Competitive Advantage and Foreign Direct Investment: Britain, 1913–1938

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The most comprehensive theoretical attempt to link advantage with the foreign direct investment (FDI) decision has been made by John Dunning in his eclectic framework. A country's accumulated FDI stock is shown to depend on three sets of advantage, to indicate respectively the *why, where,* and *how* of the FDI process. These are the ownership or competitive advantages enjoyed by firms over rivals at home or overseas; the location advantages that stand to reinforce those of ownership; and the internalization advantages of operating productive assets within the firm rather than selling or licensing them to foreign firms [Dunning, 1988, pp. 29ff.; Corley, 1992, p.9].

In Dunning's paradigm, such ownership, location, and internalization advantages can be studied at the country, industry, or firm level. The country-specific advantages may arise from factor endowments and the size of the domestic market. Likewise, location advantages tend to be influenced by physical or psychical nearness or distance, and by the amount and quality of resources, such as primary products and skilled or unskilled labor, available in the recipient or host country.

This framework should help to focus the thoughts of researchers studying British outward FDI during the first half of the twentieth century. An earlier inquiry, into the relationship between comparative advantage and overseas trade in Britain for this period, expressed that relationship in terms of human capital [Crafts and Thomas, 1986, pp. 629-45]. Here, advantage has to be gauged by other measures. First of all, its national stock of outward FDI needs to be estimated for appropriate dates during this half-century. The breakdown into industrial groups (including services) should indicate where the industry-specific advantages lay. The location advantages will have to be investigated at a future time.

The years chosen for these estimates are 1913, 1929, and 1938. An introductory discussion is necessary on what FDI is all about, and then the methods of compiling these estimates are explained. These are covered in the two following sections.

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The Essential Features of Foreign Direct Investment

Like all concepts in the social sciences, that of FDI is simple in origin, but all too often overlaid by extraneous matter, so that its basic characteristics are frequently lost sight of. Outward FDI should properly be defined as the transfer overseas – usually for profit – by incorporated companies, but also by individuals or partnerships in the personal sector, from the home to the host country or countries, of real resources over the use of which the sender plans to maintain control. FDI can be "aggressive" (a better word is positive) or defensive when it has to be undertaken as a response to rivals' initiatives [Knickerbocker, 1973].

As a consequence of FDI, multinational enterprises (MNEs) are set up; there is no essential difference between a giant MNE active in many host countries and a small unincorporated concern with one or a few affiliates. These MNEs may take the form either of overseas companies, set up to operate wholly or mainly overseas, or of domestic firms with branches or affiliates abroad. A further distinction is between market-based MNEs, which produce goods or services overseas, and resource-based ones, set up to secure basic resources, such as primary products, for the use of the home country if it lacks them in the quantity required, or for marketing elsewhere in the world.

The "real" rather than financial nature of FDI needs to be stressed, so as to avoid the confusion that sometimes arises in the literature between the resource-transferring process and the consequent money transactions such as the funding of companies. Portfolio investors who buy into overseas companies may in law be owners of such companies, but as investors they have virtually no say over their FDI activities. This FDI does have to be paid for; yet, as Edith Penrose showed in her work on the growth of the firm, a basic attribute of the entrepreneur is an ability to obtain funds, or what she termed "capital-raising ingenuity" [Penrose, 1980, p. 38; Corley, 1994b, p. 113].

Methods of Compiling Direct Investment Estimates

The figures given below have had to be estimated from a variety of different sources. Comprehensive data, obtained from official censuses of all investing firms, were not collected in the UK until the 1960s. Hence, the estimates here contain an element of approximation. What, if any, validity do they therefore have?

In economics, orders of magnitude may be used when precise data are not available, to set variables in some kind of context. As an example, the historical study of FDI and the MNE took a significant step forward when Britain's FDI stock in 1914 was shown to have comprised not merely 10 percent of the country's total overseas investment stock but as much as 35 percent [Houston and Dunning, 1976, p. 12]; the more detailed estimate in this article suggests an overall proportion of 45 percent. This step forward helped to clear the air analytically, since much theoretical discussion had been on the (often implicit) assumption that Britain's overseas investment was so overwhelmingly of the portfolio kind that FDI could be neglected. Moreover, earlier estimates had been based on an outmoded definition of "direct" investment (that did not go through a stock exchange), as opposed to the modern criterion of the control exercised.

