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Shipowning and Foreign Direct Investment

by

Stig Tenold

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Shipowning and Foreign Direct Investment

Stig Tenold – Norwegian School of Economics and Business Administration*

Non-technical summary

Foreign Direct Investment (FDI) has become an increasingly important part of the international economy. Due to the high mobility of the factors of production in the shipping industry, shipping investments in foreign subsidiaries do not necessarily imply strong links between the investment and the home and host countries. It is thus debatable whether the term *Foreign Direct Investment* should be utilised in the same manner as for other sectors.

The first part of the Working Paper is a short analysis of Norwegian shipping policy. Up until the early 1980s it was a principle of Norwegian shipping policy that all – and only – Norwegian-owned ships should fly the Norwegian flag. This affected shipping FDI both into and out of Norway, but the policy was changed in the middle of the 1980s.

In the second part of the Working Paper, the implications of the international character of the shipping industry are discussed. The vessels, which can be considered the primary means of production, are not geographically constrained. This implies that the link to any particular home or host country is relatively weak. Shipping companies sell their services and buy the bulk of their inputs in the international market, and price differences between national markets can only to a limited extent be used to explain FDI.

In the main part of the paper, it is argued that the definitions used when analysing shipping FDI should be pragmatic. Focus on tax havens and Flag of Convenience-countries may be relevant approaches in analyses of the motivation and home country effects of shipping FDI. However, we suggest that a broader analysis of FDI in Norwegian shipowning companies should focus on land-based operations. This approach will correspond in a better manner to the definition usually utilised when evaluating FDI. Moreover, by removing the focus from the vessel and its flag, it is possible to emphasis other factors of importance for success in the shipping industry.

The FDI of shipowning companies has been incorporated in Dunning's eclectic theory of internationalisation, and can be explained by an ownership advantage, an internalisation advantage and a location advantage.

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The *ownership advantage* refers to firm-specific assets such as knowledge of the shipping market and its agents, a reputation for efficiency and professionalism, a high level of competence, etc. The *internalisation advantage* implies that the shipowning company benefits from using these advantages themselves, rather than selling or leasing them to a foreign firm. The *location advantage* can be explained by the interaction between the company, their customers and other agents in the maritime sector. Dunning's approach gives important insights regarding the FDI of shipowning companies.

The critical factor in the analysis of shipowning companies and FDI is the firm-specific assets, particularly with regard to *knowledge capital*. Knowledge-based assets are more likely to lead to FDI than physical capital assets because they can be transferred easily back and forth at a low cost, and because of the joint character of knowledge. A Norwegian shipowning company may thus to some extent utilise its firm-specific assets – knowledge of the market, reputation, long-standing relationship with key customers, etc. – concurrently in the home and the host countries.

Consequently, we see that shipowning companies are exporters of the services of firm-specific assets, many of which are based on knowledge capital. Their foreign subsidiaries may be described as importers of these services. FDI is therefore a mechanism which enables the shipowning company to utilise the firm-specific assets in new markets. When companies establish themselves in a foreign market, their motivation is to reap the profits resulting from their firm-specific advantages. By utilising these advantages, they attempt to compete successfully with existing companies in the host country.

We posit that an analysis of the long-term direct and indirect consequences of FDI should focus on the land-based operations rather than tax havens or Flags of Convenience. By defining the operation of tonnage, and not the performance of a particular transport service, as the main activity of shipowning companies, this view can be justified. The success of shipowning companies can then be explained by intangible factors, the utilisation of which will be decisive for the company's ability to compete and survive in an internationally competitive environment. How the companies choose to utilise their advantage – by operating from Norway, by dividing the operation of ships between different locations or by operating from a foreign base – are elements that are central to the question of FDI in the Norwegian shipping sector.

Introduction

Foreign Direct Investment (FDI) has attained an increasingly important position in the international economy, having grown considerably faster than international trade in the last decades. Due to the mobility of the factors of production in the shipping industry, it is debatable whether the term *Foreign Direct Investment* should be utilised in the same manner as for other sectors. In the industrial sector, FDI typically refers to the establishment or purchase of a company whose economic activity is performed in a foreign country. Some restrictions apply; the investment should constitute a lasting economic relationship, and the company undertaking the investment should be able to exercise some degree of control of the business.

