that, being injured by the turn of events, allegedly were trying to "destroy" the revolution. Castro declared in one 3-1/2 hour speech that all counter-revolutionaries were in league with foreign vested interests.

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[1] R. Hart Phillips, Cuba, Island of Paradox (New York, McDowell Oblensky, 1959), pp. 335-336.

[2] The government intervenors exercised management functions, while ownership remained unchanged.

[3] New York Times, January 13, 1960, p. 49.

> The Premier declared the Revolutionary Government was being accused of communism as a pretext, because foreign vested interests do not like the revolutionary law.
>
> "All the things we do, like reducing rent, distributing land to the peasants and growing rice injure foreign vested interests."[1]

In February 1960, Ernesto Guevara, one of Castro's closest associates, challenged the worth of foreign investments:

> We maintain the point of view that foreign investments in Cuba, as in all countries of Latin America, under the conditions on which they are made, constitute a great business for the investor, but a bad business for the country.

Only a month later Guevara charged:

> Our hardest fight is against the North American monopolies.... Private foreign capital comes here only for profit and does nothing for the people of Cuba.[2]

In February, Anastas Mikoyan arrived in Cuba to negotiate a trade pact covering the sale of Cuban sugar to the Soviet Union for industrial credits and crude oil. This was followed by establishment of diplomatic relations with the Soviet Union and Communist China. At the same time that the Cuban propaganda line was taking on an increasingly Marxist flavor -- defending the Soviet Union and condemning the United States at every turn -- Soviet technicians began pouring in.

In the face of slander directed at the United States, the closer ties with the Soviet Bloc, and the expropriation of property without prompt and reasonable compensation, agitation increased in Washington to cut Cuba's sugar quota for the American market. The 1960 quota had been set, a year earlier, at 3,119,655 tons -- 59,180 tons <u>more</u> than for 1959. According to long-standing agreements with Cuba, the United States paid about 2 cents a pound above the world market price for sugar coming in under quota -- a premium of well over $100 million

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[1] <u>New York Times</u>, October 27, 1959, p. 1

[2] As quoted in the <u>New York Times</u>, February 6, 1960, p. 1, and March 21, p. 1, respectively.

per year. Castro, bitterly assailing the prospect of a quota reduction as "economic aggression," vowed stern retaliation:

> We'll take and take until not even the nails of their shoes are left. We will take American investments penny by penny until nothing is left.[1]

But before either country acted a new crisis erupted in mid-1960: The three foreign owned oil refineries in Cuba (two owned by American interests, one by European interests) refused to refine incoming Soviet crude being traded for Cuban sugar. Their refusal immediately led to take-over by Cuban authorities. This was the last straw. The Eisenhower Administration promptly cut the sugar quota by 95 per cent for the remainder of the year, and this resulted in a loss to Cuba of about $92 million in sales to the United States.

Castro lost no time in again assailing the United States for attempting to destroy the Cuban revolution. He complained that when "Cubans were being murdered in great numbers" and when the country was being "sacked" during the Batista era, it never occurred to the "Yankee Oligarchy...to have its press write of the horrors in which Cuba lived" or to demand a cut in Batista's sugar quota. The Yankee Oligarchy failed to do these things, Castro asserted, because it "was owner of our lands, our mines, our factories, our commerce, most of our banks, our public services, and withdrew millions of dollars from our economy yearly."[2]

A month later, in early August, Castro made good his earlier counterthreat when he announced a new expropriation decree covering the telephone and electric utilities, oil refining and marketing facilities, and all U.S. owned sugar mills on the island. The properties, valued at about $750 million, represented about two-thirds of the total value of U.S. private investment in Cuba. The announcement marked the beginning of the "Week of Jubilation." Immediately

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[1]As quoted in the New York Times, August 21, 1960, Section III, p. 1. See also June 24, 1960, p. 1.

[2]As quoted in the New York Times, July 8, 1960, p. 1.

the Cuban press and radio hailed the nationalization as marking the "final independence of Cuba."

> In Havana, repair trucks of the Cuban Telephone Company... one of the concerns nationalized raced through the streets filled with celebrating employees. The workers blew the horns of the vehicles, beat on the sides of the trucks with sticks, and kept up a shout of, "Cuba yes! Yankees no!"[1]

At the close of the "Week of Jubilation" the Confederation of Cuban Workers called for enlistment of worker's and peasant militia against any aggressor who, by means of direct intervention or counter-revolution, sought to destroy or subvert the Revolutionary Government. The meeting called for renewed vigilance against counter-revolutionaries, propagandists, saboteurs, and conspirators, and "to silence them with our reply or deliver them to revolutionary authorities."[2] Simultaneously, the Popular Socialist Party (the Cuban Communist Party) announced the first national assembly since the time it was forced underground by the Batista regime. Foreign observers from around the world were invited to attend.

A few weeks later, while foreign ministers of the Organization of American States were meeting in Costa Rica to consider the threat of Soviet presence in the Western Hemisphere, Castro affirmed his friendship with the Soviet Union and the Chinese People's Republic. In his lengthy speech broadcast by radio and television, Castro again assailed the OAS and the United States, declaring that the strength of the revolution would carry the nation to final victory over its enemies. Among other factors of strength, Castro pointed out that the revolution "took away the lands of the big property owners and the American companies."[3] Addressing the United States he declared that the people of Cuba:

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[1] New York Times, August 9, 1960, p. 3.

[2] New York Times, August 14, 1960, p. 1.

[3] As quoted in the New York Times, August 25, 1960, p. 12.

> ...no longer believe in your philosophy of exploitation and privilege, or in the philosophy of gold, the gold that you rob from the work of other people; no longer are we disposed to follow the orders of your ambassador. ...[Nor] do we believe in your false Pan Americanism with which you cloak the system of oppression and abuse, the system of domination that you have introduced among our divided peoples of America.... [No longer will Cuba be] an appendage of your economy nor will Cuba ever again vote in the United Nations as you indicate but will vote as our dignity and conscience indicate.[1]

Facing the increasing hostility of the Cuban regime with its closer ties to the Soviet Bloc, the U.S. government contemplated new measures to reduce the threat of a Communist-oriented Cuba in the Western Hemisphere. In late August the Senate voted to cut off foreign aid funds to any nation supplying arms or economic assistance to Cuba. In October, the United States imposed an embargo on exports to Cuba, covering everything except food and medicine.

The Cuban government then seized most of the remaining large private properties on the island. These included banks, and commercial, industrial, and transportation enterprises -- about 20 of which were owned by U.S. interests. Only about 200 small U.S. enterprises were left in the hands of their owners.

In short, the year 1960 saw the rapid deterioration in relations between the United States and Cuba. Threat was met by counterthreat, punitive action by counteraction, and all the while Cuba drew closer to the Soviet Bloc. In the words of Tad Szulc:

> From the time the Cuban sugar quota was cut, a physical clash between the United States and Cuba, directly or indirectly, was unavoidable. As it began to run out of its patience and tolerance toward Castro, the Eisenhower Administration, in the late spring, 1960, set up training camps in Guatemala for a rebel Cuban force to be used in a contingency of one sort or another. Soon, it was tacitly accepted on both sides that an invasion was inevitable sooner or later, and that it was only a question of time before it came.[2]

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[1] Ibid.

[2] Tad Szulc, The Winds of Revolution (New York, Praeger, 1963), p. 135.

U.S. BUSINESS ENTERPRISE AND THE EVENTS OF 1960

A critical aspect of the revolution involved Castro's ability to transfer the hatred his followers had for Batista, to hatred of the U.S. government and its business interests. In the beginning, the revolution was directed against the brutal suppression and terrorism of the Batista regime. Although the rebels resented U.S. support of the Batista regime, they did not wage a strong anti-American campaign. On the contrary, they vied with Batista for sympathy and aid from the United States. Castro's early support among Cuban intellectuals and professional classes was not predicted on the notion that Cuba must follow the Soviet economic pattern or that the United States was an implacable enemy. It was their hope of freeing Cuba from Batista and achieving a measure of political democracy, social justice, and sound economic reform within the framework of Western ideology that served as a primary source of revolutionary strength.

When Castro mounted his anti-American campaign in late 1959 and 1960 he lost support among the intellectual and professional groups, as the flight of thousands to Miami would suggest. But he was able to maintain influence, especially among the poorer classes, during that critical period within which the character of the revolution was radically transformed. In depicting the United States as the "aggressor" as the "rapacious and exploiting imperialist" in league with Batista, he was able to maintain a hold over the masses through 1960, consolidate his power, and move firmly into the Soviet Bloc.

For our purposes, a fundamental question relates to the role that U.S. business enterprise may have played in the anti-American campaign. To what extent did the composition and level of U.S. business investment make it vulnerable to Castro's assaults? More specifically, what was it about the character of U.S. enterprise, if anything, that made its interests easily identifiable with those of the Batista regime? In 1960, to what extent did the apparent hostility of the U.S. government to the revolution seem (among Castro's supporters) to be motivated by the desire to defend U.S. private business interests? To what extent was U.S. enterprise vulnerable to the charge that it contributed to foreign economic domination of Cuba?

<u>Investment in Public Utilities</u>

An examination of the composition of U.S. investments in Cuba may provide some clues to the answers. In the first place, note in Table 3, p. 16, that the book value of U.S. public utilities investments comprised about one-third the total value of U.S. owned Cuban investments in 1959; on a per capita basis, U.S. investments in public utilities were over ten times larger in Cuba than in other Latin American countries. The concentration of U.S. investment in public utilities may have been unfortunate from the standpoint of U.S. national interests, insofar as investment in public utilities industries may have become intimately associated in the minds of Castro's supporters with the Batista regime. These industries by their very nature are ones of large, noncompeting firms that must operate essentially as monopolies if they are to be economically efficient. As competition cannot be relied upon to ensure performance in the public interest, governments typically step in to regulate the industries directly. In some cases, especially in the United States, governments establish regulatory agencies to supervise privately owned utilities. In other cases, governments both own and operate the utilities. In Cuba, the role of the Batista government as regulator of the foreign privately owned utilities made the industry vulnerable to accusations that it was in league with the Batista regime (however unfounded the accusations may have been), and that it was an enemy of the revolution. Purely by matter of coincidence, a regulated public utility can appear to be embroiled in local politics and scandal, through no fault of its own, simply because of its special relationship with the host government.

A specific case in point involves the rate increase granted in 1957 by Batista to the Cuban Telephone Company. <u>On economic grounds</u>

the rate increase may have been long overdue and entirely justified.[1] Yet, certain evidence suggests that the environment in which the increase was granted created an unfavorable psychological effect that was conveniently exploited by Castro in later years.

On March 13, 1957, a poorly planned and coordinated attack was made by Cuban rebels on the presidential palace in an unsuccessful assassination attempt against Batista. The president escaped, reinforcements of loyal troops were rushed to the scene, and by the time the firing had ceased 25 rebels were dead. A few hours later an opposition leader, Pelayo Cuervo, was brutally murdered. According to some writers, the order for the murder had come from Batista himself on the heels of the palace attack.[2] Cuervo had been "an honest, respected, and courageous lawyer."[3] He had achieved widespread recognition in filing a brief against former President Grau, alleging that he had stolen over a hundred million pesos from the public treasury. And not long before he was murdered, Cuervo had declared that he was about to start similar proceedings against Batista. Moreover, about a year before his assassination, Curevo had filed another suit "to block a proposed increase in the rates of the American-owned Cuban Telephone Company...."[4] According to one account:

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[1]Many economists have observed that rates of return to public utilities are typically held to very low levels by Latin American governments. On one hand these enterprises face criticism for the poor service they render, on the other hand, they cannot render better service because rates they are allowed to charge consumers are too low to cover an expansion of investment. See D. F. Cavers and J. R. Nelson, Electric Power Regulation in Latin America (Baltimore, The Johns Hopkins Press, 1959). According to one source, the rate of return of the Cuban Telephone Company over a 38-year period was only about 4 per cent -- far below the rate generally allowed in the United States, New York Times, October 13, 1960, p. 34.

[2]Robert Taber, M-26, the Biography of a Revolution (New York, Lyle Struat, 1961), p. 124; Jules Dubois, Fidel Castro, Rebel -- Liberator or Dictator? (Indianapolis, Bobbs Merrill, 1959), p. 154.

[3]Dubois, op. cit., p. 153.

[4]Taber, op. cit., p. 125.