Likewise, Dunning's compilation of the world's FDI stock in 1914 and 1938 dealt in orders of magnitude. Although his sources were varied and sometimes uncertain, he was able to indicate that in 1914 FDI represented 35 percent of that year's estimated global long-term investment stock. Such a ratio was a far higher one than had been earlier surmised, and indeed more so than at any time before or since, in relation to the capital-exporting countries' national incomes [Dunning, 1988, pp. 74-5].

Thus offering estimates of FDI for a country such as Britain should both give perspective to its international involvement and encourage a search for data that could yield more reliable estimates for the future.

Britain's Overseas Direct Investments: Total Figures

According to Dunning's data of global FDI stock just quoted, Britain was the largest outward foreign direct investing country in the world up to 1945. Table 1 gives estimates of its total accumulated stock of FDI in the three years specified, namely 1913, 1929, and 1938, when FDI is found to have accounted for about 45 percent of the UK's aggregate overseas investment holdings. If the figures for the two later years are deflated by the official retail prices index to allow for inflation, in 1929 the FDI stock was in real terms worth 40 percent less than in 1913, and in 1938 almost 38 percent less.

By far the largest group was that of non-railway overseas companies. For the three relevant years, the totals had been calculated independently of one another, for 1913 by Sir George Paish [Paish, 1914, pp. 63-92]; for 1929 by *The Economist* [Economist, 1930-31], and for 1938 by Lord Kindersley, whose estimates were later taken over by the Bank of England [Bank of England, 1950]. As to overseas railway companies, their capital is not easy to estimate, as the British are known to have invested in many railroads that were not under their control. Here the capital of the British-controlled overseas railways had to be computed by grossing up that income declared to the Inland Revenue, by means of the appropriate interest rate [Corley, 1994a, p. 75]. Later returns from the Inland Revenue show income from railways in 1938 down to a quarter of the 1929 level; yet the number of assessments had fallen only to a half. The figure of £86 million for 1938 in the table may therefore be an underestimate.

The remaining group in Table 1 is of "other, including unquoted" companies. As part of an earlier inquiry, relating to 1907, Paish estimated what he termed "direct" (non-stock exchange funded) investment at £500 million. In the absence of more accurate figures, such estimates by well-informed people of the time are worthy of note. Part is known to have represented short-term overseas loans from banks or other financial companies: a sum independently calculated as £130 million in 1914 [Platt, 1986, p. 57]. The residual, £370 million, came to 10 percent of the overseas (portfolio and direct) investment total for 1913, and this percentage is used for 1929 and 1938 also.

In the "other" category, unquoted companies need explanation. Table 2 cites the number of corporate and unincorporated firms active enough to come within the Inland Revenue's ambit. Some of these corporate enterprises were unquoted ones; Paish had identified 2,172 quoted companies in his 1907 investigation, but he did not specify the number he later added to reach the aggregate capital for 1913. Nor were the numbers included in the 1929 and 1938 inquiries stated. The average annual incomes of these non-corporate firms rose only from £560 in 1927 to an average of £885 in 1937-8, no figure being given for 1909. The capital values of such firms could not therefore have been very large [Worswick and Tipping, 1967, p. 126].

Table 1: *Britain's Accumulated Outward Foreign Direct Investment Stock, 1913-1938*

	1913		1929		1938	
	£m.	% of total	£m.	% of total	£m.	% of total
Direct Investment:						
Quoted companies operating overseas and directed from Britain – capital	1,087		924		1,187	
Railways controlled from Britain – capital	454		346		86	
Total "quoted"	1541		1270		1273	
Reduction for foreign participation	-231		–		–	
Other (incl.unquoted) companies	372	10.0	374	10.0	354	10.0
Total direct	1682	45.3	1644	44.0	1627	45.9
Portfolio Investment	2033	54.7	2094	56.0	1918	54.1
Total Overseas Investment	3715	100.0	3738	100.0	3545	100.0

Sources: 1913, Corley, 1994a, p. 78; 1929, *The Economist*, 1930-1; 1938, Bank of England, 1950.

