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## The realist adjusts the sails: Vernon and MNE–state relations over three decades<sup>☆</sup>

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The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails. (William Arthur Ward)

Raymond Vernon is the father of research on the relations between nation states and multinational enterprises (MNEs). His work on this subject has dominated the field since the publication nearly three decades ago of *Sovereignty at Bay*. While his contributions to international business research are numerous and celebrated, as documented by others in this volume, his pioneering achievement is MNE–state relations, an area seen as the core of international business theory (Grosse and Behrman, 1992).

The purpose of this paper is to review Vernon's contributions through the lenses of his three best known books on the subject: *Sovereignty at Bay* (1971), *Storm over the Multinationals* (1977) and *In the Hurricane's Eye* (1998). Reading through each book in turn, one is struck by the constancy of the underlying theme that dominates all three. Vernon saw multinationals and nation states as “two systems, ...each legitimated by popular consent, each potentially useful to the other, yet each containing features antagonistic to the other” (Vernon, 1991, p. 191). These two systems generated inevitable and endemic interjurisdictional conflicts; points of friction that Vernon argued could only be reconciled through multilateral approaches. Vernon, the clear-eyed realist, spent 30

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<sup>☆</sup> I, like many others, first met Ray Vernon through his writings on multinational enterprises. In 1992–1993, at Ray's invitation, I was fortunate to spend a year as a Fulbright Scholar and Fellow in the Center for Business and Government at the Kennedy School, co-teaching with him a graduate course on multinationals and public policy. We had a wonderful time; I would do the theoretical warm-up and he would then tell it like it really was. I kept detailed notes and learned more than the students did. My own views of multinationals and public policy have been permanently influenced by Ray and I consider myself extremely fortunate to have had him as a teacher, mentor and friend.

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years developing national and multilateral “sails” designed to handle the current and expected storms over the multinationals.

### 1. The 1970s books

Vernon’s first book on MNE–state relations, *Sovereignty at Bay* (1971), was a landmark event. Vernon calls it the “tip of the iceberg” (p. v) because it presents the main results of Harvard University’s Multinational Enterprise Project, launched in 1965, which he coordinated. The overarching thesis of the book is that the basic asymmetry between MNEs and national governments, both legitimate in their own spheres, causes inevitable points of friction that need to be resolved.

Vernon argues there are two institutions, both legitimate, that come into conflict because of the differences in their goals, jurisdictions and responsibilities. The MNE’s goals are narrow (profit maximization) while the nation state’s goals are broad (economic, sociocultural and political). The MNE’s jurisdiction is global while the state is confined to its national borders. The MNE is responsible to its shareholders, the state to its citizens. Each institution is legitimate inside its own sphere of influence, with one power-based asymmetry: the nation state confers institutional legitimacy on the MNEs within its borders. Thus, Vernon sees inevitable MNE–state conflicts, with each party “at bay”.

In *Sovereignty at Bay*, Vernon focuses on the economic, social and political consequences of foreign direct investment (FDI) for home and host countries. Along the way, he introduces new topics that have now become so well known they have spawned whole shelves of library books and journal articles in their own right: the obsolescing bargain in the natural resource sector, the problems of international taxation and transfer pricing, and the issue of overlapping jurisdictions and extraterritoriality. His policy proposals offer a “choice of futures” (p. 248) directed at reducing MNE–state conflicts: unitary taxation of MNEs, joint policy harmonization by home and host governments in areas of overlapping jurisdiction, and more and better disclosure of MNE affairs. Overall, he concludes that the basic asymmetry between MNEs and nation states requires these enterprises be accountable to an international organization that can develop multilateral rules for regulating multinationals and adjudicating MNE–state conflicts.

In 1977, Vernon broadened his analysis from 187 of the largest US multinationals to 391 MNEs from the United States, Japan and Europe. His thesis in *Storm over the Multinationals* directly addresses the “double identity” of the MNE and the conflicts that can arise with both home and host governments. With rising international trade and FDI flows, he argues that MNEs will be seen as a symbol of international interdependence and therefore be a target for groups unhappy with the distribution of benefits and costs of market openness.

One of the unique features of the book is its three chapters on strategies of MNEs, more than a decade before business schools began offering courses on global strategy. While the chapter titles seem somewhat archaic (e.g., drive for stability, struggle against entropy), their contents are the essence of today’s IB textbooks: the product life cycle, the centralization of R&D, follow-the-leader strategies, modes of entry, and offshore sourcing.