> The murder of Cuervo shocked the people of Havana. There was no statement from the palace or from any government official condemning it....
>
> On the morning of March 14, hours after the attack on the palace and the reprisal murder of Pelayo Cuervo, American Ambassador Arthur Gardner entered the still bullet-marked palace with officers of the economic staff of the embassy, to be present at Batista's signing of a new contract with the Cuban Telephone Company. The effort of Gardner to help Batista convey an impression both at home and abroad that things were normal in Cuba at that moment neither ingratiated him and the State Department with the people of the country nor enhanced the popularity of the Cuban Telephone Company....[1]

In all likelihood the new telephone contract had been negotiated long before the palace attack. It was an unfortunate coincidence that the formal signing came just after the time of the attack and Cuervo's murder. But again this brings out the point -- simply by being closely associated with a host government, as is necessary with regulated public utilities, the company can become an innocent victim of circumstances.

When Castro accused the United States and its vested economic interests of supporting Batista, the association between the public utilities and the Batista government lent plausibility to the argument. And when he accused the United States and its business interests of trying to destroy the revolution, this was also a plausible argument; since the companies were presumably being hurt by Castro's early decrees, it was only natural (so Castro's supporters easily could be led to believe) for these business interests and the United States government to be hostile toward the revolution.

Besides their special association with the Cuban government, the public utilities were in a sensitive position simply because the services they supplied _were_ so basic in both the industrial development of the economy and in the direct satisfaction of consumer needs. In being so vital in both urban and rural areas they were a conspicuous,

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[1] Dubois, _op. cit._, pp. 155-156.

though perhaps unjust, target for consumer complaint about services and rates. The political sensitivity of the utilities and the vital character of their services made them convenient focal points for attack during the revolution itself. It is notable that even as early as 1953 Castro had called for nationalization of the telephone and electric companies and a reduction of rates. After he came to power, his first actions against U.S. companies included intervention of the Cuban Telephone Company (in March 1959), cancellation of the telephone rate increase that had been granted by Batista, and reduction in electric utility rates.[1]

The Sugar Economy

Referring back to Table 3, we see that a large proportion of U.S. investment in Cuba was also concentrated in agriculture -- primarily sugar production. As in public utilities, about one-third of the total book value was in agriculture and in per capita terms the concentration in agriculture was far higher in Cuba than in the rest of Latin America. Moreover, in 1955 the total sales of U.S. owned agricultural enterprises in Cuba were responsible for nearly one-half the total sales of all U.S. owned agricultural enterprises in Latin America.[2]

From the standpoint of comparative advantage in international trade, Cuba's advantage may very well have been in sugar. By exporting sugar which could be produced cheaply, and importing goods that other countries could produce more cheaply, Cuba may have been able to enjoy a higher aggregate national income than would otherwise have been forthcoming. If so, it was only natural for U.S. capital to be attracted to sugar as the operations of the market mechanism,

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[1] For a discussion of these events see Freeman Lincoln, "What Has Happened to Cuban Business?" Fortune, September 1959, pp. 110-274.

[2] U.S. Department of Commerce, Office of Business Economics, U.S. Investments in the Latin American Economy (Washington, D.C., 1957), p. 47.

presumably reflecting national comparative advantages, would make sugar production relatively profitable in Cuba.[1]

Of course, the major difficulty with this point of view is that aggregate national income is only one measure, and frequently a poor one at that, of a nation's economic welfare, and it may have little to do with the nation's political welfare. Long-run <u>growth</u> rates of income, income distribution, unemployment levels, the level of perceived social justice, are just a few of the factors that cannot be disregarded in any meaningful appraisal of the Cuban revolution. Although concentration on sugar production may have been a wise choice from the standpoint of Cuba's aggregate national income, it also generated a serious employment problem because of the seasonal nature of the crop, and it made Cuba's prosperity greatly dependent on its export trade. The U.S. Department of Commerce reports that in 1953, for example, Cuban unemployment fell to a minimum of 8.4 per cent of the labor force during the height of the sugar harvesting season, but then rose to 20 per cent of the labor force during the rainy or dead season -- as compared with the U.S. unemployment rate of 2.4 per cent in that year.[2] Cuba's exports, of which sugar products comprised almost 90 per cent in 1952, contributed between 30 and 39 per cent of its national income in 1952-1954.

> ...almost all the activities of the island are geared to the rise and fall in the volume and value of export crops. When demand and prices abroad are favorable, all sectors of the Cuban economy are prosperous, but when conditions abroad are unfavorable, the economy has very little to cushion the effects.[3]

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[1]One might argue that in terms of dynamic comparative advantage, as distinguished from the static case, perhaps Cuba's advantage was not so clearly in sugar. But we need not treat the possibility here. Rather the point made below is that even if concentration in sugar <u>was</u> in Cuba's economic interests (measured in terms of aggregate gross national income) it raised political problems and may have worked to the detriment of the United States during the revolution.

[2]U.S. Department of Commerce, Bureau of Foreign Commerce, <u>Investment in Cuba</u> (Washington, D.C., 1956), p. 5.

[3]<u>Ibid.</u>, pp. 7 and 139.

Moreover, Cuba was highly dependent on the United States for both her export markets and for imports into Cuba of other products. In 1951-1953 about 59 per cent of the value of Cuban exports went to the United States, and about 76 per cent of the value of its imports came from the United States.

When Castro complained about the domination of the Cuban economy by the United States, and when he declared that Cuba would no longer be an "appendage" of the U.S. economy, the existing pattern of economic activity gave his argument an air of plausibility in the eyes of his followers. The economic dependence of Cuba on the United States, the one-crop seasonal nature of the Cuban economy, the discontent and misery of the unemployed, all contributed to a frustration and resentment exploited by Castro in his battle with the United States.

To take a case in point, the theme of land reform appears throughout the literature of the revolution. Constant reference is made to the alleged maldistribution of land in Batista's day and the plight of the landless peasant. One writer observes:

> Seventy-five per cent of an agricultural country the size of England, with a population half again that of Ireland, was owned by eight per cent of the property holders, a few dozen rich Cuban families and the giant U.S. and Cuban sugar and cattle companies. Tens of thousands of rural Cubans lived in misery on marginal lands, in swamps and in the trackless mountains where their fathers and grandfathers had been driven by the ruthless expansion of the sugar monoculture, which produced sugar to rigid quotas and let millions of areas of land lie fallow to become overrun by brush and weeds.[1]

During Castro's expropriation program, it may have been politically disadvantageous to the United States to have so much of Cuba's sugar production in the hands of U.S. owned firms. Although American participation in raw sugar production had declined from the 1930s it still amounted to about 40 per cent of the total in the mid-1950s.

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[1] Robert Taber, op. cit., p. 303.

Furthermore seven of the ten largest latifundias were owned by U.S. interests.[1] Insofar as the land reform did injure U.S. agricultural interests in Cuba, and insofar as the U.S. government did seek to protect these interests (by protesting the inadequate measures of compensation), it was not difficult for Castro to make a plausible, and (superficially) convincing case that the "State Department" and "Wall Street" were in league to defeat the revolution. The problem here, as in the case of public utilities, is that a good deal of U.S. investment was concentrated in an area that would be especially affected by the basic reforms being preached even before Castro came to power in 1959. When the time came for the anti-American campaign, it fitted in nicely with Castro's purposes to argue that the agricultural interests owned by foreign "monopolists" stood in the way of reform -- if reforms were instituted, these interests would be hurt and, naturally, they would fight back. All the more reason, he argued, to seek help and friendship from the sympathetic Soviet Bloc in struggling against these "enemies of the revolution."

Even the favorable price and tariff treatment accorded Cuban sugar was attacked. Besides paying the price premium of 2 cents a pound, the United States accorded preferential tariff treatment on imports of Cuban sugar. Altogether the sugar premium and the preferential tariff were worth about $150 million a year to Cuba. At the same time, Ernesto Guevara condemned the sugar price and quota system as "economic enslavement" because these benefits were allegedly offset by reciprocal demands by the United States for preferential Cuban tariff treatment towards U.S. manufactured products, "making it impossible for native products or the manufacturers of other countries to compete."[2]

Investment and U.S. Foreign Policy

In conclusion, the foregoing discussion suggests that the presence and character of U.S. investment in Cuba did play a role in Castro's

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[1] Samuel Shapiro, "Cuba: A Dissenting Report," New Republic, September 12, 1960, p. 12.

[2] New York Times, March 5, 1960, p. 1.

ability to maintain a measure of popular support while simultaneously waging his propaganda campaign against the United States and moving toward the Soviet camp. But we should note that there were many sources of friction between Cuba and the United States that are not obviously related in a direct way to the presence and composition of U.S. investment. And these sources, too, Castro sought to exploit. For example, the following are notable as factors that generated resentment and distrust toward the United States:

1. The sale of arms by the United States to Batista until 1958 and maintenance by the United States of a military training mission in Cuba until Batista fled the island;

2. The apparent friendliness of U.S. Ambassadors to Batista that lent an "official" stamp of approval to the Batista regime;

3. The shock expressed by the American press toward the political executions carried out by Castro during his early months in power, while the press had paid little attention to the countless murders committed during the Batista period. Why were these executions any different, many Cubans reasoned, from the executions of German war criminals after the Nuremberg war trials?

4. The haven given to numerous "Batistiano" refugees by the United States, and the alleged freedom they were given to plot counter-revolutionary activities;

5. The scattered bombings of Cuban properties by small private planes flying out of Florida, and various covert counter-revolutionary activities that were alleged to have the approval of the U.S. government;

6. The U.S. denial of the sales of arms to Castro and U.S. attempts to prevail upon European governments to do likewise.

One could maintain that these sources of friction were quite apart from U.S. private investment activity and that they also contributed to Castro's propaganda campaign. While private investment may also have played a role, it was only one of many factors -- and it is impossible to weigh the importance of each factor in the whole chain of cause and effect relationships.

At the same time, we could ask, Why, in the minds of Castro's followers, did the United States seem to be motivated to undertake these measures that appeared so hostile to the revolution? For Castro, the answer was easy: the motivation stemmed from the desire to protect U.S. business interests that were being hurt by the revolution, and to protect the dependent colonial status of Cuba that allegedly had worked to the economic benefit of the United States at the expense of Cuba. In this sense, the factors listed above were related to the presence and nature of U.S. business activity in Cuba. Quite apart from the question as to whether this explanation was actually the basis for U.S. government policy at the time, the critical point to remember is that the objective nature of relations between the United States and Cuba made it easier for Castro's followers, at his prodding, to believe that the motivation of the United States stemmed from a desire to protect its economic interests.

ISSUES RAISED BY THE CUBAN EXPERIENCE

The Cuban experience raises several interrelated issues. Although we make no attempt to definitively treat them here, it is hoped that this summarization of the issues will stimulate further consideration of relationships between private investment and U.S. national interests.

First, to what extent do U.S. business enterprises identify themselves with the aspirations of the host countries? To what extent do they strongly support reforms of the type envisioned under the Alliance for Progress, or to what extent do they support a status quo economic, political, and social structure? Or, more specifically, to what extent would particular U.S. business enterprises be injured (at least in the short run) by thoroughgoing attempts of the host economy to engage in land reform, fiscal reform, and other measures so frequently mentioned in the press and elsewhere as being "necessary" for the rapid development of Latin America? Or what about the dilemma involved when such reforms harm certain kinds of existing U.S. business enterprise, but at the same time make more attractive the long-run, over-all investment climate for both U.S. and local business enterprises? In Cuba some U.S. enterprises were harmed by the early laws and regulations of the Castro regime. But U.S. government protests (which objectively may have been entirely justified) facilitated an identification of U.S. government policy with U.S. business interests in a manner that suggested, to some observers, that both were opposed to any major change from the economic, social, and political structure of Batista's regime.

Second, to what extent can the United States depend on the market mechanism to allocate its foreign investment in a way that serves both economic and political national objectives? We have seen that while investment in Cuba may well have contributed to Cuba's aggregate national income, it also contributed to unstable economic conditions arising from seasonal crop production. It is true that in the 1930s and 1940s U.S. investment gradually shifted away from agriculture into activities that contributed to some diversification of the Cuban economy. Table 5 shows that investment in agriculture dropped from about two-thirds to about one-third of total U.S. investment from 1929 to 1959. Yet, the remaining large holdings in sugar and the relative increase in public utility investment lead one to ask whether the composition that did prevail in 1959 was appropriate in terms of U.S. political objectives.