A further element in the "other" category were the branches and affiliates of domestic British enterprises. The book value of these was never publicly disclosed, and now that so many relevant company records have disappeared, a realistic figure would be difficult to estimate. However, some qualitative information can be given. Most of the largest ones in this group are known by name; these include Coats whose U.S. assets increased in value from £4 million in 1913 to nearly £6 million in 1938; Courtaulds, Lever, and Vickers. A vast number of overseas branches belonging to smaller firms also existed. One firm, not incorporated until 1924, was the Beecham's pill firm, which had an American branch that in 1920 was worth nearly £140,000. Mira Wilkins has discovered more than 100 UK manufacturing MNEs in the United States, owning about 255 plants, by 1914 [Wilkins, 1988, p. 14].

Table 2: *Inland Revenue, Number of UK Firms Operating Abroad, 1909–1937/8*

	1909	1927	1937/8 (Average)
Corporate	2419	2278	2014
Non-corporate	784	1224	638
Total	3203	3502	2652

Source: Worswick and Tipping, 1967, pp. 116, 118.

In the post-1918 world of high tariffs and other barriers to trade, many British companies, from Cadburys and Frys to Huntley & Palmers, for the first time undertook (defensive) FDI.

It would have been helpful to be able to check these total estimates from outside sources. For 1929, data were published by the United Nations, but only as an incomplete reworking of *The Economist* figures [United Nations, 1949, p. 32]. For 1938, Dunning gave Britain's FDI total as £2,160 million, compared with the £1,627 in this article, based on estimates by Cleona Lewis [Dunning 1988, p. 73; Lewis 1945, pp. 73-5]. Houston and Dunning gave tentative estimates of £1,543 million for quoted overseas companies' stocks in 1928 and £1,597 million in 1938 [Houston and Dunning, 1976, p.7]. Thus the relevant external guidance has been patchy.

One possible check, at least of movements over time, is an examination of income from this capital. The Inland Revenue data, quoted above, show the incomes of firms operating outside the UK for roughly the same range of years as here, and these are set out in Table 3.

Table 3: *UK Firms Operating Abroad, Net True Income, 1909–1937/8*

	Current values (£000s)	Pre-1914 values (£000s)	No. of Enterprises	Average income per assessment (current £)
1909	59,250	59,250	3,203	18,498
1927	97,900	58,448	3,502	27,955
1937/8 (average)	85,795	54,997	2,652	20,737

Source: Worswick and Tipping, 1967, pp.99ff, adjusted to net true income.

If, as indicated by the capital values given earlier, Britain had suffered a loss in real terms of two-fifths of its FDI stock by 1938, that would have been grievous for an economy that had so recently been transformed from a creditor to a debtor country. These data show that the relative fall in incomes was not nearly as dramatic as that. The division of the FDI stock into industrial categories will be examined next.

Industrial Composition of UK Foreign Direct Investment

The aggregate data in Table 1 provided the framework for what is intended to be the central part of this article. The industry groups, presented here, should indicate the competitive advantages perceived by the entrepreneurs of the companies concerned, and then exploited effectively enough for their enterprises to receive Stock Exchange quotations.

For overseas companies, these industrial groups are given in Table 4. By 1938, no less than two-fifths of their capital was in resource-based companies. That is understandable when Britain lacked so many of the primary products needed for its output or to trade with the rest of the world. Where a more or less perfect market existed for such commodities, as in raw cotton, FDI was not needed. However, market failure, for example in oil where giant corporations were striving to exert market power, encouraged FDI to counter such monopolistic tendencies.

British-controlled railways have been discussed above. It does look as if in the 1930s a good proportion had to be sold off, many compulsorily. The share of other utilities and services appears to have remained constant at 27-8 percent, with electric lighting and power showing some relative progress. The "land and other" category included land for agriculture and mining, real estate – including chartered development corporations – and finance and investment trusts.