Vernon then separates the industrialized/home countries from the developing/host countries and discusses the MNE–state tensions that can arise for each group. Published a year before Bergsten et al. (1978) examined the effects of US multinationals from a home country perspective, Vernon's book covers much the same ground for MNEs from industrialized countries (e.g., employment, GDP, balance of payments effects). The developing countries chapter is a nice review of the *dependencia* school's concerns over FDI in the 1970s. *Storm over the Multinationals* echoes the policy prescriptions of *Sovereignty at Bay*, particularly the need for an international regime to regulate MNEs.

Since the publication of *Sovereignty at Bay*, Vernon has published both 10 and 20 year retrospectives (Vernon, 1981, 1991). The best summary of the issues in *Sovereignty at Bay*, in this author's opinion, is Vernon's 1981 update "Sovereignty at Bay: Ten Years After". Short, concise and tightly argued, the piece starts with Vernon's wry assessment that "Practically every reader remembers the title of the book; but scarcely anyone will accurately recall its contents" (p. 247). His wry sense of humor is also evident in Vernon (1991, p. 191): "Twenty years after the publication of *Sovereignty at Bay*, I feel justified in offering a solid kernel of advice to aspiring young authors. If you want to draw public attention to your opus, find an evocative title. But if you want readers to remember its contents, resist a title that carries only half the message".

Vernon (1981) assesses the contribution of the product life cycle model, concluding it continues to have utility for explaining trade and FDI patterns of other countries, but perhaps not the United States. Looking back at *Storm over the Multinationals*, he sees its key contribution as laying to rest "simpleminded propositions about the effects of the multinational enterprise" (p. 250). His frustration with not foreseeing the 1973–74 oil crisis is palpable, leading him to conclude that "scholars... must live with the risk of neglecting or overlooking what may prove to be the controlling factor that determines those future events" (p. 253). The piece continues to stress the problems generated by multiple jurisdictions, which Vernon sees as increasingly problematic because the "number of players and intensity of the game" has grown rapidly since the early 1970s. He stresses bilateral tax treaties (BTTs) as the one area where governments have made a serious attempt to address the multiple jurisdiction issue, and hypothesizes that MNEs are responsible for the spread of BTTs because they see clear benefits in lower withholding tax rates. The chapter ends with Vernon restating the central problem that lies at the heart of *Sovereignty at Bay*: "How do the sovereign states propose to deal with the fact that so many of their enterprises are conduits through which other sovereigns exert their influence?" (p. 258).

## 2. In the Hurricane's Eye (1998)

By 1995, Vernon had reached the conclusion that the tranquility of MNE–state relations in the 1990s was drawing to a close. He felt "the world was slipping into a period in which the inescapable clashes between multinational enterprises and nation-states might be growing in frequency and intensity, evoking responses from both the public and private sectors that would substantially impair their performance" (p. vii). Referring back to *Sovereignty at Bay*, he notes how much the world has changed but still concludes that the underlying tensions in

MNE–state relations remain the same. The metaphor, eye of the hurricane, for Vernon represents the tranquility in MNE–state relations at the end of the century, a period of respite surrounded by turmoil.

In *the Hurricane's Eye*, Vernon addresses two research questions. The first — “Can multinationals and nation states co-exist and perform their functions well?” — is an old question addressed in Vernon (1971, 1977). The second — “Will nongovernmental organizations (NGOs) and governments attempt to use MNEs as a tool to further their own ends?” — is an extension of his extraterritoriality argument to encompass NGOs. He answers these questions by looking back at history, and then extrapolating forward to speculate about the future. For Vernon, the current openness (pro-FDI policies, liberalization, deregulation, and privatization) is the calm before the storm. He sees both old and new tensions in MNE–state relations at the end of the 1990s: old tensions in the host countries and new tensions at home.

The book first outlines how MNEs have changed since *Sovereignty at Bay* was published. Although multinationals have developed into complex networks of interlocking firms, making the boundaries of the MNE increasingly fuzzy, Vernon continues to see them as strategic oligopolists, busy erecting barriers to entry and using collusive behavior to increase their profits and market share. The biggest MNEs are now global rather than national competitors, focused on global market share, behaving much like chess players making moves and countermoves in national markets around the globe. Alliance capitalism, the increasing importance of economies of scale and scope, and the rise of information technologies and the Internet have altered their strategies, but Vernon continues to see MNEs as permanently engaged in games of strategic rivalry.

