
The Growth of International Business

edited by

Mark Casson

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Preface

The contributions to this book provide an integrated treatment of a new and expanding area of research. The contributors were commissioned to write upon a specific aspect of the growth of international business. Each contributor writes upon an area of which he has expert knowledge. The contributions were presented in draft form to the Annual Conference of the UK Chapter of the Academy of International Business held at Reading University in March 1982, and have been revised in the light of discussion at the conference.

Jill Turner was responsible for typing most of the papers and for administering the conference; Margaret Lewis, Barbara Wall and Christine Toms also typed some of the papers and worked very hard to meet the conference deadline. I am grateful to them all for their invaluable efforts. The Academy of International Business owes a great debt to Dr Michael Z. Brooke for setting up and running its UK Chapter; I am grateful to Michael, and to his colleague Dr Stanley Paliwoda, for support in organising the conference. I am also grateful to John Cantwell for his help. Finally, the authors owe a great debt to their referees and discussants, who put considerable effort into supplying constructive criticisms of early drafts; no specific acknowledgements are made, however, as the preparation of the book has been a truly cooperative effort.

MARK CASSON
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Contents

Preface	page ix
The authors	xi

THEORY

1	Introduction: the conceptual framework, by <i>Mark Casson</i>	1
2	New theories of international business: some unresolved issues, by <i>Peter J. Buckley</i>	34
3	Technological and organisational factors in the theory of the multinational enterprise, by <i>David J. Teece</i>	51
4	Pricing and sourcing strategies in a multinational oligopoly, by <i>Mark Casson</i> and <i>George Norman</i>	63

EVIDENCE

5	Changes in the level and structure of international production: the last one hundred years, by <i>John H. Dunning</i>	84
6	Industrial diversification amongst the world's leading multinational enterprises, by <i>Robert D. Pearce</i>	140
7	The growth and structure of multinationals in the banana export trade, by <i>Robert Read</i>	180
8	Strategic factors in the growth of a multinational enterprise: the Burmah Oil Company, 1886–1928, by <i>T. A. B. Corley</i>	214
9	The growth of transnational banking, by <i>George N. Yannopoulos</i>	236
	Bibliography	258
	Index	273

1 Introduction: the conceptual framework

MARK CASSON

1.1 NEW DIRECTIONS IN RESEARCH

Ten years ago industrial economics, international economics and business history were relatively stagnant areas of research. The stagnation in industrial and international economics was particularly surprising as there were very important contemporary developments which affected both these disciplines. Prominent among these developments was the rapid growth of multinational firms and their foreign direct investments. Logically, the analysis of the multinational firm lies at the interface of industrial and international economics. Yet the growth of the multinational firm could not be explained by a straightforward synthesis of the orthodox theories of the time. As a result, the study of multinational firms remained divorced from mainstream economics.

Today industrial and international economics are amongst the liveliest areas of research. New theoretical concepts have been developed – or old concepts rediscovered, according to one's perspective. These concepts have been developed partly as a direct response to the challenge of explaining the growth of the multinational firm. They have enabled the study of the multinational firm to be absorbed into mainstream economics. As a result, the way is now clear to develop and deepen our knowledge of this subject.

The situation in business history has been somewhat different. Business historians have for a long time been plagued by conflicting research objectives (Cole, 1962; Galambos, 1966; Tucker, 1972). Is the primary function of a business history simply to record the growth of a particular successful firm? To what extent should business history involve the study of wider issues such as the growth of capitalist enterprise and more recently the emergence of the large corporation? How much emphasis should be placed upon social and psychological factors, such as the personality of the individual founder of a firm and the ethos with which he imbues it? How far should historians seek to

2 The Growth of International Business

generalise about the growth of firms; in particular, is it possible to generalise about the factors which make for a firm's success?

In scientific research the primary object is to test a theory, and the business historians' problems are largely due to the fact that until recently they had no conventional theory to test. Admittedly there was an economic theory of the firm, but this had little to say about two factors of major interest: the relationship between the strategy and the structure of the firm, and the dynamics of the firm's growth. Many business historians found the most interesting theories to be those concerned with the social psychology of the entrepreneur, but these were often too lacking in precision to permit a satisfactory test. Now at last there is emerging an economic theory of business strategy and growth which is generating hypotheses for business historians to test. The availability of this theory is a major factor in the renewed vitality of business history research.