It is interesting to speculate whether a different distribution of U.S. investment, <u>even with the result of a smaller aggregate national income in Cuba</u>, might not have contributed to the rise of a more moderate regime, more kindly disposed towards the United States and the West, as well as to an economy that in the eyes of its own people would have been more viable and stable. More specifically, one might speculate as to (1) whether a concentration of U.S. investment in import-substituting manufacturing and foodstuffs and a concentration in new industries that would have diversified Cuba's export base, at the expense of traditional sugar agriculture and public utilities, would have generated a more stable employment pattern,

Table 5

BOOK VALUE -- U.S. DIRECT INVESTMENT ENTERPRISES
IN CUBA, 1929 AND 1959

Industry	1929 (million $)	1929 (per cent of total)	1959 (million $)	1959 (per cent of total)
Petroleum	9	1	147	15
Manufacturing	45	5	111	12
Public utilities	215	23	313	33
Trade	15	2	44	5
Other	635	69	341	36
Total	919	100	956	100

Sources:

Table 3 and U.S. Department of Commerce, Investment in Cuba (Washington, D.C., 1956), p. 10.

and would have reduced economic dependence on the United States, (2) whether this might have pulled the teeth out of some of Castro's arguments and made it much more difficult for him to maintain popular support against the United States in 1959-1960, or (3) whether such a structure of investment in Cuba during the 1930s and 1940s might have given rise to a quite different pattern of political change such that a Castro, or at least so hostile a Castro, would not have appeared in the 1950s.

Third, what role does U.S. private investment play in strengthening or weakening the position of the U.S. government in international bargaining? U.S. capital in Cuba may have served to reduce the credibility of the U.S. threat to cut the sugar quota in 1960. Because U.S. investors had such large holdings in sugar and related industry, some observers believed that the United States would not carry out such a threat because it would be harming its own business interests.[1] To the extent that Castro and his advisers felt this to be the case, the presence of U.S. investment in sugar may have blunted U.S. bargaining power at this most critical point in U.S.-Cuban relations. More generally, the question arises as to the credibility of threats against host countries in other circumstances where U.S. private interests would be injured. Moreover, the presence of private U.S. enterprises may increase the host country's bargaining strength to the extent that it can credibly threaten to expropriate them. On both counts, the bargaining power of the United States would be impaired vis-á-vis the host country. On the other hand, the presence of U.S. business activity provides the United States also with a bargaining tool -- for the United States can threaten to restrict operation of the activity in a manner that would harm the host economy. However, since this threat, if carried out, would endanger the

[1] Leo Huberman and Paul M. Sweezy, Cuba, Anatomy of a Revolution (New York, Monthly Review Press, 1961), p. 180.

U.S. private interests themselves, the credibility of such a threat would be in question.[1]

Fourth, what role do private investors play in affecting the course of U.S. foreign policy? It is notable that the refusal of the petroleum refineries to process Russian crude was the immediate -- though perhaps not the fundamental -- reason (or excuse) for Castro to expropriate them. The question arises about the motivation of the refineries as their refusal was, for better or worse, a factor that preceded retaliation and reprisals in the struggle and led to the final complete break between the United States and Cuba. Was their refusal a completely private act or did it have the support of the State Department after thoughtful government study of the potential consequences? One might suppose that it was a private act in that the international petroleum industry is composed largely of a relatively few highly integrated firms, each of which engages in crude production, transportation, refining, and marketing. Typically, the refineries owned by each firm process only the crude sold by its own subsidiaries or branches. When Cuba decided to bring in Soviet crude, it would have been quite consistent with accepted business practices for the refineries to refuse to cooperate.[2] This is <u>not</u> to say that refusal to process Soviet crude was necessarily an error; perhaps it was a wise move entirely consistent with U.S. government policy set down at that time. But the general question about the relationship between private acts and government policy remains.

Finally, to what extent do U.S. private investors become identified with governments of which the United States does not or "should" not approve? By this time the point has been reiterated <u>ad nauseum</u> in the literature that one of the most serious errors of government

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[1]This is true unless, of course, the threat is believed to be so effective that the hostile government would quickly fall and little injury would be inflicted on these U.S. business interests.

[2]A brief discussion of this issue appears in a letter to the editor by Professor Alfred Kahn, <u>New York Times</u>, July 10, 1960, Section IV, p. 10.

conduct in the past has been to appear too friendly toward dictatorships and other governments despised by most of their peoples, and to appear at the same time not to give sufficient support to the progressive, at least moderately democratic, governments whose survival is very much in our long-run national interest. But what about the activities of U.S. private firms? To what extent does mere conformity with laws and regulations of unpopular regimes seem to identify these firms and the U.S. government with these regimes?

Beyond exploring some of the economic-political aspects of U.S. investment in Cuba, we cannot offer more definitive treatment here of these issues. In proceeding further in this direction, it would be desirable to examine the economic-political environment of U.S. capital in other countries. One might, for example, explore the situation of petroleum in Venezuela, copper in Chile, and manufacturing in Argentina, where the experience undoubtedly varies a good deal from that of Cuba. For now, it is hoped that issues raised by the Cuban experience will be useful in stimulating and guiding further consideration of relationships between private investment and U.S. national interests.

For the remainder of this study we shall shift from analysis of historical chronology to a largely theoretical treatment of potential sources of conflict between U.S. enterprises and host countries. Rather than examining particular problems in particular countries, we shall discuss the problem of conflict on a more general level. By doing so, it will perhaps be possible to gain a better understanding of certain problems faced by foreign enterprise in Latin America.

III. CONFLICT BETWEEN U.S. BUSINESS ENTERPRISES AND HOST COUNTRIES

This section examines a number of circumstances under which conflict might arise between host countries and U.S. business enterprises. By addressing the economic nature of these conflicts, and their potential political consequences in the broader context of U.S.-host country relations, we may perhaps gain some additional insight into the problem of formulating future public policy toward private investment in foreign countries. The analysis concentrates first on special problems encountered in extractive, export-oriented industries, and then goes on to consider some of the sources of conflict involving business enterprise in general. It concludes by treating very briefly government and business policies and programs designed to improve the economic-political impact of U.S. business activities.

PROBLEMS OF EXTRACTIVE, EXPORT-ORIENTED INDUSTRY

Any number of writers have pointed out that (aside from the public utilities) host country resentment, threats of expropriation, and other kinds of hostile behavior, tend especially to be directed toward the extractive, export-oriented industries -- those whose products are sold primarily in markets <u>outside</u> the host country, as distinguished from domestically oriented industry whose product is sold primarily within the host country. To consider just two examples, on the basis of public opinion surveys undertaken from time to time in Latin American countries, one analyst has concluded:

> ...[a] generalization which stands out from this research is that opinion may differ widely in terms of <u>what kind of U.S. business</u> we are talking about. Roughly speaking, there are three types of U.S. business which carry with them different connotations for the local Latin publics, and therefore elicit different attitudes. The first of these types is the extractive and utility business -- the petroleum, mining, gas and electric companies. Opinions regarding U.S. ownership and operation of these industries tend to be polarized in many of the Latin countries in the direction of nationalization and expropriation.

> Next, there is the somewhat vague concept of "big foreign" businesses, which arouse strong opposition with sectors of the public in these countries, though not so strong as that directed toward the utilities and extractive industries.
>
> And finally, there is the general run of small and medium-size U.S. business operations which appear to arouse comparatively little opposition in most of these nations.[1]

Another observer writes:

> ...well over half of our investments are in the very fields where our activity is specifically resented.
>
> These are, of course, extractive industries, industries that wrench something out of the soil or subsoil and ship it elsewhere; industries whose incomes depend not only on cheap local labor but also on vigorous exploitation of cheap local natural resources. Quite apart from the Communist line, is it any wonder that we are known here as "exploiters"?[2]

The question immediately arises as to why extractive, export-oriented industries are singled out for such criticism. After all, these industries pay taxes and royalties, they provide employment and training, they purchase local materials, and in doing so they provide a badly needed supply of foreign exchange to host economies. Examining the Department of Commerce surveys of U.S. investment in Latin America, one is struck by the fact that these industries contribute to host economies in apparently the same way as do other industries in terms of employment, local materials purchases, taxes, and so forth.[3] On the basis of the figures, one would be hard pressed to show that some U.S. investment activities are superior to others in terms of economic impact.

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[1]Elmo C. Wilson, "Current Latin American Attitudes and Motivations Affecting the Climate for U.S. Business in Latin America" (New York, International Research Associates, 1963), mimeo., p. 2.

[2]D. H. Radler, <u>El Gringo</u> (Philadelphia, Pa., Chilton Co., 1962), p. 49.

[3]See, for example, U.S. Department of Commerce, <u>U.S. Investments in the Latin American Economy</u> (Washington, D.C., 1957).

Here we shall identify and discuss certain characteristics of export-oriented industries that set them apart from other industries. Because these characteristics can, at least in theory, give rise to conflict between these industries and the host governments, the analysis may provide some insight into the reasons for the frequently observed resentment and hostility.

Benefits to the Host Country

A distinctive aspect that may be particularly important in giving rise to conflicts between host governments and export-oriented enterprises is that changes in costs incurred by such industries are reflected in price changes largely to consumers outside the host country, whereas changes in costs incurred by domestically oriented industries are reflected in price changes largely to consumers within the host country.

To maximize its own share of the gains accruing from the foreign investment, the host government has an incentive to impose excise taxes, high minimum wages, labor fringe benefits, and other cost-increasing restrictions on export-oriented industry, insofar as any increase in price is passed on to foreign consumers. The government may be more reluctant to impose the same conditions on domestically oriented industry where the resulting price rise would affect its own consumers.

Of course, one could immediately object that raising the costs of an export-oriented industry will have an adverse effect on output, profits, employment, and foreign exchange earnings in the industry. And, of course, there is some limit beyond which such costs cannot be increased, lest the industry find itself no longer able to compete at all in world markets. Would not the reduction in output and loss of employment and foreign exchange suffered by the economy more than offset any gain that the host economy would receive from imposing such restrictions? Not necessarily. By imposing such restrictions, within some range, the host country's gain in terms of higher wages, larger excise taxes, and so forth, per unit of output may more than offset the losses occasioned by the adverse effect on total output of the industry.

If the sales volume of the industry is not very sensitive to price change, then an increase in cost and price imposed by the host country will not affect output or industry profits very much. Rather, the cost increase will be passed on to foreign consumers in higher prices, and host country gains from the cost increase will (at some level of demand insensitivity) outweigh the losses resulting from output decline. The case of demand insensitivity to price change would arise if the host country produces a very large share of the world's supply of this export commodity, and if the world-wide demand for the commodity is not sensitive to price change. Moreover, even if sales volume _is_ very sensitive to price, or at the extreme, if the industry in the country can sell _all_ it can produce at a given world price, the host country may _still_ reap an advantage by imposing discriminatory cost-increasing restrictions. The case of high sensitivity of sales volume to price change, which is the case we would normally expect to find, arises if the host country produces only a small part of total world supply of the commodity.

However, a more rigorous explanation of the conditions under which, theoretically, net gains accrue to the host country from such restrictions on export-oriented industry and the maximum level beyond which restrictions should _not_ be carried in maximizing net gains to the host economy, requires the use of technical, theoretical tools of economic analysis. This treatment is reserved for the Appendix.

For present purposes three points require emphasis:

(1) The analysis here and in the Appendix does not imply that the host country would _never_ impose cost-increasing restrictions on a domestically oriented industry. If the host government believes that the result of such restrictions would be merely to reduce "excess" profits of the domestically oriented enterprises, rather than to increase prices to its own people, it would have incentive to act

against these enterprises as well. The point here is that such restrictions in domestically oriented industry generally would, to some extent, raise prices to local consumers and result simply in a redistribution of local income. Less incentive would exist to impose such restrictions than in the case where there is a possibility of increasing host country gains at the expense of foreign consumers.[1]

(2) The analysis does not imply that growth of domestically oriented industries should be encouraged and export-oriented industries discouraged in the development program of the host country, or that the economic contribution of the former is greater than that of the latter. On the contrary, one could easily imagine circumstances under which the welfare of a host economy would actually depend on the existence and growth of export-oriented industries. Even so, the government may have reason to believe that the gains can be <u>further</u> increased by discriminatory treatment.