The heart of the book, the old and new tensions in MNE–state relations, are next addressed. The traditional tensions, already documented in Vernon (1971, 1977), lie in four areas: employment, tax, security and interjurisdictional conflicts. The first tension, employment, is a misnomer; in fact, it is the obsolescing bargain problem. The issue is the tension between host country goals and MNE performance, where governments offer carrots (subsidies, tax cuts) and sticks (threats of regulation) to induce more contributions to the local economy in the form of FDI, jobs and technology. Vernon discusses the so-called locational tournaments that arise when several governments jockey to induce MNEs to locate plants in their jurisdiction. After entry, the bargain begins to obsolesce with host governments demanding, “What have you done for me lately?”

The second tension arises in the international tax arena where two policies, a vast network of BTTs and adoption of the arm's length standard for regulating transfer prices, are now widely used as methods to reduce cross-border MNE–government tensions. Vernon argues that these methods cannot solve the underlying problems of assigning tax bases and apportioning global income. National security is the third tension, with Vernon arguing that a broader definition of security is needed, one that includes technology and oil. The fourth tension arises from jurisdictional, cultural and principled conflicts. Jurisdictional overreach, Vernon hypothesizes, will increase over time as economies become more interdependent. Cultural conflicts will be exacerbated by the Internet, with the general public not making much distinction between MNEs and the Internet as targets causing the spread of “corrupting foreign ideas” (p. 57).

NGOs, in their attempts to advance their own agendas, will increasingly use MNEs as partners and targets.

A tour through emerging economies follows. Vernon argues that Latin American governments, as “old hosts” to FDI, have lots of experience with multinationals. His concern is that the rapid privatization of key sectors in the 1990s, sectors that are politically sensitive, could cause a backlash from the general public as the number of foreign takeovers rise. The current openness to FDI in Latin America might therefore generate enough resentment that the pendulum would swing in the other direction.

Asian governments, on the other hand, have little experience with inward FDI and are now opening up large capital-intensive public utility projects to foreigners. Vernon worries that political risk insurance through MIGA and OPIC may be encouraging a moral hazard problem of too rapid an influx of FDI into Asian markets, setting these firms up for a replay of the obsolescing bargain model in the future. At the same time, a new crop of multinationals from Asian countries, firms that are closely tied to their home governments through corporatist governance structures, may raise extraterritoriality problems ahead.

In the transition economies, Vernon sees little experience with inward FDI on the part of countries that are absent the discipline of rules of law and plagued by corruption, in “long transition pointed toward an obscure destination” (p. 94). Overall, Vernon worries that the emerging economies have (with the exception of Latin America) little experience with foreign MNEs, while their own new MNEs may be Trojan horses for their home governments.

Vernon next turns to the Triad economies (Europe, US and Japan) where he argues that MNE–state relations appear cooperative, focused on engineering competitive advantage. However, there are differences across countries. In Europe and Japan, corporatism implies that domestic firms have a public responsibility, as part of the business–labor–government bargain, that is broader than simple profit maximization. This means they carry the shadow of their home governments with them and cannot be seen as wholly autonomous actors. At the same time, their MNEs are becoming more global in their mindsets and more footloose, raising tensions at home as firms threaten exit unless more privileges are forthcoming.

In the United States, on the other hand, Vernon argues that a laissez-faire attitude and national treatment historically meant close working relations between MNEs and the US government. However, Vernon worries that, as the Triad economies, particularly the United States, have become more exposed to international forces, parochial interests inside these countries (e.g., unionized labor, local governments) will increasingly see internationalization as a threat and pass blame on the MNEs. MNEs, as primary beneficiaries of open markets, will react by attempting to veto agreements that restrict openness and banding together in international coalitions to push their common agendas.

The struggle over open markets is the key new tension that Vernon sees in relations between MNEs and home countries. He argues that the US government and public are ambivalent to openness, as demonstrated by the failures of government initiatives such as fast track, the Multilateral Agreement on Investment (MAI) and the accession of Chile to NAFTA. Europe, too, is preoccupied with deepening its own union. At the same time, an aging population with rising social costs suggests less willingness to tolerate the shocks that accompany open markets. Moreover, the general public sees recent international agreements such as the General Agreement on Trade in Services (GATS), the agreement on trade-related

investment measures (TRIMS) and the North American Free Trade Agreement (NAFTA) as policy initiatives that primarily benefit multinationals. The failure to launch a new WTO-sponsored multilateral trade round in Seattle in November 1999 is another example, occurring after publication of *In the Hurricane's Eye*, that provides additional evidence supporting Vernon's concerns.