The study of the growth of international business links the disciplines of industrial and international economics on the one hand, and of business history on the other. The documentation of the growth of international business is already well established. Like most historical research, it is hampered by a lack of data, notably by the absence of consistent economic time series on direct investment flows. There is, however, a considerable amount of archival material obtainable from individual firms, and some of this has been collated and standardised, and is available in published form (Vaupel and Curhan, 1969, 1974). A particularly valuable source is contemporary studies and reports on foreign direct investment: the most prominent of these include Frankel, S. H. (1938), Lewis (1938), Marshall, Southard and Taylor (1936), Moore (1941), Remer (1933), and Southard (1931).

The standard references on the history of international business are two volumes by Wilkins (1970), (1974a). Wilkins provides most useful bibliographies, as do Brooke, Black and Neville (1977) and Stewart and Simmons (1964). References to more recent work are available from the bibliography at the end of this book.

1.2 ORIGINS OF THE MODERN THEORY OF THE FIRM

The object of this introductory chapter is to outline the theoretical concepts which underlie the study of international business growth. The relevant concepts are those of the institutional theory of the firm. The antecedents of this theory are to be found in papers written in the 1930s on the nature of the firm.

It is useful to begin with Kaldor's critique of the Marshallian long-

run theory of competitive supply (Kaldor, 1934). Even today the radical implications of this paper have not been fully grasped.

Marshall deduced the upward-sloping industry supply curve from the upward-sloping supply curve of the representative firm (Marshall, 1920). In the long run, of course, the number of firms in the industry is variable. Thus before he could derive the industry equilibrium, Marshall had to assume that in the equilibrium there would be a sufficient number of firms to sustain competition. Kaldor points out that this assumption is warranted only if, as output expands, the average cost of the representative firm increases faster than the average cost of the industry as a whole. If it increases at the same rate then the number of firms would be indeterminate. When inputs are hired competitively, Kaldor's condition is satisfied only if the firm employs a fixed factor. Kaldor concludes that even in the long run the representative firm in a competitive industry has a fixed factor.

But what can this fixed factor be? Kaldor considers three possibilities: a capacity for uncertainty bearing, as defined by Knight (1921), supervision (analogous to the 'superintendence' discussed by Mill, 1848), and coordination.

Kaldor argues that joint-stock capitalisation makes uncertainty-bearing a variable factor which can be hired through the equity market. Supervision may involve indivisibilities – e.g. the full-time employment of a foreman – but the indivisible inputs can be replicated under constant returns – e.g. by appointing more independent foremen with non-overlapping spans of authority. But coordination is fundamentally fixed as well as indivisible: the coordinator must be 'one' otherwise he cannot coordinate:

You cannot increase the supply of co-ordinating ability available to an enterprise alongside an increase in the supply of other factors, as it is the essence of co-ordination that every single decision should be made on a comparison with all the other decisions already made or likely to be made; it must therefore pass through a single brain. This does not imply, of course, that the task of co-ordination must necessarily fall upon a single individual; in a modern business organisation it may be jointly undertaken by a whole Board of Directors. But then it still remains true that all the members of that Board will, in all important decisions have to keep all the alternatives in their minds – in regard to this most essential mental process there will be no division of labour between them – and that it will not be possible, at any rate beyond a certain point, to increase the supply of co-ordinating ability available to that enterprise merely by enlarging the Board of Directors. The efficiency of the supply of co-ordinating ability can be increased by the introduction of new

4 *The Growth of International Business*

technical devices, e.g. by a better system of accounting; but given the state of technical knowledge and given the co-ordinating ability represented by that enterprise, the amount of 'other factors' which can be most advantageously employed by that enterprise will be limited. (Kaldor, 1934, pp. 68-9)

Coordination, in Kaldor's view, is the essence of what is commonly called 'entrepreneurship'. It is the one factor which in the long-run is 'rigidly attached to the firm, which, so to speak, lives and dies with it'.