In international shipping, the factors of production have a more international character than in other sectors. Consequently, investment in a subsidiary in a foreign country does not necessarily imply strong ties between the investment and the home and host countries. Although the “*genuine link*” between shipowner and flag has been embraced as an ideal, there is little correspondence between the ownership and registration of a considerable share of the world fleet. In the late 1980s, Norwegian owners had tonnage registered under 25 different flags, whereas American companies owned vessels under 36 different flags (Cashman, 1989:77). In 1998, more than a third of the Norwegian-owned fleet was registered under foreign flags.

To illustrate the different options available when addressing Norwegian shipowning companies’ investments abroad, we may consider the following basic scenarios where Norwegian agents are involved:

- (a) Agents operating from Norway establish a subsidiary or purchase a company abroad, and the vessels owned by the subsidiary are registered in *the host country*.
- (b) Agents operating from Norway establish a subsidiary or purchase a company abroad, and the vessels owned by the subsidiary fly the flag of *a third country*.
- (c) Agents operating from Norway establish a subsidiary or purchase a company abroad, and the vessels owned by the subsidiary fly the *Norwegian flag*.

Furthermore, Norwegian agents operating through foreign legal entities, e.g. London-based shipowners who are Norwegian nationals, may be taken into consideration, thereby further increasing the number of possible scenarios. In addition, there are several Norwegian nationals with substantial fleets whose parent companies have been established abroad, and who consequently have never had a Norwegian base of operation.

Studies of Norwegian FDI have generally omitted shipping, due to the complexity of the sector (Heum *et. al.*, 1998: 5) or insufficient statistics (Hodne, 1993: 141). This working paper is the first outcome of a project, entitled “*The multinational business of Norwegian shipowning companies*”, seeking to remedy this neglect. The aim of the project is to study the consequences and composition of the multinational business of the Norwegian shipping sector in general and FDI in particular. This working paper gives an overview of some of the aspects that are important when defining and analysing the FDI of Norwegian shipowning.

FDI and Norwegian Shipowning Companies

One intriguing question regarding Norwegian FDI and shipowning is why the Norwegian authorities have treated shipping companies differently from other companies in much of the postwar period. While companies in other sectors of the economy were encouraged to invest abroad, the possibilities for Norwegian shipowners to do so were limited. Up until the early 1980s, the Norwegian shipping policy was based on the idea that all – and only – Norwegian-owned vessels should fly the Norwegian flag. This affected FDI both into and out of Norway.

Foreign shipowners were not allowed to register their ships in the Norwegian registry according to *Sjøloven av 20. juli 1893* [The Norwegian Maritime Act], which had been partly motivated by foreigners’ use of Norway as a Flag of Convenience. Paragraph 1 of this act lays down the conditions for the inclusion of a ship in the Norwegian registry (Gombrii *et. al.*, II-110):

- Norwegian subjects had to hold at least 6/10 of the capital.
- Norwegian subjects should be entitled to exercise at least 6/10 of the voting rights in the company.
- The chairman and the majority of the members of the board must be Norwegian citizens resident in Norway, and have lived there for the preceding two years.

The condition that Norwegians should have a controlling interest in the company in fact eliminated inward FDI. Prior to World War II there was no direct parallel limiting outward FDI in the shipping sector.

Norwegian investments abroad were restricted under the provision of *Valutaloven* [The Currency Control Act], originally a provisional ordinance dated 1944, but later passed as an act and amended several times in the postwar period. Due to the foreign exchange legislation, Norwegian agents were generally not allowed to invest in foreign shipowning companies. Shipowners wishing to invest abroad had to apply to the Ministry of Trade and

Shipping for exemption from the general rules.¹ In accordance with the increased FDI of Norwegian companies, the practice was gradually liberalised in the postwar period. However, the authorities claim that the enforcement of the regulation was relatively strict for shipowning companies.

Shipowners' direct investments abroad can be placed in two categories. The first category is subsidiaries with a similarity to the sales offices of industrial companies, undertaking import and marketing of goods produced in Norway. The equivalent in the shipping sector would be agencies or broker offices, and in this area the licensing practices of the authorities have been liberal. The second category, the founding of new shipowning companies or purchase of foreign companies, is equivalent to investment in foreign production facilities in the industrial sector. In this area the licensing has differed; industrial companies would be granted a license, whereas the licensing of shipowning companies would be restrictive (Norges Offentlige Utredninger nr. 45 (1980): 26).