(3) Even if the local economy benefits a good deal from the foreign investment, the distribution of the benefits to the host economy, foreign investors, and foreign users can nevertheless constitute a source of conflict among them. We can easily imagine a situation in which the U.S. government gets involved: an export-oriented industry will most likely resent the "onerous" tax laws and "unjust," "unrealistic" labor legislation. If the enterprises are American owned they may exert pressure on the United States to "do something" -- such as making U.S. government aid programs in the host country conditional on host government promises and performance in encouraging rather

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[1]In the case of both domestically oriented and export-oriented industry, the government would, presumably, try to tax away any net profit <u>in excess</u> of a "reasonable" return to the private investors. This might be accomplished by an income tax on sales revenue in excess of all costs including a reasonable return on investment. In contrast to cost-increasing restrictions of concern above, an income tax defined in this manner would not add to costs and, theoretically, changes in income tax levels would <u>not</u> affect price for either kind of industry. Of course, the interpretation of what level of net profit does in fact constitute a "reasonable" return on investment can itself give rise to serious conflict between host governments and private investors.

than discouraging private foreign investment.[1] Such pressures may or may not induce the host government to abandon practices that discourage foreign investment. If things do go from bad to worse, the host government could become even more suspicious and hostile toward private investors -- it could counterthreaten to seek aid and solace from communist nations and perhaps actually do so. Local ultra-nationalistic political elements probably would lose no time in exploiting the situation in an attempt to gain popular support for themselves.

The problem is complicated, too, by the fact that it is easy for the host government to miscalculate in trying to increase gains to the economy. Whether it succeeds in doing so depends on the sensitivity of demand to price and the cost conditions in the local industry -- conditions that cannot be precisely known. Tempted by the prospects of increasing its own gains, the host government can easily go too far in imposing such restrictions. Such actions might be due to a belief that price will not rise by as much as it actually does (as a consequence of the restrictions) or to a belief that sales volume is less sensitive to price change than in fact it is.

(4) These considerations together suggest that in some cases behavior of host governments, which from the point of foreign investors might seem irrational, may in fact make economic sense from the host country's point of view, or at least have a strong appearance of making sense in the short run. In the longer run, of course, such behavior of the host government may unintentionally frighten off potential investors in other industries, leaving the country perhaps worse off than before.

Technological Change, Efficiency, and Conflict

The preceding discussion has implications for the attitude of host countries toward export-oriented enterprises that attempt to

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[1] Examples of the high taxes encountered by some U.S. owned, export-oriented enterprises are found in the 88th Congress, 2nd Session, Joint Economic Commitee, Private Investment in Latin America, Hearings (Washington, D.C., 1964), pp. 19 and 115.

introduce new cost-cutting technology and, more generally, to operate efficiently in the sense of minimizing costs to themselves for any given level of production. Here we shall demonstrate on theoretical grounds how conflict could arise between export-oriented industries and host governments simply because these industries do attempt to operate efficiently and to introduce, through time, technological advances in their production processes. While it is in the interest of these industries, and the rest of the world, for them to try to minimize the cost of producing any given output -- as by adopting new technology -- there are circumstances under which it may not be in the interest of the host country for costs to be minimized. If the industry cuts its costs per unit of output, the host country may lose some of the benefits it would otherwise derive from the activity, and it may seek to compensate by imposing new higher wage legislation, higher taxes, featherbedding and other cost-increasing restrictions.

To delineate conditions under which this situation could arise, consider the following highly simplified example. In country Y the output of an industry, selling entirely for export, is such that it purchases 10 units of labor at a wage rate of x dollars per unit of labor. Its total wage bill is therefore 10x. Suppose, however, that had this investment not been made these 10 units of labor would have been displaced into less productive local employment, or would perhaps have remained unemployed altogether. In this case, the "opportunity" cost or "social" cost to the economy per unit of labor is less than x. If the cost to the economy in terms of the value of alternative employment foregone is less than x, then the net gain to the economy per unit of labor input purchased by the industry includes (among other things) the difference between the wage rate paid and this lower opportunity cost. Suppose that this opportunity cost to the economy is only 0.6x. The net gain to the economy is therefore 0.4x per unit of labor employed, or a total of 4x.

Now let us consider an alternative case where the industry decides to adopt a new technology such that the labor input per unit of output is cut in half. The labor input at the old output level

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drops from 10 units to 5 units, the wage bill from 10x to 5x, and the net gain to the economy declines from 4x to 2x. Of course, with the reduction in costs to the industry, the selling price also falls and the volume of sales is stimulated. Output therefore rises and labor input rises above 5 units. A critical question is whether output and new employment rise by enough, or more than enough, to offset the initial reduction in employment from 10 to 5 units caused by the adoption of the new technology. If output doubles when labor input per unit of output falls by half, the economy is left with its net gain of 10x as before.

The extent to which output rises, relative to the earlier level, as a consequence of the fall in unit cost depends on the sensitivity to price change of the sales volume for the product country Y is exporting. If country Y produces only a very small part of the total world supply, its sales may rise rapidly as a consequence of the fall in price and output will rise by more than enough to offset the unfavorable effect of technical change. In this case, it would be in the interest of country Y to allow the new technology to be introduced.[1] But if country Y produces a large share of the world's total supply of the product, and if the world-wide demand for the product increases little due to the fall in price, then output in this country may not increase enough to offset the loss of labor employment occasioned by the technological advance. Or, even if the country produces only a small portion of the world supply, so that in a free market the demand facing the country is very sensitive to price, the output of the country may be subject to output restrictions because of world-wide quotas imposed on production of the commodity. In either event, the reduction in cost due to adoption of the new technology may result in a combination of profit rise for the enterprises and a price fall to consumers, with a relatively small increase in output.

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[1] In the extreme case, if the rest of the world adopts the new technology and the industry in country Y does not follow suit, the industry may find itself unable to compete at all in world markets. Again it would be in the interest of country Y to allow the introduction of the new technology.

In either of these two cases in which output does not rise very much, the host government could seek to recover losses arising from the adoption of the new technology by:

(1) Taxing away the industry's "excess" profits generated by reductions in unit cost;

(2) Imposing cost-increasing restrictions such as higher minimum wages, new fringe benefits, and larger excise taxes per unit of output, along the lines discussed in the preceding subsection; or

(3) Preventing the adoption of the new technology or directly countering its effects. For example, it could enact labor legislation that encourages, or at least condones, pressure against the industry for stretch-work, make-work, or featherbedding practices.

These kinds of pressures are encountered in Latin America,[1] and it is partially because of these pressures that relations between host governments and export-oriented industries are frequently strained. But notice the irony in all this. The enterprises in these industries are penalized because they <u>are</u> efficient and progressive. The more they try to reduce their costs by more efficient utilization of local resources, or by introduction of new technology, the more they may be subject to criticism that from the point of view of the host country may seem to make good economic sense. And again, notice the critical difference between export-oriented and domestically oriented industry. In the latter case the benefits of efficiency go largely to host country consumers in the form of lower prices that offset or more than

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[1]An excellent treatment of such labor pressures is contained in the Mission Report on pre-Castro Cuba by the International Bank for Reconstruction and Development, <u>Report on Cuba</u> (Baltimore, The Johns Hopkins Press, 1952), pp. 134-153. The report astutely observes (p. 152) that labor accepts the "credo that there is only so much work to be done in Cuba, and that this limited supply of work must not be used up too fast or by too few people." At first glance, many economists would regard such a credo as mischievous, misguided, and just plain wrong in terms of the over-all welfare of the Cuban economy (as distinguished from the welfare of the laborers themselves). However, this credo may indeed make sense in terms of over-all welfare of the economy (at least in the short run) if the country is heavily dependent on export-oriented industry whose sales volume is not very sensitive to price change.

offset the losses described above. But in the former case the benefits go largely to aliens.

Market Structure and the Threat of Expropriation

Another potential source of conflict between export-oriented industry and the host country arises because of the market structure of the industry. Suppose that country Y produces and exports only a small part of the total world supply of the commodity so that it takes the world price as "given," and it is able to sell all it can export at that price. However suppose that this commodity is produced in country Y by one or several foreign owned enterprises, each of which has enough similar operations in other countries so that each enterprise can affect the world price by its over-all level of sales. That is, the structure of the market that faces the country is not the same as that facing the foreign owned enterprise.

In this case, the foreign owned enterprise, attempting to maximize its own total profit, may set output in country Y at a lower level than the government of country Y would have set had it been in control of the industry. The enterprise takes into account that a higher output in this and other countries will tend to reduce the world price. Presumably, it will adjust output in each country to a level such that (1) the additional or marginal cost of producing an extra unit is the same in each country (abstracting from transportation costs), that is, it will not produce an extra unit in country Y if it can produce the unit more cheaply elsewhere, and (2) the total output for all countries is such that the marginal cost of producing the last unit is just equal to the additional revenue obtained by the firm in selling it. The enterprise thus sets a total output that maximizes its own profit -- taking into account the fact that additional sales would lower the world price.

However, country Y would likely operate at a higher output were it in complete control of the enterprises. If the country produces only a small part of the world's output, its government may not take into account that additional sales would lower the world price. Of course, if all countries were to think this way and act accordingly, the world price would fall. Nevertheless, if the government believes that its actions will not affect the actions of other countries, it may complain that the enterprise is producing too small an output and that the enterprise should invest more to increase the scale of operations. Even if the government is already able to tax most (or even all) of the excess profit generated by local production, it may assert that the economy would be even better off, and that the enterprise would be no worse off, at a higher level of output. But the reason the government holds this view is that it believes that the larger output would not perceptibly affect the world price. The enterprise would disagree with this view, realizing that if it increases output in this country it might be under greater pressure to increase output in other countries as well. And such pressure, if successfully brought to bear, would reduce the world price. Furthermore, the enterprise may want to diversify its sources of supply from a number of countries to "spread the risk" of its operations. To increase output in country Y alone could make the enterprise more dependent on the output of country Y than it would desire.

Under these circumstances serious conflict may again arise between the host government and the foreign owned enterprise. To increase employment and other benefits flowing from the enterprise, the government may exert pressure, such as threatening expropriation, to force an increase in investment and output. The enterprise management may complain that given the local laws and regulations, it is already saddled with very high local taxes and wage levels far in excess of those being paid by locally owned business. To management it would appear a folly for the host government to insist on more investment at the very time it imposes regulations calling for higher wages and taxes (along the lines discussed earlier) that directly worsen the investment climate.

The host government might then be tempted to expropriate. Reasoning that it could increase investment and output and make additional, profitable sales at the given world price, the government may foresee larger net gains to the economy than those arising from foreign ownership and lower output -- even after paying "reasonable" compensation to the former owners. This calculation depends, of course, on the world price being sustained (and on the country being able to finance the additional investment). If other countries reason the same way, and act accordingly, the world price will fall under the pressure of increased output and they could all be worse off than before.[1] But if the government believes that its actions will not affect the behavior of other producing countries, one way or the other, it may decide on expropriation as being wise on economic grounds. And, of course, if it faces nationalist demands at home to get rid of the alien influences, quite apart from the economic considerations narrowly defined here, the pressure to expropriate will be that much greater.

The economic justification that the host government may see in expropriation can, of course, raise serious problems in relations with the United States in much the same manner as we explored in the preceding subsection. The insistence of the host government on progressively higher taxes and wages, the resistance then offered by the foreign owned enterprise, the threats of expropriation levied by the host government, the complaints by the enterprise to the U.S. government of the "unjust" treatment it is facing, the attempts by the U.S. government to forestall expropriation, the accomplishment of expropriation by the host government, the attempt to reach a "reasonable" settlement of compensation -- all this can seriously affect the relations between the host country and the United States. A more rigorous theoretical analysis of factors that affect the

[1]Whether they would be worse off depends on the sensitivity of world demand to price change for the product and the ability of the governments to tax away excess profits of the privately owned enterprises. If lower prices increase world sales only a little, and if governments are already taxing away the excess profit of the enterprises, the additional gains they receive in higher outputs would be more than offset by the reductions in price.

potential gains and losses to the host government through expropriation is carried forward in the Appendix.