Coordination is essentially a dynamic function: it is the activity of adjusting to disequilibrium. It has no place in the long-run steady state. Under static conditions coordination is valueless and so the optimum size of the firm – and hence the number of firms in the industry – becomes indeterminate. What renders the size of the firm determinate is the average pace of economic change. Kaldor appears to suggest that if demand conditions in the product market or supply conditions in the factor markets change frequently, unpredictably and by large amounts, then the demand for coordination increases. Since coordination is unitary, the optimum size of firm is reduced and the optimum number of firms – and hence of entrepreneurs – increases. Kaldor concludes that:

In relatively 'quiet' times, i.e. when tastes and the rate of saving are steady, technical innovations rare and changes in population small, we may expect the actual size of 'representative firms' to expand ... The reverse is true in times of 'disquietude', when changes of data become more frequent and far-reaching. (Kaldor, 1934, pp. 74-5)

The concept of coordination as a dynamic activity was endorsed by E. A. G. Robinson (1931), (1934). According to Robinson, coordination is the function of the manager. The successful manager

must see an opening where a new enterprise can be expected to succeed, he must possess or secure capital, he must choose the best site for his plant, he must decide what equipment to install, and arrange its most efficient lay-out. He must design the goods that he is to produce, and prepare the necessary drawings; he must buy materials, estimate costs, and fix his price. He must organise and supervise production, instruct his workers as to how the goods shall be made, inspect them when made for defects, arrange their packing and transport, and collect payment. He must keep the factory accounts and see where profits are being made and where losses, he

must work out the depreciation of the plant, and negotiate with the rapacious Inland Revenue authorities. He must persuade unwilling and suspicious bankers or investors to lend him money, producers of raw materials to give him credit, middlemen to buy his goods. He ought, no doubt, to have time and patience to read those outspoken articles in which journalists, politicians, even economists, tell him how to run his business. (Robinson, 1931, pp. 36–7)

Although it is very much concerned with disequilibrium, Robinson's analysis still makes extensive use of equilibrium concepts. This is not so contradictory as it sounds, for there are many different kinds of equilibrium. Robinson is not concerned with an exact deterministic equilibrium but rather with an economic system in continual movement within the neighbourhood of such an equilibrium. Spontaneous changes are continually moving the system away from full equilibrium. Without management the system would diverge increasingly from full equilibrium. The function of management is to adjust to the change and restore the system toward an equilibrium. The greater are the changes, the greater is the demand for management services to initiate a response. This demand induces more managers to enter industry and leads to a smaller average size of firm. In line with Kaldor's argument, the greater is the pace of change the greater is the number of managers that will be used to maintain the stability of the system.

Robinson himself does not, however, pursue this particular line of reasoning very far. So far as Robinson is concerned, management is just one of several functional areas of the firm, the others being production, marketing and finance. The optimum size of firm is determined not by management alone but by the interplay between the optimum sizes for each of these functions. In his discussion Robinson attaches equal weight to each of these functions, though he argues that management has a particular significance in that it sets an upper limit to the size of the firm.

Consider first the economics of production. Robinson postulates that in each industry there is a minimum efficient scale of production; below this scale the average cost of production is falling; above it, average cost is constant. Marketing and finance exhibit increasing returns to scale. Management exhibits first increasing and then decreasing returns to scale. The increasing returns are accounted for by the advantages of the division of labour between specialisms, which becomes easier as the size of the managerial unit is increased. Decreasing returns set in because of the difficulties of communication that are encountered as the hierarchy of reporting and control expands. Since management is the only function which exhibits

6 *The Growth of International Business*

decreasing returns, it is management which effectively sets an upper limit to the size of the firm.

One of the weaknesses of Robinson's analysis is that he relates costs to a single variable – size – although for the firm as a whole the influence of size upon costs depends critically upon other variables, in particular the structure and diversity of the firm's operations. Structure and diversity in turn reflect the degree of integration effected by the firm. Without a satisfactory theory of integration Robinson was unable to take his analysis of the optimum firm any further. This lacuna in the theory was filled a few years later in a seminal paper by Coase (1937).

1.3 THE CONCEPT OF INTERNALISATION

Coase's analysis of internalisation is a landmark in the development of the institutional theory of the firm (Coase, 1937). Coase demonstrates, amongst other things, that integration simply involves the substitution of coordination by planning for coordination by prices. The economics of integration are not primarily technological – as had previously been thought – but are organisational and contractual.

According to Coase, the firm is a planning unit which 'supersedes the price mechanism'. Without the supersession of the price mechanism there would be no firms. He quotes with approval Robertson's comment that firms in a market economy are 'islands of conscious power' in an 'ocean of unconscious cooperation' (Robertson, 1923, p. 85).

