GOVERNANCE, MULTINATIONALS AND GROWTH
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Forthcoming with Edward Elgar Publishing in 2005

CHAPTER 1: INTRODUCTION AND OVERVIEW

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Introduction

The touchstone for this volume is the work of Edward Safarian, widely recognized as the "Dean" of Canada's scholars who study foreign direct investment (FDI) and multinational enterprises (MNEs). A professor at the University of Toronto since 1966, Safarian has been President of the Canadian Economics Association (1977-78) and a Fellow of the Royal Society of Canada since 1973. From his pioneering works on *The Canadian Economy in the Great Depression* (1959) and *Foreign Ownership of the Canadian Economy* (1966) to his later works on *Governments and Multinationals: Policies in the Developed Countries* (1983) and *Multinational Enterprise and Public Policy: A Study of the Industrial Countries* (1993), Safarian has been a major contributor to our understanding of multinational enterprises and public policy. The occasion of his eightieth birthday in 2004 provided an obvious opportunity, not only to celebrate his academic and policy contributions, but also to contribute new work that is forward looking.

Governance, Multinationals and Growth is a theme that reflects the main strands in Safarian's work on multinationals. The springboard for many of the papers was Safarian (1966), which covered a broad range of issues concerning multinationals in a host country, including parent-subsidiary relationships, intrafirm trade, creation and transfers of knowledge within the MNE, and the impact of nationality on firm performance. The papers were designed to build on Safarian's contributions by exploring the linkages among multinational enterprises, growth and governance, and by addressing issues that remain unresolved or under-researched in the thematic areas of his work. Some of the broad areas covered at the conference were:

How does nationality affect firm performance?
Does foreign ownership matter for economic growth and national welfare?
What are the linkages between multinationals, productivity and economic growth; and how has trade liberalization and regional integration altered these linkages?
How have trade liberalization and regional integration affected FDI patterns; in particular, how have the Canada-US Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA) affected FDI patterns and firm strategies?
How are mergers and acquisitions different from other forms of FDI?
How has the growth in foreign and domestic multinationals affected the capability for public governance?
How have national and international governance of multinationals changed over time?
What policies should national governments be adopting towards multinationals, in the context of globalization?
How do small countries differ from large countries in terms of their public policy issues

vis à vis multinationals and FDI?

The first paper in the book, by Edward Safarian, provides a retrospective on his research and teaching career. The book is next divided into three main groups of papers, each of which deals with a different sub-theme within the overall theme of governance, multinationals and growth. The first section covers corporate governance, multinationals and growth; the second section covers free trade, multinationals and growth; and the third section, public governance, multinationals and growth. The final paper in the volume was contributed by Richard Lipsey who served as conference rapporteur. We turn now to an overview of each of the book chapters.

Overview

The first paper is contributed by **Edward Safarian, "How to Thrive in an International Economy",** with a retrospective on his research and teaching career. He reflects on the fundamental research question that drove much of his research and teaching interests: "How best can a relatively small country thrive and pursue its objectives while being part of an international economy and while living next to a very large and dynamic neighbor?"

Safarian explored this question through four major projects. The first project was an analysis of Canada in the Great Depression (Safarian, 1959). His second major project, Safarian (1966), was built on a database of foreign- and Canadian-owned firms in Canada, developed through interviews and surveys. This project, perhaps the one for which he is most famous, covered a broad range of issues concerning multinationals in a host country, including parent-subsidiary relationships, intrafirm trade, creation and transfers of knowledge within the MNE, and the impact of nationality on firm performance. The third project analyzed the national welfare effects of the division of regulatory powers between the federal and provincial levels of government (Safarian, 1974). The fourth project was a history and analysis of government policies towards MNEs, in industrialized countries since 1945, focusing on the determinants and effects of these policies (Safarian, 1983, 1993). In the latter two books, Safarian found that government policies towards MNEs were more likely to be the outcome of political decisions over issues such as income distribution and rent capture, electoral pressures, and attempts to maintain key sectors, rather than national welfare maximization. Moreover, countries varied significantly in their relative abilities to achieve their goals. He also found that government policies towards MNEs appeared to be cyclical, with periods of liberalization followed by periods of tightening.