Norwegian exchange controls have thus been used as a tool of Norwegian flag policy, restricting the outward FDI of Norwegian shipowning companies. Despite this policy, some Norwegian-owned vessels were flying foreign flags, either as a result of exemptions from the general rule, or through investments in "unregulated companies", i.e. companies established before the strict foreign exchange control regime was introduced during World War II.

Due to the need for dispensation from the general rules in connection with FDI, we have access to detailed information about the *declared* reasons for Norwegian shipping companies' foreign investments in the period before liberalisation (Stortingsmelding nr. 23 (1975-76): 24):

- Local regulations implying that vessels can only be operated under a given flag.
- Local activity which makes it operationally unnatural to register the vessels in a distant, foreign country, e.g. coastal fishing, barges etc.
- Dependence upon near contact with foreign business associates.
- Dependence upon foreign legislation giving special financing arrangements necessary for the accomplishment of the project.
- Dependence upon transport contracts which otherwise would not be attainable.
- Co-operation on major projects where the risk is spread among several types of interests, e.g. banks, yards and shippers.

¹ For a thorough account of Norwegian legislation regarding investments in foreign shipping, see Breistein (1984). For most companies outside the shipping sector, Norges Bank, i.e. the central bank, undertook the

- Dependence upon and utilisation of foreign managerial and technological competence.

Licenses had not been granted in connection with applications where the main reasons were to exploit advantages with regard to lower taxes, cheaper crews, lower social expenses or to exploit advantages in connection with subsidies or national preferences.

There might of course be discrepancies between the reasons shipowners give when applying for licenses and their actual reasons, e.g. due to the fact that shipowners are likely to have some idea about the conditions necessary for licenses to be given. The fact that 121 licenses were granted, and only 20 applications turned down, in the period 1962-1975 does not intuitively correspond with the authorities' assertion that a restrictive policy was followed.² However, there is reason to believe that several shipowners wishing to register ships abroad, but for the "wrong reasons", withheld their applications because they knew that they would not be given a dispensation.

In 1975, the government emphasised that "*Norwegian shipping, as a main rule, shall be based on vessels flying the Norwegian flag and employing Norwegian crews*" (Stortingsmelding nr. 23 (1975-76): 25). Although the government made provisions for the flagging out of vessels due to high Norwegian costs, this possibility was refuted by the parliament. In 1979, a parliamentary committee supported temporary flagging out of Norwegian vessels as an alternative to the sale of these vessels to foreign-owned companies (Norges Offentlige Utredninger nr. 13 (1978) and Innst. S. nr. 167 (1978-79): 9).

The large outflow of Norwegian tonnage after the restrictions on FDI were liberalised might be an indication that there had been an unsatiated need for foreign registry which the legislation previously had been able to hold back. However, the situation in international shipping in the late 1970s and early 1980s was such that considerable sales of Norwegian vessels should be expected. Nevertheless, the Norwegian flag policy, together with the establishment of the Guarantee Institute and more favourable taxation of KS-companies (limited partnerships), undoubtedly delayed the flight of tonnage from the Norwegian fleet (Tenold, 1999).

licensing. Licensing in some other sectors, e.g. fisheries and agriculture, was also allocated to their respective ministries.

² This claim can for instance be found in Stortingsmelding nr. 23 (1975-76) where the term "*relatively restrictive attitude*" is used, and in Norges Offentlige Utredninger nr. 45 (1980) where it is declared that "*the traditional practice of allowing registration under foreign flags can be considered restrictive*". Interestingly, a former bureaucrat in the Ministry of Trade and Shipping claims that, in spite of a great deal of arbitrariness, the practice was "*liberal*" (Breistein, 1984: 83)

In 1984, Norwegian shipowners held interests in almost 400 foreign-registered vessels, totalling more than 1 million dead weight tons. The basis on which licences were granted, can be put into eleven different categories (Stortingsmelding nr. 53 (1984-85): 36):

Table 1. The Basis for Licenses for Registration Abroad, 1984

Basis for license	Number of vessels	Tonnage 1000 dwt.	Norwegian share (per cent)
Discrimination	70	467	78
Access to equity	93	3391	84
Access to cargoes	97	3235	64
Technically obsolete tonnage	14	74	100
Renewal 1:1	19	708	97
Temporary registration abroad	32	1377	100
Nordic co-operation	5	225	85
Local business	22	230	87
Co-operation with developing countries	8	133	36
Minority shares	15	158	9
Other licences	7	462	100
Total	382	10460	80