The rationale of the firm is that it avoids the cost of using the price mechanism:

The most obvious cost of 'organising' production through the price mechanism is that of discovering what the relevant prices are. This cost may be reduced but it will not be eliminated by the emergence of specialists who will sell this information. (Coase, 1937, pp. 390–1)

Contrary to popular opinion, Coase was not primarily concerned with analysing the economics of integration. He was concerned with a still more fundamental issue in the theory of the firm – an issue which has received surprisingly little attention (though see Simon, 1957; Williamson, 1975). This issue concerns the nature and scope of management's control of the worker: an issue which is not merely of theoretical interest, but of practical social and political importance. Coase demonstrates that managerial control stems from the employment

contract, which accords the employer discretion over the activities of the employee. The rationale for the employment contract is that it substitutes a single large transaction for many separate smaller transactions; by reducing the number of contracts it economises on the costs of using the price mechanism:

The costs of negotiating and concluding a separate contract for each exchange transaction which takes place on a market must . . . be taken into account . . . It is true that contracts are not eliminated when there is a firm but they are greatly reduced. A factor of production (or the owner thereof) does not have to make a series of contracts with the factors with whom he is cooperating within the firm . . . For this series of contracts is substituted one . . . The contract is one whereby the factor, for a certain remuneration (which may be fixed or fluctuating) agrees to obey the directions of an entrepreneur *within certain limits*. The essence of the contract is that it should only state the limits to the powers of the entrepreneur. Within these limits, he can therefore direct the other factors of production. (Coase, 1937, p. 391)

Coase explains the long-term open-ended nature of the typical employment contract along similar lines:

It may be desired to make a long-term contract for the supply of some article or service. This may be due to the fact that if one contract is made for a longer period, instead of several shorter ones, then certain costs of making each contract will be avoided. Or, owing to the risk attitude of the people concerned, they may prefer to make a long rather than a short-term contract. Now, owing to the difficulty of forecasting, the longer the period of the contract is for the supply of the commodity or service, the less possible, and indeed, the less desirable it is for the person purchasing to specify what the other contracting party is expected to do. It may well be a matter of indifference to the person supplying the service or commodity which of several courses of action is taken, but not to the purchaser of that service or commodity. But the purchaser will not know which of those several courses he will want the supplier to take. Therefore the service which is being provided is expressed in general terms, the exact details being left until a later date . . . The details of what the supplier is expected to do is not stated in the contract but is decided later by the purchaser. When the direction of resources (within the limits of the contract) becomes dependent on the buyer in this way, that relationship which I term a 'firm' may be obtained. (Coase, 1937, pp. 391–2)

8 *The Growth of International Business*

It is clear that Coase has in mind the labour contract, because he goes on:

A firm is likely therefore to emerge in those cases where a very short-term contract would be unsatisfactory. It is obviously of more importance in the case of services – labour – than it is in the case of the buying of commodities. In the case of commodities, the main items can be stated in advance and the details which will be decided later will be of minor significance. (Coase, 1937, p. 392)

According to Coase the extent to which the price mechanism is superseded is governed by the margin where ‘the costs of organising an extra transaction within the firm are equal to the costs involved in carrying out the transaction in the open market’. To some writers this conclusion seems little more than a tautology. Coase did, however, attempt to formulate testable hypotheses on the basis of this result:

it would appear that the costs of organising and the losses through mistakes will increase with an increase in the spatial distribution of the transactions organised, in the dissimilarity of the transactions, and in the probability of changes in the relevant prices. (This assumes that an increase in the probability of price movements increases the costs of organising within a firm more than it increases the cost of carrying out an exchange transaction on the market – which is probable.) As more transactions are organised by an entrepreneur it would appear that the transactions would tend to be either different in kind or in different places . . . Inventions which tend to bring factors of production nearer together, by lessening spatial distribution, tend to increase the size of the firm. Changes like the telephone and the telegraph which tend to reduce the cost of organising spatially will tend to increase the size of the firm. All changes which improve managerial technique will tend to increase the size of the firm. (Coase, 1937, p. 397)

These hypotheses are particularly valuable as they link the size of the firm to its industrial and geographical diversification. The remarks about inventions and managerial innovations are particularly relevant to the growth of a geographically diversified firm such as a multinational.