The last third of the book deals with policy responses for "righting the balance" in MNE–state relations (p. 178). Vernon starts with an assessment of current national and international regulations affecting MNEs. At the level of global principles, he reviews briefly the failure of the proposed International Trade Organization (ITO) in 1950, the shift to non-binding hortatory codes of conduct, the TRIMS agreement and the recent failure of the MAI. He concludes that, "The record suggests that the world is not ready, if it ever will be, for a strong agreement, global in scope, that articulates the basic principles for the treatment of multinational enterprises" (p. 188). The rapid growth in the network of BTTs and BITs (bilateral investment treaties) since the mid-1980s suggests the pendulum has tilted in favor of the MNE, but Vernon argues that these treaties do not promise very much, can be easily breached and are fragile instruments. Nor do industry-level agreements offer much hope at the international level. Vernon does see regional trading agreements, such as NAFTA, as increasing the bargaining power of MNEs within the free trade area and offering more possibilities than multilateral agreements.

Lastly, the book turns to possible new initiatives. Some of these proposals date back to *Sovereignty at Bay*: improving transparency, a shift from the arm's length standard to unitary taxation, sorting out conflicting jurisdictions. Others are new to *In the Hurricane's Eye*: reducing the use of location subsidies, controlling restrictive business practices at the international level, and making anti-dumping less of a protectionist tool for domestic interests. Vernon argues that adoption of these policies would go "a little further toward reducing the tensions" (p. 216) between home and host governments, but cannot fully deal with the internal tensions in the Triad countries caused by the uneven distribution of the benefits and costs of market openness. The bottom line is that "the world is likely to be in for a long period of learning, as nation states grope for adequate responses to the problems of openness. . . . During that long period, multinational enterprises will be especially vulnerable to the accusation that they are the prime cause of those problems" (p. 219).

Published in the fall of 1998, *In the Hurricane's Eye* is the culmination of Vernon's 40 years of studying MNEs (Vernon, 1998, p. ix). The book contains several new advances over his earlier works. For example, he stresses the fuzziness of the boundaries of the MNE and the difficulties that causes for MNE–state relations. His question, "What have you done for me lately?", suggests that Triad country governments are demanding more from the MNEs in their midst, reminiscent of the obsolescing bargain model but now from a home government perspective. Unitary taxation and transfer pricing, long preoccupations of Vernon's, are seen as even more problematic in a world of e-commerce and MNE networks. He worries that NGOs in the Triad countries will attempt to channel MNEs for their own ends, a concern that foreshadows the Seattle WTO debacle. His concerns about the political impacts of liberalization and privatization on MNE–state relations in the emerging economies of Latin America, Asia and the transition economies are much more nuanced and informed than in his earlier books. Lastly, Vernon hypothesizes that newly minted MNEs from Asia and

Europe, influenced by their corporatist national origins, are less autonomous actors than their older US cousins, suggesting that extraterritoriality is evolving into a global, not just a US-generated, problem.

### 3. An unfinished agenda

In the tranquil period at the end of the 20th century (the eye of the hurricane), Vernon takes a clear-eyed realist approach to the problem of MNE–state relations; relations that he sees as primarily conflictual. Vernon spent much of his academic life trying to understand these points of friction and develop ways to “adjust the sails” so the world could learn from storms over the multinationals that had occurred in the past and avoid those he feared lay just over the horizon.

*In the Hurricane's Eye* is Ray Vernon's last book. He leaves us with an unfinished agenda. For the scholars and students of the MNE, Vernon's many key theoretical contributions (e.g., the product life cycle and technology development, the obsolescing bargain, global strategic rivalry of MNE networks, the allocation and taxation of MNE global profits) remain central to the field of international business research. For policy makers, his proposals to lessen interjurisdictional conflicts (e.g., more harmonization of national regulations, global approaches such as unitary taxation, and an international organization to which MNEs would be accountable) offer a rich menu of policy options.

Vernon's own assessment of his contributions to the field of international business stresses this unfinished agenda:

Over the years my scribblings have moved from public policy issues to business environment issues and back again to public policy issues that related to the international environment of business. Not surprisingly, my current preoccupation is with the public institutional infrastructure that will be required in a world of nation-states and multinational enterprises. The pieces of that infrastructure are beginning to appear, but much of the structuring is single-mindedly devoted to clearing away the remaining obstacles to the spread of multinational enterprises. Salutory as that trend has been, it is leaving behind a trail of issues and problems that, if unattended, can visit great pain on both governments and enterprises. Because so many of these neglected issues are arising in home countries rather than host countries, official recognition and response are coming very slowly. I hope to be able to spread that recognition and to help identify constructive solutions (Vernon, 1999, p. 427).

With the loss of Ray Vernon, are there others who will adjust the sails in the face of the winds that lie ahead?

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