Extraction of Irreplaceable Resources

There is often a peculiar psychological problem associated with extractive, export-oriented industry. Many Latin Americans view U.S. enterprises in the industry as taking out both the profits and the wealth, and this somehow seems like double exploitation. In other industries -- such as retail merchandising -- this bizarre notion is not prevalent because it is apparent to the people that local resources are converted into other higher value local resources that, instead of leaving the host economy, remain to be consumed. But in extractive, export-oriented industry, the resources themselves leave the country and the price that the foreign buyers pay may not seem, to Latin Americans, at all "fair" for the wealth given up. When the industry extracts "excess" profit on top of the unfair price, it adds insult to injury.

We should note that the previously discussed conflicts arise because of the export-oriented, rather than the extractive, nature of the industries. This last source of conflict, however, may arise specifically because of the extractive nature of the export-oriented activity. The idea that the country gives up wealth to foreigners by depletion of irreplaceable natural resources, as in mining and petroleum, carries an invidious connotation of economic "exploitation," especially if the process of extracting the wealth is also in the hands of foreigners.

SOURCES OF GENERAL CONFLICT

In addition to the special problems associated with export-oriented industry discussed above, we shall explore briefly three sources of resentment directed against foreign investment in general.

Profit Flows

A recurring theme of the antagonists of U.S. private investment is that Latin America is kept impoverished while the United States grows fat and rich from profits flowing back to investors. A good example of this campaign is given by a recent radio broadcast from Panama:

> U.S. firms established in Latin America derive approximately 500 million dollars monthly from profits. In other words, while the U.S. Congress allocates 525 million dollars for the Alliance for Progress program next year, the United States in one year extracts from Latin America the sum of six billion dollars in profits through firms which U.S. capital has established in impoverished Latin American nations. As can be easily observed, Latin America has its own Alliances for Progress in favor of the United States, supplying six billion dollars actually toward contributing to the high living standard enjoyed by the North American people.
>
> While the U.S. Congress debates on loans to be granted to Latin American nations for the construction of schools, hospitals, roads, and so forth, Latin America is contributing toward the economic potential of the most powerful ~~country~~ of the world. Considering the cited figures, which reveal the increasing poverty of Latin America, it is not strange that the disturbed American hemisphere continues to be jolted by great social upheavals.[1]

Three notable points must be made with respect to this line of argument: first, both in this quotation and in innumerable other instances, the size of the profit flow is grossly exaggerated. The asserted six billion dollar annual profit figure is off by roughly a factor of eight -- according to the Department of Commerce, for 1962 the remitted income of U.S. direct investment enterprises was $761 million, not six billion.[2] Second, no recognition is accorded to the possibility that Latin America is materially better off with the

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[1] Radio Tribuna, Panama City, December 18, 1963.

[2] Survey of Current Business, August 1963, pp. 18-19 (preliminary data). Given a book value of $8472 million estimated by the Department of Commerce for these enterprises, the rate of remitted profit on investment figures is about 9 per cent. Such rate of return computations must, however, be interpreted with great caution; for a discussion see U.S. Department of Commerce, U.S. Business Investments in Foreign Countries, op. cit., p. 51.

private investment, and the accompanying profit outflow, than she would be in the absence of both. Third, in one sense both the preceding points are irrelevant. The most important aspect of the above quotation is not that it is factually inaccurate; rather the crucial consideration is that this argument is accepted as valid in some segments of Latin American society. If we seek to promote U.S. investment in Latin America in the future as a means of furthering U.S. national interests, it is not enough that we believe the investment works for the material benefit of the host countries. Quite regardless of how much "objective" truth is on our side, the position of the United States will suffer, if the antagonists kindle anti-American sentiments by successfully exploiting these kinds of arguments.

The profit flow is criticized also on grounds that it far exceeds the flow of new foreign private investment. It is argued that because U.S. investors are taking out more dollars than they are putting in, they are obviously exploiting Latin America for their own benefit. To quote Beals:

> The present drain of U.S. private profits from absentee capital invested in Latin America totals at least a billion [dollars] a year above reinvestments. In 1961 the take was over 2 billion. Most of this investment is in raw materials and public utilities, not into manufacturing or consumer goods industries. Such investments dovetail with the U.S. economic empire, not with the productive life of the countries where they operate.[1]

In this case the antagonist need go no farther than figures published by the Department of Commerce (see Table 6) which show that profit remittances do exceed direct investment inflows for nearly every year in the period 1950-1962. Even so, the antagonist is on shaky ground: profits are a function of the value of existing total investment while new positive investment flows are merely an increment to the existing total. The difference between the two is

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[1] Carleton Beals, Latin America: World in Revolution (London, Abelard-Schuman, 1963), p. 312.

Table 6

U.S. NET DIRECT INVESTMENT AND REMITTED INCOME IN LATIN AMERICA, 1950-1962[a]
(millions of dollars)

Year	Net Direct Investment	Remitted Income[b]
1950	$ 45	$ 513
1951	182	630
1952	302	569
1953	137	561
1954	70	579
1955	167	672
1956	618	800
1957	1163	880
1958	299	641
1959	218	600
1960	95	641
1961	173	730
1962	- 32[c]	761[c]
Total	$3437	$8577

Notes:

[a]Excludes Western Hemisphere dependencies.

[b]Remitted earnings of subsidiaries plus total branch profits.

[c]Preliminary data.

Sources:

U.S. Department of Commerce, Office of Business Economics, U.S. Balance of Payments, Statistical Supplement (Washington, D.C., Revised Edition, 1963), pp. 178-183, 194-199; Survey of Current Business, August 1963, p. 19.

no direct measure of the economic contribution of U.S. private capital to Latin America.[1] Even if recent investment flows were zero, the productivity to host economies of the existing investment might be far in excess of profit withdrawals.

A more sophisticated variant of this argument is the belief, held by some Latin American economists, that the difference between dollar profit remittances and new dollar investment inflow exerts an unfavorable effect on the host country's balance of payments. But as Raymond Vernon has said, "The argument may make good propaganda, but it is bad economics."[2] The effects of investment on balance of payments go far beyond the mere difference between these two dollar flows. To take a hypothetical example, the value of a foreign petroleum enterprise in a particular country could remain constant from year to year, that is, net investment remains at zero, yet its annual export sales could bring into the country an enormous volume of dollars to cover local purchases and taxes far in excess of the proportion of sales covering profit remittances. (In fact, in 1955, remittances of $398 million by U.S. petroleum companies in Venezuela were equaled by the local tax payments of $398 million alone.[3]) Or the existing investment might be in import-substituting manufacturing activity. Even though remitted dollar profits may be large relative to new dollar investment, the savings in dollar foreign exchange due to the substitution of domestic manufacture for the imported product could be far greater than remitted profit.

But again, the critical factor is not that this argument is analytically defective, but rather that it is widely accepted by responsible people.

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[1] We might also object that new investment should include undistributed corporate profits. But even if they were added to net direct investment in Table 6, the over-all total of $5660 million would still fall below the remitted income total of $8577 million.

[2] Raymond Vernon, "Saints and Sinners in Foreign Investment," Harvard Business Review, May-June 1963, pp. 146-161.

[3] U.S. Department of Commerce, U.S. Investments in Latin America, op. cit., pp. 186-187.

Competition with Local Capital

One element especially hard to assess is the extent to which U.S. private investment competes with, rather than complements, local capital formation. Interestingly, most studies assume that U.S. investment plays a complementary role -- after all, one of the most crying needs of Latin America is for external assistance; if U.S. private capital satisfies some of that need, then obviously Latin America gains. In a number of cases U.S. investment does directly stimulate local capital formation; the many documented cases of U.S. firms buying materials and services from locally owned firms, and even supplying technical and financial assistance to them, attest to that fact. And certainly the vocational, technical, and managerial training provided by U.S. firms contributes to a pool of skilled labor and managerial talent from which local firms may draw.

Even so, some worrisome aspects arise that we cannot afford to overlook. Local enterprise constitutes a large proportion of the private sector in Latin America.[1] Given the relatively large local capital base, it is inevitable that to some degree U.S. investment activity conflicts with lines of local enterprise. Latin American businessmen have complained at times about the superior financial and technical resources of U.S. owned firms that to them constitute "unfair" competition. In this country there has been a tendency to ignore this complaint on grounds that while few people in Latin America may be hurt by foreign owned activities, this loss is overwhelmingly compensated for by the contribution to the general welfare of the host countries. After all, economic development must, by its very nature, entail losses for certain groups in the society.

In terms of economic theory, we would presume that if certain local entrepreneurs are frustrated in their plans by the presence of a U.S. business enterprise, they would release local capital resources

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[1]For evidence of the importance of local enterprise see U.S. Department of Commerce, the Commerce Committee for the Alliance for Porgress, Proposals to Improve the Flow of U.S. Private Investment in Latin America (Washington, D.C., 1963), p. 6.

that can be channeled into some other noncompeting local enterprise. True, the alternative enterprise is likely to be less productive than the original, contemplated project would have been in the absence of U.S. competition. To this extent the net contribution of the U.S. investment to the host economy must take into account this loss of productivity of local capital. But the mere fact that these losses are incurred does not mean that the net contribution of U.S. capital is necessarily negative.

At the same time we must avoid the common pitfall of being concerned with only aggregate effects. The distribution of gains and losses may be crucially important. Suppose, for example, that losses are concentrated among politically vocal groups of businessmen who are very aware of the losses, while the gains are diffused among consumers who are less politically vocal and less aware of the positive benefits of U.S. enterprise. This could result in our losing support among key groups in Latin American society not compensated by additional support elsewhere.[1]

The reader is likely to view this example as an extreme one, if not actually a red herring. For even among politically active local business groups in host countries, the complementary nature of U.S. business enterprise must surely far outweigh the negative aspects mentioned above. But there are two reasons why we cannot completely dismiss these negative aspects: first, increasing emphasis is being given to the idea that future private U.S. investment ought to veer toward medium- and small-scale business rather than toward the very large businesses that traditionally have formed the bulk of U.S. activity in Latin America. To the extent that private U.S. investment

[1]This problem is analogous to that arising in international trade: while free international trade may very well contribute more to aggregate economic welfare than would restricted tariff-laden trade, free trade is politically difficult to maintain because businessmen and workers directly hurt by it are acutely aware of the loss and are in a good political position to lobby for trade protection. On the other hand, those who gain from free trade are dispersed throughout the economy, are frequently not aware of the benefits they are receiving, and have great difficulty combining forces to lobby for preservation of free trade.

does go into the smaller enterprises the problem of competition will attain greater importance, for it is in these kinds of activities that local investor interests are most prevalent. Second, and more important, if private investment is promoted in the future by a liberalized U.S. government incentive program, the problem of competition may become paramount. If local businessmen in the host country complain that U.S. enterprise has superior technological and private financial resources, their arguments may carry little weight, because it is the very superiority of U.S. enterprise in these respects that makes it so valuable in Latin American economic development. But if local businessmen complain (and European foreign investors too) that U.S. enterprises are able to compete "unfairly" because they are being "subsidized" by the U.S. government, that is something else again. Ironically enough, the greater the extent to which U.S. investments were subsidized the better off the host economies would be in the aggregate. But it would be dangerous to disregard the distributional effects and the propaganda impact.

Personnel Policies

In many instances a basic source of resentment expressed toward U.S. owned companies is that they reserve the high-level, responsible, administrative, and technical positions for Americans brought down from the United States, and they pay these Americans far more than local personnel receive for work that "seems" roughly comparable. The crucial importance for foreign companies to integrate themselves into the host economy by hiring and promoting local personnel is, of course, widely recognized. The point is very well made by Theodore Geiger:

> No matter how helpful and constructive a company may be in specific ways, unless the local people believe that it is basically motivated by a genuine regard for them, it is not likely to escape resentment and dislike.
>
> The most important way in which a company can convincingly demonstrate its basic respect for the host country is by its policies for the training and promotion of local

> people.... I do not believe that the importance of such a policy can possibly be overemphasized. The opening of top-level executive and managerial positions to qualified local people is a crucial element in the acceptance of American companies by host countries.[1]

In fact, the actual number of U.S. citizens working for U.S. owned firms in Latin America is small. The Department of Commerce reports that of the 624,000 employees of direct investment enterprises covered in a 1955 survey, only 9000 were sent from the United States -- a ratio of about 70 to one.[2] Moreover, many firms claim to follow nondiscriminatory hiring policies, and they seek to hire and promote local personnel whenever possible.