1.4 VERTICAL INTEGRATION

So far as the multinational firm is concerned, particular interest attaches to the factors influencing vertical integration. It may be satis-

fyng to know that the internalisation of markets in highly specific labour services constitutes a rationale for the firm. But the international firm exemplifies a particular species of firm, namely the multi-plant firm. The multinational firm is simply a multi-plant firm whose plants are located in two or more different countries. The real significance of internalisation for the international firm is not that it explains the existence of the firm but that it explains multi-plant operation over space.

Vertical integration is an important factor in many multi-plant operations. Prior to the development of internalisation theory, economies of vertical integration were usually assumed to be technological. In modern terminology, vertical integration was assumed to allow the exploitation of beneficial 'externalities' between adjacent plants, e.g. the conservation of heat achieved by the integrated steel works. It is apparent that technological economies of this kind normally work against the internationalisation of production by restricting the scope for the international division of labour between different stages. To explain international production in terms of vertical integration the economies must have a very different origin. By focusing upon the contractual nature of vertical integration the theory of internalisation suggests what these economies might be.

Buckley and Casson (1976) distinguish several economies of vertical integration which are particularly relevant to the multinational firm.

First, there are economies of internalising long-term contracts. As Coase indicates, it is usually convenient to make long-term contracts contingent upon future states of the world. But long-term contingent contracts are often difficult to enforce. Williamson (1975, 1979) shows that using alternative contractual arrangements it is possible to establish a more efficient 'governance structure'. This structure internalises the transaction and thereby substantially reduces the risk of default.

Long-term contracts are particularly important in industries which make intensive use of illiquid capital assets (such as long-lived producer durables). Raw materials are purchased on long-term contracts in order to secure future supplies and so keep the assets fully utilised. This is a major factor in, for example, the economics of oil-refining and metal-refining. Internalisation of the raw material market leads to the integration of the extraction and the processing of the mineral.

Second, a monopoly of supply in an intermediate product creates an incentive to internalise the market. This is because of the difficulty of enforcing price discrimination in an external market. A monopolist maximises his profit by charging discriminatory prices based upon each buyer's demand curve (the classic reference is Pigou, 1938, who

distinguishes several degrees of discrimination). The opportunities for arbitrage that exist in an external market limit the monopolist's ability to discriminate. Even if he could discriminate, efficient pricing would be inhibited by lack of information about the buyer's demand curve. He is therefore obliged to charge a uniform price, and this reduces his profit. More significantly, it reduces the profit of the monopolist by more than it reduces the profits of the buyers. In other words, there is a deadweight loss of profit on account of uniform pricing. This loss can be avoided by internalising the market. Internalisation prevents resale and also gives the seller full information about the buyer's demand (Arrow, 1975). With internalisation the monopolist can transfer the intermediate product from one activity to another at notional discriminatory prices, such that the marginal unit is priced at marginal cost. This allows both activities to operate at more efficient levels, and earns a higher profit for the integrated firm.

This analysis suggests, for example, that the integration of the extraction and use of a primary commodity will be greatest when the supply of the commodity is monopolised. Robinson (1931) reaches a similar conclusion, though by a rather different argument. He maintains that by 1930 vertical integration within the coal, iron and steel industries had proceeded further in Germany than in Britain because the degree of monopoly in coal-mining was much greater. He predicted that contemporary British legislation to 'rationalise' mines into larger groups would indirectly promote vertical integration in Britain along similar lines.

Third, there are economies of transfer pricing. The importance of transfer pricing for multinational firms has been stressed by numerous writers (for empirical evidence see e.g. Ellis, 1981). Transfer pricing can be used to reduce the incidence of *ad valorem* tariffs, to exploit international differentials in rates of profit taxation and to by-pass exchange controls. Transfer pricing illustrates an even more general phenomenon, namely the ability of internal markets to avoid many of the government regulations and fiscal interventions that are experienced in external markets. This is one of the advantages of internalisation stressed by Coase:

exchange transactions on a market and the same transactions organised within a firm are often treated differently by Governments or other bodies with regulatory powers. If we consider the operation of a sales tax, it is clear that it is a tax on market transactions and not on the same transactions organised within the firm . . . Similarly, quota schemes, and methods of price control which imply that there is rationing, and which do not apply to firms producing such products for themselves, by allowing advantages to