Safarian concludes by asking where academic research fits into policy debates about "how a society makes its way in an increasingly integrated world". He argues that it is important for academics to be involved on what are valid or invalid economic arguments even if they do not have the skills or desire to engage in public debates.

The theme of the first group of papers is corporate governance, multinationals and growth. The author of the first paper is Alan Rugman on **"Continental Integration and Foreign Ownership of Canadian Industry: a Retrospective Analysis".** In his examination of Canada-US economic integration, Rugman provides an overview of the Canadian debate in the 1960s and 1970s, which pitted those supporting deeper integration against those who worried about loss of economic sovereignty and stimulated a debate about the role of multinationals in the Canadian economy. Rugman concludes that Safarian “virtually stood alone as a serious analyst of FDI”, and that he was right to “discredit the widespread fears of foreign control and anti-Americanism of the times”. Rugman provides extensive data on the strong economic linkages between Canada and the United States, and supplements the macro-level data with firm-level data on US and Canadian firms in the list of the world’s 500 largest firms. As he points out, Canada-US economic integration is not an exceptional event; rather deep integration in North America is part of a general worldwide trend to intraregional integration.

“Who Owns Whom? Economic Nationalism and Family Controlled Pyramidal Groups in Canada”, by Randall Morck, Gloria Tian, and Bernard Yeung, explores the conjecture that economic nationalism can aid the expansion of family controlled pyramidal groups.

Pyramidal groups are a phenomenon whereby a few rich families in a country can control multiple corporations through a pyramidal ownership structure, crossholding, and placing family members in key positions throughout the organization. Typically associated with family controlled firms in East Asia and Latin America (e.g., grupos, zaibatsu, and chaebol), Morck, Tian and Yeung argue that Canada also has an unusually high proportion of family controlled pyramids relative to other developed economies, in particular, the United States. The authors hypothesize that economic nationalism, which they define as privileging local products, investments and firms relative to foreign products, investments and firms, may have contributed to this anomaly.

The current explanation for the existence and growth of family controlled pyramids stresses the roles of capital market frictions and firms’ desire for control. Capital market frictions make raising external financing expansion and internal seed money a necessity. To expand control, a family can instruct one firm that it controls to set up a second, new firm rather than use the family’s own money. By doing so, the family can use the retained earnings of the first firm as seed money to raise expensive external funds, rather than pay out dividends. Additionally, the family ends up controlling both the existing firm and the new one.

Morck, Tian and Yeung argue that in the first half of the 20th century, Canadian corporate governance evolved parallel to the United States, shifting from the so-called robber baron families to freestanding, widely held corporations. However, in the 1970s, Canada reversed course and corporate pyramids controlled by a few wealthy families expanded. By the end of the 20th century, freestanding firms were a minority in terms of both numbers and assets, similar to the early 1990s.

In trying to understand the shift in Canadian corporate governance structure, the authors provide several speculative hypotheses. The most likely explanation, they conclude, is economic nationalism during the 1970s and early 1980s. Their data show that heightened economic nationalism, the introduction of stringent policies against foreign ownership of domestic corporations, the shrinkage of foreign ownership of Canadian corporations, and the absorption of widely held freestanding Canadian corporations into family pyramidal groups all occurred simultaneously with the rise of family-controlled pyramid groups. With restrictions on foreign ownership, domestic firms were privileged relative to foreign firms in terms of mergers and acquisitions. Foreign firms were not able to compete rigorously for host country investment projects and investment funds.

The high proportion of family controlled pyramids in Canada is a problem, according to the authors. Family controlled pyramids, as a form of corporate governance structure, create conflicts between insiders that control the firm but own only a small percentage of it, and shareholders at large. Pyramid groups are also less vulnerable to takeovers, more insulated from shareholders, and more susceptible to forms of income shifting or tunneling. Morck, Tian and Yeung argue that restrictions on inward FDI may therefore have had the unintended consequence of encouraging a less-efficient form of corporate governance structure.

In the 1980s and 1990s, international mergers and acquisitions (M&As) became the dominant mode of foreign direct investment for both developing and (especially) developed countries. While policy makers have expressed concern in the past about the economic welfare benefits of M&As to host economies, at least in comparison to "greenfield" investments or joint ventures, there is little empirical evidence concerning whether and how international M&As are a unique form of FDI. **"Assessing International Mergers and Acquisitions as a Mode of Foreign Direct Investment", by Steven Globerman and Daniel Shapiro,** fills a hole in this regard.