When regarding the reasons for applications for licenses, we can see that the motives are very much policy induced. The Norwegian shipowners who wanted to establish themselves abroad – and were allowed to do so – often did this as a response to national legislation. There is thus reason to believe that a large share of the Norwegian vessels owned abroad did not fit into the historically most dominant frame of Norwegian shipping, viz. large scale bulk shipping. This can be confirmed by the fact that only in three categories – temporary registration abroad, Nordic co-operation and other licences – is the average size of the vessels for which licences were granted more than 40 000 dead weight tons. At the same time, the average size of the vessels in the Norwegian fleet was more than 50 000 dead weight tons.³

In the middle of the 1980s, the authorities realised that “*a flexible flag policy is necessary to maintain a Norwegian shipping sector*” (Stortingsmelding nr. 53 (1984-85): 40). After some parliamentary wrangles, the Norwegian policy was further liberalised (Nordvik, 1997: 13-20). The end result was that the act establishing an open Norwegian shipping register was passed, and the register came into effect from 1 July 1987. At the same time, liberalisation of the foreign exchange legislation had made it easier for Norwegian

³ Figures for the Norwegian fleet are taken from *Review 1983*. However, these figures are not necessarily directly comparable with the figures from Stortingsmelding nr. 53 (1984-85) due to the fact that the classification of vessels may differ. The average size of vessels registered abroad (27 000 dead weight tons) is smaller than the corresponding average for the Norwegian fleet (54 000 dead weight tons). This supports the idea that the Norwegian vessels registered under foreign flags to a large extent were engaged in liner and special trades, where the average size of the vessels is smaller than in the bulk trades.

shipowning companies to establish subsidiaries abroad. The basis for the major turnaround in Norwegian flag policy was twofold:

- that “*the access to operation under a foreign flag in many cases is a condition for the operation of shipping from Norway*” and
- that “*this kind of shipping implies that the most profitable functions, demanding the highest competence, are maintained as Norwegian businesses*” (Stortingsmelding nr. 53 (1984-85): 40).

The establishment of the Norwegian International Ship Register (NIS) was a means through which the authorities sought to maintain and develop Norwegian maritime competence, while at the same time countering the flight of Norwegian tonnage to foreign flags.⁴

The International Character of the Shipping Industry

In international shipping, the vessels performing the transport service, which are generally considered the primary means of production, are not geographically constrained. Consequently, the main productive assets do not have a “national base” in the manner usually found in most other industries, and the link to any particular home or host country is relatively weak.

This relatively weak link can be illustrated by an example. If a German company sells its factory in Germany to Norwegian interests, the factory is still placed in Germany, and the goods will, at least for a period of time, continue to be produced there. Therefore, the location of the production constitutes a link to the German economy. However, if a German shipowner sells his fleet to Norwegian interests, the vessels will continue to perform their service in international waters, and most of the links to Germany will be broken more or less immediately. This is a result of the fact that most of the business links are related to the individual company rather than to each vessel. In addition, the labour component tends to be more international in shipping than in other industries, reducing the secondary effects through domestic personal taxation.

A traditional feature of the shipping sector has been its reliance on international markets. Notwithstanding the parts of the shipping sector affected by discriminatory practices, the nationality of shipowners is usually disregarded when contracts about the transport of goods are entered into. In general, and in the bulk sector in particular, the demand side has an international character. However, nationality may be of importance in some market segments,

⁴ A publication by the prominent Norwegian shipowner Erling Dekke Næss (1985), entitled “*Can Norway survive as a shipping nation?*”, was important in this connection.

where preferential arrangements imply that operation under a specific flag is a precondition for market access. This type of policy may induce FDI.

In addition to the international aspect of the demand side, shipping companies are separated from their national markets, as they tend to buy the bulk of their inputs in the international market:

- Shipowners order ships where they get the most value-for-money, not necessarily in their home country.⁵ There is also a well-functioning, international market for second-hand ships.
- Debt financing is arranged in the international capital market.⁶
- Even though an international market for sea labour exists, national legislation regarding manning *may* influence the nationality of the crew. For vessels registered in the Norwegian International Ship Register, foreign crews can be employed in all positions. In principle, the captain should be a Norwegian citizen, although this requirement may be waived (Kopperud, 1989: 198).
- The purchase of bunkers, provisions and spare parts is determined by the localisation of the ship, rather than by the home country of the shipping company.