At the same time, a study by John Shearer discloses that for a number of U.S. firms surveyed in Brazil and Mexico, the hiring and utilization of local personnel generally leaves something to be desired. Among other things he concludes:

> Despite usual home-office professions that their dependence on Americans is steadily decreasing, few subsidiaries reported significant changes in their employment ratios over recent years, and many overseas Americans denied that this dependence would, should, or could be diminished for many years to come.
>
> The unvarying concentration of Americans in the subsidiaries highest posts gives them importance far beyond their relatively small numbers. Most combination subsidiaries [those who hire both Americans and locals for high-level positions] are completely dominated by Americans.[3]

Moreover, salaries paid U.S. citizens are higher than those paid local employees. Shearer observes that the ratio is two or three to one in the case of Mexican subsidiaries.[4] Latin Americans working

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[1] 85th Congress, 2nd Session, Committee on Ways and Means Private Foreign Investment, Hearings (Washington, D.C., 1958), p. 464.

[2] Department of Commerce, U.S. Investments in the Latin American Economy (Washington, D.C., 1957), p. 122.

[3] John Shearer, High-Level Manpower in Overseas Subsidiaries (Princeton, N.J., Princeton University, Industrial Relations Section, 1960), pp. 117-118.

[4] Ibid., pp. 46-47.

closely with U.S. citizens who receive large salaries and generous foreign-duty allowances can hardly be expected to feel less than deep resentment at the real (or imagined) discrimination involved.

The ostensible reasons why this situation persists are not hard to find. U.S. companies frequently have difficulty in finding local personnel who are technically qualified to handle the positions now held by the higher paid Americans. In addition, other reasons have been cited for the disqualification of nationals:

> (1) nationals have conflicts of loyalties to country and to company; (2) nationals are not "company men," that is, they lack the requisite domestic experience; and (3) nationals are disqualified by general national character weaknesses.[1]

In conclusion, this theoretical analysis will likely strike the reader as an extreme abstraction of the real world, which in fact it is. However, if we are concerned about the relationship between U.S. private investment and broad national interests, we must seek a better understanding of the reasons why host governments behave as they do toward U.S. private enterprise. It is especially important to inquire into behavior that has a sound economic basis (at least in the short run) judged from the host government's point of view. By identifying some of the central factors that can play a role in the relations between business firms and host governments, the present analysis (though abstract) may contribute to that end.

U.S. POLICIES AND PROGRAMS AND THE PROBLEM OF CONFLICT

That U.S. private capital sometimes generates conflict and resentment in host countries should come as no surprise to the reader. The problem is, in general terms, well recognized in government and business circles. The critical issues relate not to recognition *per se*, but to the nature and severity of the problem and to the positive measures

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[1] *Ibid.*, p. 91.

that government and business might adopt in coping with it. In this subsection we shall briefly explore examples of present-day government and business policies and programs that bear upon these issues.

U.S. Government Policy

A basic policy of AID in its lending and investment guarantee programs is to favor the joint-venture arrangement wherein the U.S. private investor takes in a local partner in financing and managing the enterprise.[1] The joint-venture approach to U.S. investment abroad has a number of attractive features that have been widely discussed,[2] for example:

o If local investors share directly in financing and managing the enterprise, the enterprise will probably be more welcomed by the host economy. Among other things, personnel policies of a joint enterprise will probably tend to show less favoritism to U.S. citizens than a wholly U.S. owned enterprise, and on that score alone it will be better received.

o By combining with local capital, the U.S. investment may serve as a more effective catalyst in mobilizing local financial and human resources.

o By joining with local capital in a large number of medium and large enterprises, rather than concentrating in a few very large and conspicuous sole-ownership ventures, U.S. investment may be less subject to accusations of foreign domination.

o By actively seeking combinations with local capital, the competitive aspects of foreign and local capital discussed earlier may present a less serious problem.

In short, the joint-venture approach shows promise in alleviating some of the sources of conflict and resentment with which we have been concerned.

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[1] U.S. Agency for International Development, Aids to Business (Overseas Investment), (Washington, D.C., January 1963), p. 3.

[2] The most extensive study to date of joint ventures is by Wolfgang G. Friedman and George Kalmanoff, Joint International Business Ventures (New York, Columbia University Press, 1961).

At the same time, the advantages of joint ventures should not be overrated. Disagreement and conflict between local and foreign investors can blunt the favorable effects noted above.[1]

Given the potentially attractive features of joint-venture arrangements, the question arises as to the ability of the U.S. government, under present law, to promote such joint arrangements. Presumably, if AID were faced with two applications for a dollar loan, one consisting of sole U.S. ownership of an enterprise, the other a joint venture, the agency would select the latter, everything else being more or less equal. And, presumably, it would more readily grant guarantee coverage for joint ventures than for sole-ownership arrangements. Because the eligibility of an enterprise for loans and guarantees inevitably depends in part on subjective judgments, it would be reasonable to expect that AID would be somewhat more lenient in its appraisal of the eligibility of joint ventures for assistance than it would in the case of sole-ownership enterprises.

One may speculate, however, about how effectively government <u>can</u> promote joint ventures under present law, given the expressed reluctance of many U.S. firms to enter into such arrangements. Shearer reports that of 23 companies he studied, 17 favored 100 per cent ownership of foreign subsidiaries by the parent corporation.

> Approximately half of them made it a strong, or even rigid policy. Two of the seventeen made voluntary exceptions only because of very unusual circumstances. Three of the twenty-three corporations welcome the sharing of equity with local interests on a minority basis, and the remaining three firms approach the matter on a flexible basis, their preferences depending upon the particular situation.[2]

Friedman and Kalmanoff report a great diversity of viewpoints regarding joint ventures, some investors strongly favoring them, others

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[1]For an interesting account of how and why conflict did actually arise in one joint venture, see K. H. Silvert, "A Matter of Business," American Universities Field Staff (Letter), New York, April 20, 1958.

[2]John Shearer, <u>op. cit</u>., pp. 17-18.

quite the reverse. They observe a trend toward increased acceptability of joint ventures, but at the same time note that certain very large firms still strongly oppose the idea.[1]

Department of Commerce data support the notion that joint ventures have played only a minor role in U.S. direct investment in the past. They also disclose that, at least until recently, there has been no significant trend toward joint-venture arrangements in Latin America. Table 7 indicates that only a small percentage (1 to 4 per cent) of the total value of direct investment enterprises is represented by situations in which U.S. investors take a minority position. By far the largest percentage is comprised of 100 per cent or nearly 100 per cent U.S. ownership. Moreover these percentages have not varied greatly over the years. It is true that a good deal more joint-venture capital is reputed to be going abroad nowadays than in past years. Unfortunately, available Department of Commerce data carry only through 1957 so that we cannot determine the proportion of non-U.S. ownership in enterprises established since then.

It is notable, too, that the present U.S. government programs favoring joint ventures are not without critics:

> ...the United States Government has adopted some over-simplified doctrines which have tended to discourage private investment in the developing areas. One of these doctrines is that strong preferences should be given to joint ventures, and that normally aid should be considered for a project originated by a U.S. investor only if he takes in a local partner. Superficially this policy might seem designed to build up local enterprise, and this may have been the result in some instances; but the reverse is also true.... The availability of a local partner may sometimes encourage an investment from abroad, but in other circumstances a prospective investor may wish to avoid the managerial problems, financing difficulties, disagreements on dividend and reinvestment policies, tax burdens and political favoritism that are sometimes involved in joint ventures. Each project needs to be judged on the basis of its own special circumstances.[2]

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[1] Joint International Business Ventures, op. cit., pp. 133-134.

[2] Emilio Collado, "Economic Development Through Private Enterprise," Foreign Affairs (July 1963), p. 713.

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Table 7

VALUE AND PERCENTAGE OF U.S. OWNERSHIP IN LATIN AMERICAN ENTERPRISES, BY PERIOD OF ESTABLISHMENT, PRE-1946 THROUGH 1957[a]

Date Firms Established	Book Value of U.S. Share in Each Ownership Category[b] (million $)				Distribution of Firms, Per Cent in Each Ownership Category[b]			
	$\geq$ 95%	50-95%	$<$ 50%	Total	$\geq$ 95%	50-95%	$<$ 50%	Total
Before 1946	4745	701	145	5591	85	12	3	100
1946-1950	587	72	9	668	88	11	1	100
1951-1957	1017	111	47	1175	90	6	4	100
Total through 1957	6349	884	201	7434	85	12	3	100

Notes:

[a]Excludes Western Hemisphere dependencies.

[b]Each firm is placed in one of three ownership categories depending upon the share of its ownership in U.S. hands: (a) 95 per cent or more, (b) 50 to 95 per cent, or (c) less than 50 per cent.

Source:

U.S. Department of Commerce, U.S. Business Investments in Foreign Countries (Washington, D.C., 1960), p. 101.

In addition to this official policy regarding preferences for joint ventures, a number of government agencies -- the Department of Commerce, the United States Information Agency, the State Department, and AID -- are very much concerned about the economic-political impact of U.S. investment. They are engaged in a number of activities in cooperation with the business community to increase the over-all effectiveness of private enterprise abroad. For example, the government is currently working with a number of private organizations to establish an Executive Service Corps. As visualized at this writing, the corps would be a new, private organization, or a consortium of existing organizations, to recruit American businessmen either retired or on leave from their own business, who would be willing to serve abroad for periods up to two years as advisors or in management positions with enterprises in the less-developed countries.

The Business Community

Business groups too are concerned about the impact of U.S. private investment abroad. To name just a few, the Latin American Information Committee, The Action Committee for International Development, the United States Inter-American Council, and the Business Council for International Understanding all participate in programs designed to improve the understanding of private enterprise within host countries and to enhance relations between the U.S. business community and local foreign interests.[1]

To enumerate examples of the activities of these organizations, the BCIU meets periodically with government officials to exchange views on international affairs and to plan activities through which private enterprise can contribute more effectively to U.S. foreign relations. It sponsors a training program for international business executives at the American University in Washington, D.C. in order to

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[1]Detailed descriptions of some of these activities are contained in the United States Inter-American Council bimonthly periodical, Inter-American Bulletin, and the Business Council for International Understanding, Summary of BCIU--April 1963 (New York, 1963, mimeo.).

equip them to represent effectively the United States in their foreign tours of duty; it has organized for Latin American radio broadcast a series of business dialogues among U.S. and Latin American leaders; and it has engaged in a host of other projects.

The Action Committee for International Development, a business organization of chief executives of U.S. firms, was established in 1961 to encourage business leaders to operate effectively in the field of international development and to assist emerging nations by promoting trade and industrial development. Among many other things, the committee disseminates to industry specific information on investment opportunities, advises local prospective joint-venture partners about the capabilities of U.S. counterparts, and reports significant actions by U.S. or foreign governments affecting the business climate in particular parts of the world.

A promising new approach to mobilizing private capital from advanced nations, in cooperation with local capital, is represented by the recent organization of The Atlantic Community Development Group, ADELA Incorporated, with headquarters in Paris. The project calls for $40 million in equity capital from banks and other private firms in Europe, the United States, Canada, and Japan. With a goal of an additional $40 million in local capital, ADELA hopes to borrow up to $120 million to aid small and medium-size companies in Latin America on joint-venture bases.[1]

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[1] A much more detailed description of the organization and objectives of ADELA is contained in Joint Economic Committee, <u>Private Investment in Latin America, Hearings</u>, <u>op. cit</u>., pp. 129-153.

IV. CONCLUDING REMARKS

To recapitulate briefly, the preceding analysis notes that U.S. private investment does have an important r e to play in Latin American economic development. The imaginative, flexible manner in which private investment decisions can be made, the direct and indirect material benefits to the local economy from foreign operations, and the catalytic effect of foreign investment on local capital formation and local entrepreneurial attitudes are valuable, if not indispensable, elements of the total U.S. foreign assistance effort in Latin America.

At the same time the study raises questions about the extent to which the level of U.S. foreign investment in particular industries and host countries should be left to the dictates of market forces interacting with policies pursued by host governments. Today, U.S. investment outflows are directed primarily by the decisions of private businessmen on the basis of perceived market conditions. Host governments, in turn, are able to impose discriminatory taxes, and regulations concerning such matters as labor and ownership that can have far-reaching effects in encouraging or discouraging foreign investment. Discriminatory treatment can generate conflicts involving U.S. investors, the host government, and the U.S. government. Moreover, the unstable political conditions existing in some host countries make it difficult to rely over the long term on the choices expressed by the regime in power at a given time. One regime may favor, or at least condone, particular forms of U.S. investment; the successor regime may expropriate them. U.S. investors may enjoy good relations with an unpopular regime but both the regime and the foreign investors associated with it may be expelled in the next round.