Their paper evaluates whether the location determinants of FDI are sensitive to whether or not FDI takes the form of international M&As. The authors specify and estimate parsimonious models of the determinants of inward and outward M&A flows for a sample of 154 countries with data averaged over the period 1995-2001. In so doing, they identify variables that are potentially M&A mode-specific. The authors also address the degree of similarity between the M&A model and a model of aggregate FDI flows. Their results confirm the empirical significance of macro governance variables as determinants of both inward and outward FDI *regardless of mode*. They also confirm the statistical importance of liquid and efficient capital markets as determinants of cross-border M&A activity, but show that good overall governance promotes more liquid stock markets.

Someshwar Rao and Jianmin Tang, in "Foreign Ownership and Total Factor Productivity", examine the consequences of inward and outward FDI on a country's competitive position, which they define as total factor productivity. Their paper focuses on several big research questions that have puzzled Edward Safarian and other students of FDI: Are foreign-controlled firms more productive than domestic-controlled firms? Do they create productivity spillovers for domestic firms in host countries, and are there productivity spillovers at home from investments made abroad? How do inward and outward FDI affect other drivers of economic growth such as capital accumulation, trade expansion and R&D?

Drawing on ten years of research sponsored by Industry Canada (a department within the federal government), the authors analyze the contribution of foreign-controlled firms to a host country's total factor productivity, using Canadian micro and industry level data as a case study. The authors find that foreign-controlled firms, after controlling for the influence of other factors, on average, are 10 to 20 per cent more productive than domestically controlled firms, which they attribute to the firms' superior technological and managerial know-how. In addition, foreign-controlled firms do exert significant positive productivity spillovers on firms in host countries. The authors do not find, however, significant productivity spillovers from home multinational enterprises to other firms in a country. Moreover, domestic and foreign MNEs do raise real incomes through their positive effects on variables such as trade flows, capital accumulation, innovation and net investment income.

Rao and Tang recommend that countries such as Canada should improve the investment climate if they want to attract and retain inward FDI, and should also work towards improving access for Canadian multinationals abroad. In particular, they argue that if Canada were to reduce its restrictions on inward FDI and remove many product regulations, it could significantly increase inward FDI flows.

The next group of papers focuses on free trade, multinationals and growth and begins with "**Factor Price Differences and Multinational Activity", by Ignatius Horstmann and Daniel Vincent,** who develop a theoretical model of multinational activity and outsourcing. Their model assumes there is free trade (no tariff or FDI policy barriers) between countries, but the countries differ in their factor endowments. The authors' paper is motivated by the growing trend in North America to outsource stages of the value chain to foreign countries (e.g., manufacturing to maquiladoras in Mexico, back office functions to India).

Existing economic models of MNE activity explain trade and FDI patterns using scale economy and/or transportation cost differences, rather than factor price differences. Scale and transport cost arguments can explain horizontally integrated MNEs that engage in similar activities across countries (e.g., distribution and sales), but do not well explain vertically integrated MNEs that perform different stages of the production chain in different countries. Factor price differences can be used to explain vertically integrated MNEs, but the multinational activity occurs in one direction; either country 1 firms have affiliates in country 2 or vice versa, but not both.

Horstmann and Vincent's approach solves this puzzle by unbundling MNE activity into a continuum of tasks that require different factor intensities. Their model assumes that production of any good involves the completion of a continuum of tasks and that each economy is endowed with a continuum of factor types, each type specific to a different task. In the presence of costs of coordinating tasks across countries, neither free trade alone nor free trade with outsourcing generates factor price equalization. The model produces outsourcing even between countries with very similar factor endowments, as well as two-way outsourcing. The model also suggests that the appropriate measure for multinational activity in each country is total factor payments or value added, not sales. These observations square well with data on multinational activity, generating MNEs that are both vertically and horizontally integrated. The model also has the feature that outsourcing varies continuously and in a predictable manner as elements of the environment change. This outcome is in contrast to most previous models of multinational activity that involve discontinuities.

The paper by **Richard Harris, "FDI in an FTA with Uncertain Market Access",** explores some of the relationships between trade and FDI within a free trade area (FTA), where market access to the other member's markets is not secure. The real world puzzle that underlies this paper is Canada's experience in North America with the Canada-US FTA and NAFTA, where Canadian firms have less than secure access to the much larger US market.