Historically, the only area where substantial differences between countries have existed is with regard to the cost of equity, i.e. the demands on the return on the owners' investment (Wergeland, 1992:41). The large Norwegian investments in the shipping industry in the postwar period have often been explained by the relatively low return on alternative investments in Norway, as well as by a tax system that has given incentives to shipping investments. Consequently, Norwegian shipowners have entered the capital-intensive shipping sector on a large scale due to the low opportunity cost of capital (Eriksen & Norman, 1973: 141). It may be argued that the significance of this element has been reduced as a result of the liberalisation of the international investment regime, which has increased the possibilities for cross-border investments. At the same time, differences in taxation imply that investors wanting to maximise post-tax returns may incorporate their companies in zero tax countries (Knudsen, 1997).

⁵ One might argue that this is not fundamentally different from other sectors. However, it is far easier for a shipowner to utilise lower-cost foreign labour and materials, than for someone investing in domestic-based traditional industries.

⁶ This might apply to companies in other sectors as well. However, the use of international sources of finance was common in the shipping industry at a time when it was still considered difficult for most companies in other sectors. Norwegian shipowning companies thus have a relatively long history of relationships with foreign financial sources.

Despite the fact that the shipping industry generally is characterised as highly international, some reservations are in order. The shipping sector is highly diversified and consists of several distinct segments. Some segments, e.g. shortsea shipping, have a more local base than others. In some parts of the shipping sector, e.g. chemical shipping, the basis for competition is long-term relationships between shipowners and shippers, rather than outright price competition. In most of the shipping sector economies of scale are related to the ship. However, some segments have substantial barriers to entry and the supply side is characterised by a limited number of agents, whose fleet size is important for their competitive advantage. The diversity of the shipping sector implies that the motivation for and effects of FDI might vary, depending on the market segment analysed.

Another reservation is necessary with regard to the operation of shipowning companies. The proportion of shore-based employees relative to ship crews varies with the type of shipping performed. For our purpose it might be helpful to divide the labour component into a mobile category, comprising the crew, and a relatively immobile category, comprising those employees engaged in land-based operations. For the latter group, the location of the activities influences the wage level. Similarly, a share of the costs of operation is directly connected to the land-based activities, and will thus be influenced by where these are performed.

In general, however, the international character of the shipping industry can be symbolised by the weak national links of the factors of production. As the output and the majority of the inputs in the shipping industry are traded in the international market, price differences between national markets can only to a limited extent be used to explain FDI. At the same time, the question of location is essential to decisions about FDI, and we should look for the motivation for FDI in other areas of the business activity or the business environment. Before we present other possible reasons for FDI, it is necessary to determine how FDI in the shipping sector should be defined.

FDI and Shipowning Companies

The international aspect of the shipping industry can be illustrated by the considerable degree of separation between actual ownership and vessel registry. The fact that some 30 per cent of the world fleet is registered in open registries is in itself an indication of large cross-border investments.

However, this separation of country of registry from actual ownership does not necessarily constitute a good basis for the evaluation of FDI. The links between the actual

owner and the country of registry are often spurious, constituting little more than a “mailbox company”. The recipient of FDI can be placed in one of the following categories:

- A *tax haven*, where a shipowning company is incorporated.
- A *flag country*, where some or all of the vessels are registered.
- An *operational base*, where some or all of the functions of the shipowning company are performed.

The different characteristics of the three alternatives mean that the definition of the term *the host country* becomes important for the consequent analysis.

This working paper is not based on analysis of empirical evidence, but rather intended as a concept for those wishing to analyse FDI in the shipping sector. Thus, our suggestions are founded on what one might expect to find, based on our knowledge of the shipping industry. One of our main points is that the definition of *host country* in an analysis of the shipping sector should be pragmatic.

We suggest that the definitions used in an analysis of FDI should be closely linked to the purpose of the study. The following table indicates in which instances the various definitions may be applicable. The alternative definitions of the host country are indicated in Column 1, the possible purposes of the analysis are indicated in Row 1.