Moreover, the problem remains -- To what extent, if at all, does the allocation among industries and countries of investments by U.S. business, seeking profits on the basis of perceived market conditions, conflict with U.S. national interests? In justifying a particular foreign investment, it is not enough to show that economic benefits flowing from it into the host economy are large. The manner in which those benefits shape development of the host economy is of central importance. We saw in the case of Cuba that the composition of the large U.S. investment flow may have become identified with Cuba's dependence upon a single major export crop that tied her economic fortunes closely to the behavior of the United States, a situation that Castro found convenient to exploit in his anti-American propaganda campaign.

Moreover, the presence of particular foreign owned enterprises, especially in extractive, export-oriented industries can give rise to political problems for the United States. Section III demonstrated on theoretical grounds how a host government may discriminate against these industries by establishing higher minimum wage laws, greater labor fringe benefits, and other cost-increasing restrictions to increase the flow of benefits to the host economy. We have seen how the industries may be subject to discriminatory treatment simply because they do try to operate in an efficient and progressive fashion. Moreover, the foreign-owned enterprise, trying to maximize its own welfare, may select a level of output lower than the one the host government would select were it in control; conflict between the two over output and investment decisions may lead the government to favor expropriation (perhaps quite mistakenly) as a means of increasing the net gain to the economy. With respect to foreign investment in general, the personnel policies pursued by foreign firms, competition with local capital, and large profit remittances relative to new investment inflows are other potential sources of difficulty. These factors, among others, can give rise to distrust and resentment, and produce a hostile climate for private investment leading to strained relations between the United States and the host government.

One might therefore conjecture that the U.S. government should go beyond present programs in guiding business activity in a manner consistent with long-run national interests. It might be argued that particular projects should not be encouraged just because they entailed employment of x number of local workers, payment of y value of foreign exchange to the local economy, or z value of local tax revenues; they should be appraised also in terms of their broader economic-political impact, related especially to the rising pressures of nationalistic aspiration, the communist propaganda offensive, and the effective formulation and execution of U.S. foreign policy. In particular, it might be argued that the U.S. government should provide special incentives for firms to engage in joint ventures with local capital as this arrangement holds promise of alleviating some of the sources of resentment, distrust, and hostility. For example, generous U.S. tax credits might be allowed for new investment abroad if it were associated with local ownership of some minimum specified percentage of the enterprise. Or one might suggest that the current government programs in financing and guarantees should be strengthened in the case of certain activities and withdrawn in the case of others.

This brings us face to face with the critical question: <u>To what extent could the government guide private investment, as by instituting highly selective incentive programs, without suppressing the valuable, unique characteristics of private investment as a tool of economic development?</u>

As distinguished from direct government assistance programs, much can be said for private investment in terms of the spontaneity with which new opportunities can be quickly identified and explored, and financial and human resources brought to bear in developing them. If the government specified preferred paths of investment and then undertook to force private capital flows along these paths, the essential characteristics of the "private" contribution to economic development could be easily suppressed. Were the government to decide on the eligibility for tax credits of each contemplated private investment, the time-consuming bureaucratic decisionmaking process would add an element of delay and uncertainty to impede bold and imaginative private investment decisions. The complex task of defining eligibility requirements would open the way to additional delays and uncertainty, as well as bountiful opportunities for political favoritism.

The problem is compounded, of course, by the fact that our knowledge about the economic-political effects is still inadequate to serve as a satisfactory basis for establishing guidelines in the selection process. While a particular industry may be especially susceptible to resentment and conflict in general, this is surely not true for every enterprise in the industry in every country. To identify and predict the differential economic and political effects of particular investments may well be an insuperable task. Not only would a highly selective incentive program possibly lead to delays and undue favoritism, it might also lead to many decisions that turn out simply to be wrong.

This, then, constitutes a dilemma. To leave the level and allocation of private investment to the dictates of present-day market forces, either with or without additional across-the-board government administered incentive programs, carries the danger that some business activities will not operate in a manner consistent with national interests. But the greater the level of government imposed direction, the greater the danger that the most valuable characteristics of private decisionmaking will be suppressed.

Much more study is required for an adequate understanding of the many dimensions of this dilemma. We need especially to know much more about the interaction of the political and economic effects of U.S. private investment in host countries and the problems that the behavior of U.S. investors pose for the formulation and execution of U.S. foreign policy. More study, too, is needed of possible alternatives open to the business community, as distinguished from government action, in voluntarily undertaking programs to improve the performance of foreign business activities in the eyes of the host countries. In addition, much study is needed of the conflicts of ideology in Latin America as they relate to the environment in which foreign investment must operate. The rising pressures of nationalism combined with a widespread suspicion of western economic institutions, especially with respect to the role of business profits and the workings of the private market mechanism, are powerful forces that must be taken into account in formulating public policy in the future. The present Memorandum has identified and discussed a few issues relevant to these questions, but at best it has only opened the door.

Finally, while avoiding oversimplified solutions to enormously complicated problems, we might speculate for a moment on one possible approach toward solving the dilemma. U.S. foreign business operations have a number of dimensions; not only do they include direct investment by U.S. residents in firms controlled by U.S. interests, but they also include such elements as portfolio investments by U.S. residents in firms not controlled by U.S. interests, transfer of patent rights, and technical and managerial assistance. Perhaps a program could be devised that would encourage the continuing contributions of U.S. private business in transferring new technology to less-developed areas, as well as in transferring dollar funds, but divorcing this from U.S. ownership of foreign enterprises. Perhaps a feasible program could be formulated in which U.S. income taxes would be forgiven on income of U.S. residents derived from (1) royalty and fee payments on patent rights conferred to foreign firms not owned by U.S. interests, (2) technical and managerial assistance contracts with foreign owned firms, and (3) interest and dividends on portfolio investment as distinguished from direct investment. Of course, a good deal more study would be necessary before this kind of program could be seriously proposed. The problem is complicated especially by the fact that today we have only a vague understanding of the process by which technology is transferred and assimilated by less-developed countries. But this approach might provide a useful guideline for future research on the role of U.S. business enterprise in economic development and political change.

Appendix

SOURCES OF CONFLICT: A GEOMETRIC ANALYSIS

BENEFITS TO THE HOST ECONOMY

In Section III, we described a source of potential conflict that could arise from attempts of the host government to impose cost-increasing restrictions on an export-oriented industry in order to increase net gains to the host economy, at the expense of foreign consumers. However, because an increase in costs might reduce the industry's output, which by itself would be disadvantageous to the host economy, a question arises about the extent to which such cost-increasing restrictions could be imposed by the host government to maximize the net gain from the presence and operation of the industry. In this Appendix we shall employ elementary economic analysis in treating this question.

Figure 1 depicts the cost and demand conditions for a constant-cost, export-oriented industry in country β. The horizontal curve MSC represents the long-run marginal social cost, as a function of the output; social cost includes the alternative nature or opportunity cost to country β of the resources devoted to industry, including tax revenues that would have been collected and domestic consumer surplus that would have been generated on these resources in their next most valuable use. For purposes here, social cost includes also a "reasonable" or "normal" rate of return to the industry on its investment. The higher horizontal curve, MPC, represents the long-run marginal private cost of the industry, that is, the payment to country β by the industry for local resources.[1] The net gain to the economy per unit of output is represented by the vertical distance between MPC and MSC, the difference between payments made for local resources and the social cost of those resources.

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[1] For simplicity we shall assume that the industry uses only local resources from country β, that is, the industry does not import goods, services, and labor as factor inputs.

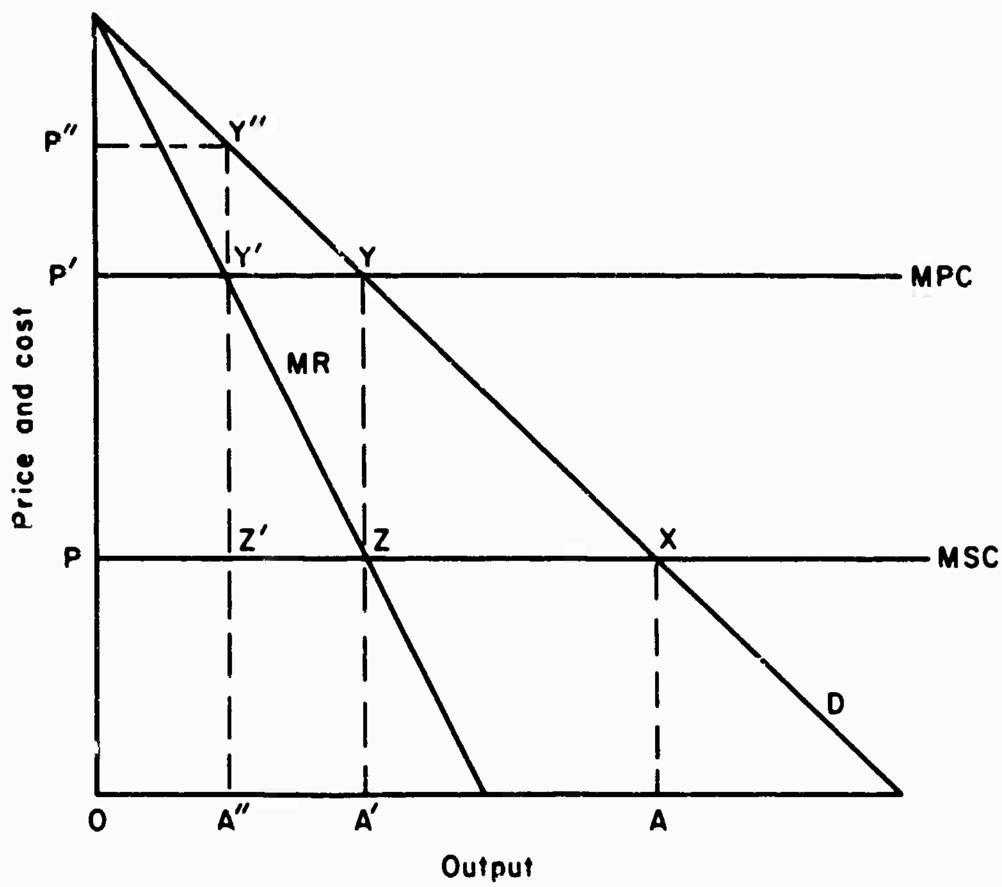

Fig. 1—Optin ... level of private cost

Suppose now that the government of country β is able to raise or lower the payments made by the industry for local resources. For example, the government might adjust the royalty payments or excise taxes per unit of output, or the level of minimum wages and structure of the labor fringe benefits paid in the industry. In these cases the private costs to the industry can be varied <u>without</u> affecting the real resource cost or social cost to the host economy for various levels of output.[1] In other words, the MPC curve can be shifted upward or downward in Fig. 1, depending on the level and composition of the payments imposed by the host government, while MSC remains fixed. The problem, then, is: given the demand curve and given a level of marginal social cost for various levels of output, <u>what level</u> of marginal private costs would the government seek to impose on the industry in order to maximize gains to country β? In other words, for a given D curve and MSC curve in Fig. 1, where would the MPC curve be placed, in relation to MSC, in order to maximize the difference between the total payments made by the industry to country β and the total social cost of the resources used?

In treating these questions, we shall presume first that the industry in country β is composed of many separate firms and that the industry faces an aggregate downward sloping demand curve D in Fig. 1 for exports of the product. Therefore, the output of the industry is given by the intersection Y of MPC with the demand curve D.

If the host government were to allow private costs in the industry to reflect simply the social cost (and if there were no favorable or unfavorable externalities that affect the relationship between MPC and MSC), the MPC curve would be coincident with the MSC curve in Fig. 1, output would be set at OA on the horizontal axis, and the

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[1] We assume here that the physical amount and composition of local resources remain constant for a given level of output. In fact, depending upon the kinds of payments imposed by the host government, the industry may be able to substitute between factor inputs (in trying to minimize its own cost) in a way that would affect social cost as well. But we need not explicitly consider this possibility here.

economy would gain nothing from the industry insofar as payments by the industry for local resources would not exceed social cost. Moreover, because this is a constant-cost industry in which every firm is "marginal" and earns only a "reasonable" return on investment (which is included here in MSC), no excess profit would be generated to be taxed away by the host government. In order to maximize gains to country β, the government would impose private costs on the industry to raise the MPC curve so that it intersects the D curve at point Y, directly above the intersection point Z, of the MSC curve and the marginal revenue MR curve. Output would fall from OA to OA', price to foreign consumers would rise from P and P', and the gain to the economy, equal to the area PP'YZ, would rise to its maximum level. We see, then, that even though cost-increasing restrictions cause a reduction in output, due to the rise in private cost, the economy would enjoy a net gain under the conditions postulated here.