Harris explores the implications of incomplete access on the pattern of inward FDI to a regional FTA where countries differ in size. He assumes firms must make ex ante sunk investments before uncertainty is resolved and firms know the degree of market access. Using a simple two-country model of trade within an FTA, where one country is much larger than the other, Harris examines the sensitivity of firm location decisions in the small country to the degree of access to the larger partner's market. With uncertain access, he argues excess capacity is likely to occur in industries with large sunk costs (e.g., steel, automobiles). If firms in the large country seek contingent protection through anti-dumping or countervailing duties, the threat of lost access to the large market can have large negative implications for location in the small country.

Harris simulates the impact of sunk costs and insecure market access on the viability of FDI in the small country relative to the large country, using a range of estimates. For example, if sunk costs are 80 per cent of total costs, and the security of access to the large country's market increases by 10 percentage points, Harris finds that the level of costs at which FDI is competitive in the small country increases by 23 per cent. However, if firms are risk adverse, the competitive position of the small country falls rapidly as the level of contingent tariff protection in the large country increases. Thus, both security of access to the large country's market and the degree of risk aversion by firms affect the choice of location between large and small countries.

Since both insecure market access and firms' risk aversion encourage location in the large country, this creates a substantial policy problem for the smaller country seeking to attract or retain FDI. Harris discusses two policy options for the small country. These options -- location subsidies and a market access insurance scheme -- are designed to offset the market access disadvantage of location in the small country's market. Harris compares the two policies and argues that, while their welfare effects are similar, the market access insurance scheme is superior on practical grounds.

Walid Hejazi and Peter Pauly, in "How Do Regional Trade Agreements Affect Intra-regional and Inter-regional FDI?" review theories that explain the existence and location of FDI, and extend the discussion of those theories to the introduction of a free trade area. The authors argue that the effects regional trade agreements can have on trade and FDI is a complicated issue. Theoretically, the effects depend on several dimensions: the degree of trade integration prior to the implementation of the agreement, the horizontal versus vertical nature of FDI, the relative size and levels of development of countries in the agreement, as well as the distinction between intra-regional versus inter-regional FDI. Because of these complexities, it is impossible to predict ex ante the impact an FTA will have on the distribution of FDI. This means that the net impact on FDI patterns observed in the aftermath of an FTA is the result of many different underlying effects, not all of which reinforce one another.

Using two data sets, one for bilateral US outward FDI to each of 52 countries and a second for bilateral OECD data among 28 countries, Hejazi and Pauly measure the impact the Canada-US FTA and NAFTA have had on the attractiveness of North America as a destination for FDI, and on each of the three member countries. The results show clearly that Mexico and the United States were net beneficiaries of the NAFTA in terms of their ability to attract FDI. In contrast, Canada became less attractive for US (insider) FDI but more attractive to OECD (outsider) FDI. They conclude that existing theories are able to explain these results.

“Responses to Trade Liberalization: Changes in Product Diversification in Foreign and Domestic Controlled Plants”, by John Baldwin, Richard Caves and Wulong Gu, studies the impact that a small country joining a regional trade agreement might be expected to gain from the exploitation of plant-level scale and scope economies as firms scale up to meet the demands of the regional market. The real world puzzle behind this paper is how firms adapt multi-product production to plant-level scale and scope economies and to changing levels of production associated with trade liberalization.

The paper makes use of the experience of Canada, from the late 1980s through the late 1990s, over the period when the Canada-US FTA and the NAFTA were signed and implemented. In the 1960s and 1970s, high Canadian and US tariffs were both linked to greater plant diversification; that is, tariff barriers encouraged plants to produce too many products with too short production runs so that plant-level economies of scale were underutilized.

One of the predicted effects of free trade that the economics literature focused on was that manufacturing plants would be better able to exploit scale economies with increased access to US markets. In addition, the economics literature argued that foreign plants tended to produce an excessively large range of products behind high tariff barriers and that free trade would lead to increasing specialization in this group. Tariff liberalization, therefore, should lead to longer production runs and more product specialization.