Table 4: *Quoted British Overseas Companies by Industry Groups, 1913-1938 (%)*

	1913	1929	1938
Resource-Based			
Mining	18	12	19
Oil	3	9	12
Plantations (tea, coffee, rubber)	4	9	11
Total Resource-Based	*25*	*30*	*42*
Market-Based			
Brewing	1	1	1
Iron, coal, steel	2	3	1
Other	9	11	15
Total Market-Based	*12*	*15*	*17*
Railways	*30*	*23*	*8*
Banking and Insurance	*5*	*5*	*6*
Utilities and Services			
Electric light and power	2	4	6
Gas and water	2	2	2
Trams and buses	5	4	4
Telegraphs and telephones	3	3	3
Shipping, docks, etc.	1	2	1
Land and other	15	12	12
Total Utilities	*28*	*27*	*28*
Total	100	100	100

Source: See Table 1.

The market-based or manufacturing overseas companies are significant in providing a test of Britain's competitive advantage in its manufactures.

Attempts to discover the precise nature of these companies' activities have encountered the difficulty that listings have tended to place them in a catch-all "industrial and commercial" category. However, Thomas Houston extracted the names of 3,373 overseas companies from the *Stock Exchange Year Book* for 1914-15, with an aggregate capital value exceeding £1,300 million. While 53 percent by number were resource-based ones and 35 percent utilities and services (including railways), the 12 percent in manufacturing belonged to an extensive range of industrial activities [Houston and Dunning, 1976, p.40]. The 400 manufacturing companies are listed by category in Table 5. Even if many of these enterprises were not technically advanced ones, their directors judged it advantageous for them to venture overseas.

Table 5: *Number of UK Quoted Overseas Companies in Manufacturing Sector, 1914*

	UK Registered	Registered overseas	Total
Food	55	11	66
Brewing, wine making, etc.	34	2	36
Tobacco	7	3	10
Chemicals and allied	23	12	35
Mechanical engineering	11	7	18
Instrument making	2	–	2
Electrical engineering	8	5	13
Shipbuilding, marine engineering , vehicles and railway workshops	16	3	19
Other metal manufacture	47	30	77
Other metal goods	10	2	12
Textiles, jute, asbestos	34	14	48
Leather	2	1	3
Bricks, pottery and glass, Cement, abrasives	9	2	11
Timber, furniture	29	8	37
Paper, pulp, packing	8	–	8
Rubber, linoleum, sports equipment, musical instruments	6	1	7
	301	101	402

Source: Dr. T. Houston, extracted from *Stock Exchange Year Book* 1914/15.

Table 4 omits domestic firms that had branches abroad, in the absence of quantitative data. Yet most that are known by name fell into the category of manufacturing or market-based companies. To convey some idea of how their inclusion in the table would have altered the proportions, assume that half the "other" companies by value were manufacturing ones. That would have raised the market-based share from 12.6 to 22.6 percent of the total in 1913 and from 16.6 to 23.8 percent in 1938. Such assumed changes are not offered as estimates, but simply as a means of focusing attention on the orders of magnitude entailed. Britain's apparent deficiency in manufacturing FDI at that time cannot therefore have been nearly as extensive as the data in Table 4 indicate. The question of how much success UK MNEs achieved is studied in the following section.

How Successful Was British Foreign Direct Investment in This Period?

Several criteria of success are considered here. One might be that of survival, by tracing a sample of companies quoted in 1913, to see if they were still being listed in 1938. Alternatively, success can be measured by the incomes of those firms. Thus in 1907-8, Paish found that the profits of his 2,172 overseas companies, totalling £57 million, amounted to 7.7 percent of the £737 million capital. As a rough indicator of subsequent yields, the incomes given in Table 3 for 1929 and 1937/8 are related to those years' capital values as set out in Table 1; the apparent returns on capital were 7.7 and 6.1 percent respectively. Dividends and interest seem to be less reliable guides. According to calculations in *The Economist*, those actually paid for the year 1927/8 in respect of UK overseas companies and those registered abroad that had British majority control were at the rate of 11 percent on capital [*The Economist*, 1930, p. 800].

Broader criteria emerged from the 1960s debates in both Britain and the United States on the economic effects of outward FDI. Analyzing these debates, Dunning pointed to the sharp divergences likely to occur between the private and social benefits (and costs) of such FDI [Dunning 1970, p.120]. At the national level, economic and business historians have frequently raised the question of whether the level of UK outward investment overseas before 1939 – and more especially in the pre-1914 era – were too high for the economy's overall good. Many of their discussions lacked authority in confining themselves explicitly, or more often implicitly, to the role of portfolio investment. Now that FDI has been estimated to comprise nearly a half of Britain's overseas investment, the basis of debate has been somewhat changed.