We can immediately appreciate the difference in situation between export-oriented industry and domestically oriented industry. In the latter case, a rise in price from P to P' would reduce consumer surplus of country β by the area PP'YX. If the government of country β counts the value of domestic consumer surplus on a par with the value of payments by the industry to the local economy, it would set MPC equal to MSC for domestically oriented industry. In this case, the area PP'YX, representing the increase in consumer surplus, exceeds PP'YZ, the value of net payments to the economy foregone by lowering private costs and price.[1]

In addition to the competitive situation above, we shall also consider the example of a single monopoly firm operating the industry in country β. The output of the monopoly firm would be set at the intersection of MPC and the marginal revenue MR curve rather than at the intersection of MPC and D. If the government imposes costs to

[1]This analysis presumes, for simplicity, that the export-oriented industry produces entirely for export, and that the domestically oriented industry produces entirely for local consumption.

raise MPC, as before, to intersect the vertical axis at P', the firm would operate at output OA" and sell at price P". The economy will gain the net amount equal to PP'Y'Z' (which is less than the PP'YZ of the competitive case) while the industry will enjoy the excess profit of P'P"Y"Y'. If the government can tax away this excess profit through an income tax, net gain would rise -- but the maximum total net gain attainable by country β of PP"Y"Z' would still be less than the gain to the economy of PP'YZ in the earlier competitive case. In order to maximize the gain to country β, the government would lower private costs to equal social cost and tax away 100 per cent of the excess profits. With MPC equal to MSC, the monopoly firm would set output at OA' and the excess profits PP'YZ would represent, through tax payments, the net gain to the economy -- an amount equal to that of the competitive case.

However, it may be much more difficult to enforce tax laws on excess profits than laws relating to royalty payments or excise taxes on output. If the host government is unable to capture all the excess profit, it may impose excise taxes, higher wages, and other cost-increasing restrictions as a partial substitute for income tax revenue.[1] In this case MPC would rise above MSC, excess profits would fall as output is cut back from OA' and the gains to the economy would consist of a combination of income tax revenues and payments made by the industry in excess of social costs.

Finally, we shall consider the case where the industry faces a perfectly elastic demand for the product -- the industry in the host country produces such a small proportion of total world output of the product that the industry can sell all it is able to produce at the given price. In Fig. 2, the horizontal demand curve D intersects the vertical axis at world price P. The industry, assumed here to

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[1]The internal distribution of gains may also enter into the host government's calculation in choosing particular means to increase the economy's gains: a dollar of tax revenues may not be valued as equal to a dollar, say, in higher wages within some ranges of net receipts to the host economy.

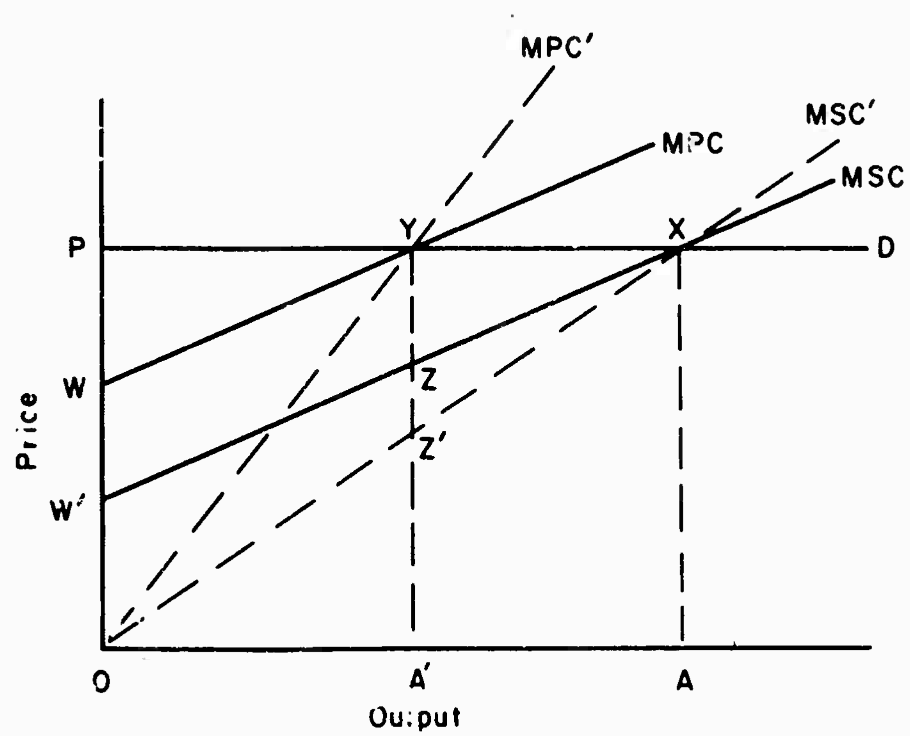

Fig. 2—The perfectly competitive case

entail increasing costs, is subject to the marginal social cost schedule MSC. Given the MSC curve and the demand curve, what level of private cost would the host government impose to maximize net gains to the economy? It is immediately clear that if the government is able to levy a 100 per cent excess profits tax, it would set MPC equal to MSC. The industry would produce output OA, the government would collect the revenues equal to the area of the triangle PXW', and the net gains to the economy would be maximized. However, if it is impossible to enforce a 100 per cent excess profits tax, or if the government prefers a composition of gains involving larger labor benefits at the expense of tax revenues (within some range), then it might impose additional private costs to move MPC above MSC. If <u>no</u> excess profits tax revenues are forthcoming, and if we presume that MPC remains parallel to MSC, then net gains to the economy are maximized when MPC cuts the demand curve D at exactly <u>one-half</u> the distance OA, that is, net gains to the economy, represented by the parallelogram WW'YZ, are maximized at output OA' which is one-half the output OA. Therefore, we see that even if the demand for the product is perfectly elastic, the host government may nevertheless find it advantageous to impose private costs in excess of social costs.

Of course, there are many cases in which MPC would not remain parallel to MSC. The imposition of higher prices for local resources, for example, would affect the relationship between MPC and MSC differently than would a fixed value tax or royalty per unit of output, where the gap between MPC and MSC is of fixed size at all levels of output. In the former case, the gap between MPC and MSC would be a function of resource use. In an increasing cost industry shown in Fig. 2, the slope of MPC would be steeper than the slope of MSC; and the solution for the maximum would be more complicated. If the two curves were to radiate from the origin, shown by the dotted curves MPC' and MSC', then again the net gains to the economy represented by the triangle OYZ' are maximized at output OA' -- one-half of the output OA. If the two curves intersect the vertical axis at a positive value, the maximum would not be attained exactly at OA', but it would still be attained at some point to the left of point X; that is, MPC would still lie above MSC if gains to the economy are to be maximized.

MARKET STRUCTURE AND THE PROBLEM OF EXPROPRIATION

In Section III, we discussed the possibility that the determination of an appropriate level of output (and investment) in the industry could give rise to conflict between enterprises and the host government because the structure of the market that faces the host country is different from that facing the foreign owned firms. In Fig. 3, the diagram on the right illustrates the demand and cost conditions facing the firm in the world market, where this firm produces a sufficiently large proportion of total world production so that its demand curve is less than perfectly elastic. However, let us suppose that the firm has operations in a large number of countries and exports from each only a very small portion of total world supply. For each individual country the world price is taken as given. On the left of Fig. 3, country β faces the horizontal demand curve D', the world price P, and has marginal social costs and marginal private costs given by MSC and MPC' respectively. Given these conditions, the firm would produce output OA in country β. This output, together with the output produced by the firm in other countries would amount to a total output of OC shown on the right. Total excess profits of the firm would be PYZW, of which PY'Z'W' are earned in country β.

Immediately, we see that the net gain of country β is not maximized at output OA. Even if it could tax away the entire excess profit PY'Z'W', its total gains would be lower than they would be at OA', or even better, at OA". The firm would resist pressure brought by the host government to increase output, because a large output beyond OA in the one country alone would entail higher marginal private costs than expanding output in other countries, that is, MPC to the right of output OC lies <u>below</u> MPC' to the right of OA. "Giving in" to the demand to increase output beyond OA might generate pressure by other countries to increase their output, too; if these countries succeeded

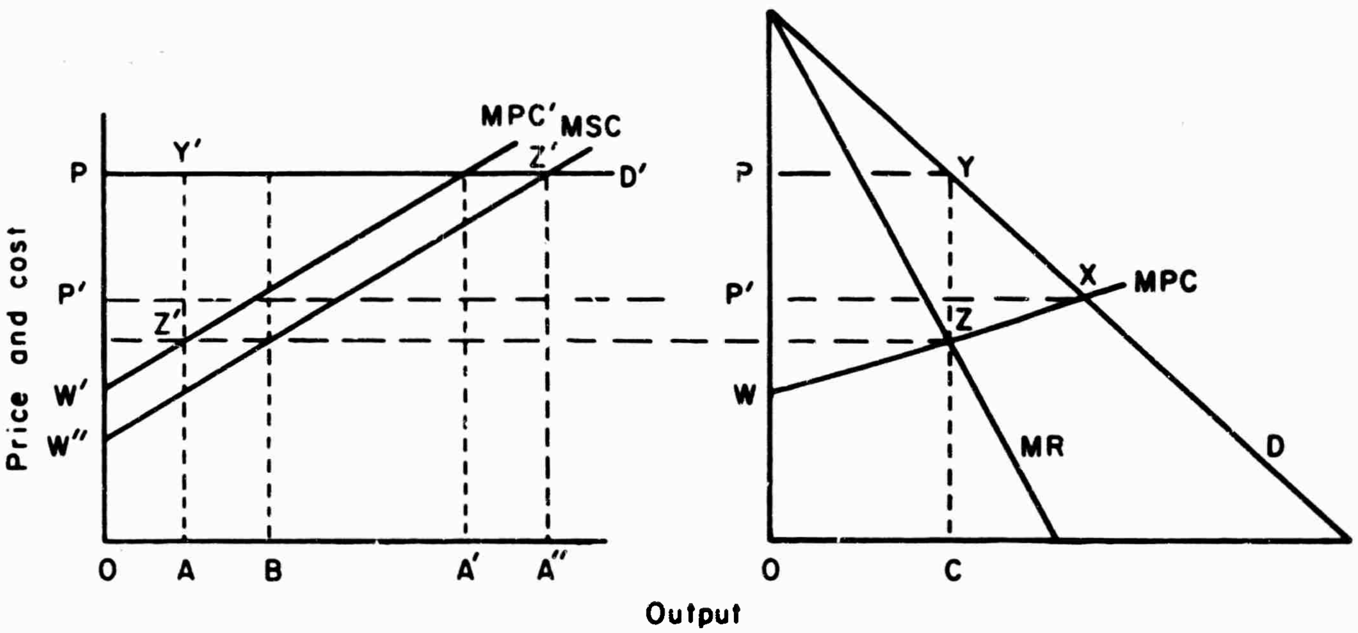

Fig. 3—Market structure and the problem of expropriation

in forcing an increase in output, world price would fall perhaps to P', the profits of the firm would also fall, and each country might be worse off than before, depending on the slopes of the D and the MPC curves.

Moreover, if the government of country β were to reduce private costs to the firm in order to stimulate output, the measure would be only partially successful. If MPC' were moved down to be coincident with MSC, the firm would expand output only from OA to OB rather than to OA' or OA", as the new MPC' would be equal to MPC (the marginal private costs of other countries) at output OB.

On the other hand, the government might consider expropriation: if it believes that other countries would not follow suit, it would be tempted to expropriate, increase output to OA", and reap the whole gain represented by the triangle PW"Z'. Even after subtracting from PW"Z' a "reasonable" compensation to the firm for the expropriated properties, the government might estimate that net gains to the host economy would be larger than before.

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