The authors find that there was a general increase in the pace of commodity specialization at the plant level around the time of implementation of the FTA and NAFTA. Plant diversity was higher in larger plants and in industries with assets that are associated with scope economies. Diversity was also higher in industries that had higher rates of tariff protection. Over the 1980s and 1990s, plant diversity decreased with reductions in both US and Canadian tariffs. The decline was greater during the post-NAFTA era than before, thereby suggesting that this treaty had an impact beyond that just engendered by the tariff reductions associated with NAFTA.

The study also found that foreign-controlled plants tended to be larger than domestic-controlled plants. Controlling for size of plant, foreign-controlled plants were more specialized than domestic-controlled plants, most likely because they were better able to optimize production for the whole North American market through their parent-subsidiary networks. With the introduction of the FTA and NAFTA, the decline in product diversification was faster for the foreign-controlled plants, and the tariff effect was stronger. Baldwin, Caves and Gu conclude that foreign-controlled plants adapted better to trade liberalization during the specialization process than domestic-controlled plants.

The theme of the third group of papers is public governance, multinationals and growth. For many years, international business scholars have studied the ways in which host country governments affect the extent and pattern of inbound FDI. While national policies differ, there are many common influences. **John Dunning, in “FDI and the International Policy Environment, Back to the Future? Not Quite!”** identifies and analyzes these common influences, how they have evolved, and how they have affected (and been affected by) FDI and other MNE activities.

Dunning divides his historical analysis into three periods that roughly correspond to host country attitudes towards FDI and MNEs that are liberal (1950s and 1960s), regulatory (late 1960s to late 1970s), and global (early 1980s to the present). His analysis is organized both chronologically and cross-sectionally. In each period, he distinguishes between policies that focus on inward FDI and outward FDI. Within each period, he distinguishes between developed, outward-oriented developing, and other developing countries. He argues that the third period has policies that are similar to, but not the same as, the first period (hence the title, “Back to the future? Not quite!”).

In his historical review, Dunning argues that government policies towards FDI *per se* are becoming less important as governments concentrate more on upgrading and restructuring in order to cope with the pressures of globalization. Governments are more concerned about the consequences of FDI for national competitiveness and economic and social development. As a result, FDI-specific policy is moving from the national to the regional and supranational levels, such as NAFTA, the European Union and the WTO (Dunning calls these top-down policies). Moreover, special interest groups such as NGOs are becoming more important actors influencing MNE activities and policies (bottom-up initiatives).

Looking ahead, Dunning believes MNE-state relations are becoming “more challenging and problematic”, along the lines foreseen in Vernon (1998). Moreover, international terrorism and other security concerns are raising further complications for MNEs. A major challenge will be how to reconcile different views about regulating FDI without “killing the goose that laid the golden egg”.

Edward (Monty) Graham’s paper on, “Economic Issues Raised by NAFTA Chapter 11 Investor-to-State Dispute Settlement Cases having Environmental Implications”, links multinationals, trade policy and the environment. The motivation behind this paper is the NAFTA, which in Chapter 11 introduced an investor-state dispute settlement mechanism. Multinationals that believe they have been damaged by national environmental regulations can sue the relevant government for compensation for these damages. Environmental NGOs therefore see Chapter 11 as diluting national environmental laws.

Graham attempts to determine whether public compensation of private investors is a socially optimal policy from a societal cost-benefit analysis. Looking at these cases as negative externalities, he asks whether Coase’s theorem -- the national welfare effects are identical regardless of whether the externality is eliminated through a “polluter pays” or the “public pays” approach – holds here. His conclusion, however, is that the two are different, and that the “polluter pays” is preferable for several reasons including government fiscal illusion and moral hazard arguments.

“Location Incentives and Inter-State Competition for FDI: Bidding Wars in the Automotive Industry”, by Maureen Appel Molot, analyzes bidding wars in the North American auto industry. Competition among jurisdictions in the United States, and by extension to Canada, for new automotive assembly investment, which has long existed, has reached new heights. The large auto MNEs and state governments have become quite sophisticated at playing the location incentives game. However described – as a location incentives game or a locational tournament - the point is the same – the inter-jurisdictional competition or bidding to attract FDI. States, anxious to attract jobs (direct and indirect) actively compete with each other by offering a range of subsidies to European and Japanese assemblers to locate in their jurisdictions. One set of locational tournaments unfolded in the US in the 1980s; a second began in Canada at the same time and a third in the US in the early 1990s that continues unabated in the early years of the 21st century. Using a number of propositions derived from the literature on MNE-state bargaining and that on firm and country specific advantages, Molot's paper examines the political economy of locational tournaments. She argues that experience has enhanced the capacity of auto MNEs to play the incentives game. Moreover, the number of jurisdictions bidding for an investment enhances the capacity of the MNE to play off one bidder against another to its own advantage. An important additional consideration in auto MNE location decisions is the availability of untrained labor and the absence of a union environment.