To help clear minds on this issue, two analytical questions seem relevant. First, is overseas portfolio investment a perfect substitute for FDI, and second, is FDI a substitute for direct investment at home? The first question was addressed at the beginning of this paper, emphasising the "real" nature of FDI, undertaken by different categories of people from portfolio investors, with different motives and sought-after factor rewards. Only if this "real" aspect is overlooked, do certain peripheral issues arise to complicate matters, such as would-be investors deciding whether to undertake portfolio investment in domestic or in overseas companies.

The second question, of FDI as a possible substitute for direct or real investment at home, has several strands that need to be kept separate. If the implied criticism is that early twentieth-century FDI "crowded out" investment in Britain itself, then blame cannot be put entirely on its capital market for channelling funds overseas rather than into technologically-advanced but risky ventures at home [Kennedy, 1987, pp. 153-63]. That merely addresses the half of total investment that was of the portfolio kind. A start can be made by comparing the structure and outcome of FDI and of home investment from the Inland Revenue data cited earlier. The comparison is given in Table 6.

Table 6: *Home and Overseas Corporate Incomes, 1909–1937/8*

	1909	1927	1937/8 (average)
Income (£ million) in UK	386	836	852
from overseas	59	98	86
Total	445	934	938
Number of assessments (000s)			
UK	419	1,055	1,007
Overseas	3.2	3.5	2.7
Average income per assessment (£)			
UK	921	793	847
Overseas	18,498	27,955	32,684

Source: Worswick and Tipping, 1967, pp. 99ff, adjusted to net true incomes.

In 1909, overseas ventures contributed no less than 13 percent of total corporate income from domestic and overseas firms combined, namely £59 million, with only 3,200 assessments compared with 419,000 for domestic firms. In 1937/8, the average income of £86 million was over 9 percent of a much larger aggregate income, the 2,700 assessments still being a minute proportion of more than a million assessments. Thus while firms at home returned incomes averaging well below £1,000 in each of the three years, the annual incomes of the country's overseas firms rose on average from £18,000 in 1909 to nearly £32,700 in 1937/8, the latter being equivalent to £21,460 if allowance is made for inflation.

Because a lot of small firms existed at home, earning not very much, did British entrepreneurs do better by looking overseas? In reality, the country's FDI stock was made up of many individual investment decisions, arrived at for any number of reasons, some of them market-based and some of them resource-based. Dunning's verdict here, based on the transatlantic research of the 1960s, found no simple alternative of this kind.

Many economists, he stated, believed that firms in their investment decisions sought to equalize their returns on capital from all such projects, so that domestic and overseas direct investment should be seen as competitive with one another. That was not the view held by business people. For instance, worthwhile investment opportunities might not exist at home because of government policy or the business cycle. Where they did exist, but involved having to introduce unfamiliar and more sophisticated processes, management and skilled labor might not be available. Hence, if a firm wished to grow, it could do so more satisfactorily by installing the current level of technology in a branch overseas [Dunning 1970, p. 132].

The issue of the success or failure of British outward FDI during this period therefore turns out to be more complex than it is sometimes portrayed, and could profit greatly from more intensive analytical and empirical research.

Conclusion

To understand properly the course of Britain's economic history during the eventful first three decades of the twentieth century, the country's international involvement as a whole needs to be studied, given its role as an open economy. On the outward side, while precise data on exports are available and have been widely investigated, the other main item in this involvement, namely FDI, requires careful scrutiny at both the macroeconomic and industrial levels.

This article has discussed the theoretical and empirical difficulties of compiling estimates at both of these levels; clearly, flow data of annual changes in the FDI stock – to supplement the recorded flows of exports – would be impossible to reconstruct for the pre-1939 period. However, here FDI stock estimates are offered, covering the total and its composition by industry. Even orders of magnitude turn out to be illuminating in raising fresh questions to inspire further investigation. Meanwhile, it seems that Britain in this era enjoyed a number of advantages, from which home-based entrepreneurs sought to benefit overseas through ventures in a number of different industrial sectors.

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