The next paper consists of three short policy analyses contributed to a roundtable discussion examining Canada's international economic policy options. **Wendy Dobson, Grant Reuber and Andrei Sulzenko, in "Policy Roundtable: Life as Neighbor to an Economic Giant – Issues and Options",** focus on Canada's priorities as a country living next door to the US economic giant. They explore some of the generic issues that small economies located in proximity to very large economies can expect to face in managing their external relations. The key challenge facing small countries is to "identify and pursue their own economic objectives in a turbulent and uncertain economic environment". The papers identify three general goals: (1) how the small economy manages its bilateral trade and investment relationship with the large economy so as to ensure that it maintains access to the larger (and wealthier) market; (2) how the small economy can globally diversity its trade and investment relationships so as to reduce its bilateral dependence on the large economy; and (3) how to develop and update domestic economic policy frameworks so the small economy can take advantage of opportunities in the changing world economy. The authors argue that Canada has achieved the first objective (see Rugman for a similar assessment and Harris for an opposing view), but at the cost of becoming ever more dependent on the United States. Thus, the first goal has been (unintentionally) at the expense of the second goal. The third goal – creating stronger innovation and growth through higher productivity and greater flexibility– is a continuing challenge.

In the concluding paper**, "Issues on Governance, Multinationals and Growth: Thoughts on Method, Policy and Research Suggested by the Festschrift Papers", Richard Lipsey** provides his own perspective on the preceding papers. Lipsey's paper may remind some readers of Susan Strange's famous article, "Cave! hic dragones (Help! here be dragons!): a critique of regime analysis" (Strange, 1982). A "dragon" was a pitfall for the unwary scholar. Her article criticizes international regime theory of harboring five dragons: a passing fad that makes no long-term contribution to knowledge, imprecise and wooly, value biased, distorting by overemphasizing the static and underemphasizing the dynamic elements of change in world politics, and narrow-minded. While Lipsey's pitfalls for the unwary are not as devastating a critique as Strange's dragons, he does raise somewhat similar, and just as important, questions about potential research pitfalls that can affect scholars of FDI and multinationals in general, and in this book in particular.

Lipsey divides his paper into four topics: issues of method and interpretation, issues for further research, general issues of policy, and Canadian-specific issues of policy. In terms of methodology and interpretation, Lipsey highlights several possible dragons: language as a barrier to continuity, what theoretical models can (and cannot) tell us, internally driven versus externally driven research programs, how scholars deal with awkward facts, what we can learn from single equation regressions, and the impact of how quantitative measures are reported. In terms of items for further research, he identifies four: industrial organization, outsourcing, factor price equalization, and total factor productivity. Four general public policy issues are identified and discussed (NGOs, competitive bidding for plants, competition policy and dealing with human capital). Lipsey's paper concludes with five Canadian-specific policy issues: small country problems, the decline in Canadian inbound FDI, relative efficiencies of foreign-controlled versus domestic-controlled management, Ontario's dependence on autos, and the need to rethink microeconomic policy in Canada.

Conclusion

This volume began with an innocent question at another conference, "How is Ed Safarian?" The response to this question posed by one of the editors included reference to the approach of Ed's eightieth birthday. That conversation led to a celebratory conference in 2004 honoring Safarian and his work, and to the book you now hold in your hands. Conferees honoring Safarian included some of the world's leading scholars on multinationals. They contributed enriching and intellectually stimulating papers on governance, multinationals and growth to this book that make significant progress in our understanding of these issues.

While the book is aimed primarily at graduate students and faculty in business schools and economics departments that focus on international business, we believe public policy makers and corporate executives will also find it worthwhile reading material. We are confident this volume will prove worthy of Edward Safarian's pioneering efforts in the study of multinationals and foreign direct investment.

Lorraine Eden and Wendy Dobson, October1, 2004

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