Table 2. Definitions of Host Country and Purpose of Analysis

Definition/ Purpose	Motivation for FDI	Home country effects	Host country effects
Tax havens	May be relevant	May be relevant	Small and difficult to measure
Country of registry	Relevant in the case of national discrimination	Relevant when analysing flag policy	Small and mainly fiscal Potential legal effects
Land-based operations	Relevant – may be similar to other industries	Relevant for the maritime cluster	Relevant for the maritime cluster

All three categories may be relevant in an evaluation of the *reasons for FDI*:

- The inclusion of tax havens will shed light upon investments undertaken for the purpose of minimisation of company or personal taxation. The large number of shipowning companies incorporated in no tax countries illustrates that this is not an uncommon practice in the shipping industry.
- Analyses of FDI by country of registry can lead to a greater understanding of the choice of flag. This is particularly relevant in the case of national preference arrangements. The importance of the choice of register is partly influenced by maritime policies and the extent to which national preference arrangements are tolerated. A general liberalisation of

maritime policies, e.g. under the auspices of the World Trade Organisation, may reduce the importance of this motivation.

- The inclusion of countries where some or all of the company's functions are performed may give information about the basis for decisions about the "internationalisation" of land-based operations. In this respect, the arguments should be similar to those usually encountered when analysing FDI in other sectors, e.g. location advantages, proximity to important customers etc.

Similarly, when analysing *the effects of FDI for the home country*, all three definitions of the FDI recipient may be relevant, depending on the scope of the analysis:

- In the short term, FDI undertaken for tax minimisation purposes reduces the tax base of the home country. In the longer term, an increase in tax-motivated FDI may influence the tax legislation in the home country, leading to reduced possibilities for tax induced FDI, or to a relaxation of the tax rules in order to improve the attractiveness of the home country.
- Defining FDI by country of registry is relevant when flag policies are analysed. If the authorities regard a large national fleet as an advantage, domestic shipowners' registration of vessels under foreign flags contradicts national objectives. In Norwegian postwar shipping policy, this aspect has been particularly relevant, based on the experiences from World War II. Similarly, emerging maritime nations might benefit from an increasing number of vessels registered in their own fleets, e.g. as a stepping stone in a policy seeking to increase domestic maritime activity.
- When analysing home country effects of FDI, the effects for the maritime cluster may be an important element. The term *maritime cluster* is used to characterise the maritime environment, along the lines described in Wergeland (1992: 1-7 and 153-155).⁷ The effects of FDI for the maritime cluster will vary with the type of FDI undertaken. Incorporation of subsidiaries in tax havens or registry of ships under foreign flags does not necessarily lead to a reduction of the parent company's activities in the home country. More important, however, is the transfer of some or all of the land-based operations to subsidiaries established abroad. Such moves will gradually reduce the impetus of the domestic maritime cluster, and may in itself be a motivation for other agents in the maritime cluster to transfer some or all of their activities abroad.

⁷ The maritime cluster encompasses companies engaged within industry and transport, brokers, insurance companies, financing companies, maritime research and educational institutions, as well as technical and legal consultants.

Like in the earlier examples, *the effects of FDI for the host country* are likely to depend upon whether the host country is defined by legal links or by the location of land-based activities:

- The effects of FDI in tax havens are likely to be small and difficult to measure. It is doubtful whether the investment leads to any substantial economic activity in the tax haven, save for the employment of local lawyers, nominees, registrars and maybe bankers. By definition, the fiscal effects will be low, but not necessarily negligible.⁸
- There are mainly two effects that should be taken into consideration when analysing the effects of FDI for the flag country. On the one hand, there are fiscal consequences. Even though the competition between registries has given a very low level of tonnage taxes, this income may be substantial for some of the countries, owing to the relatively small size of other government revenues. On the other hand, there might be legal implications, like the availability of a domestic fleet in the event of for instance a war.⁹
- When FDI involves the transfer of land-based operations, we can expect to find relatively large effects in the host country. The entry of foreign-owned companies will strengthen the maritime cluster, at the same time leading to demand for a range of goods and services. It is likely that the transfer of land-based operations, due to its indirect effects, will have the most far-reaching consequences for the home and host countries.

FDI and host country aspects

Tax havens and Flag of Convenience-countries may be important in analyses of the motivation and home country effects of FDI. Nevertheless, in a broader analysis of FDI in Norwegian shipowning companies, we suggest that the focus should be on land-based operations. Two considerations can justify this approach.

First, our approach to the term *host country* will correspond in a better manner to the definition usually utilised when evaluating FDI. The use of Flags of Convenience and open registries will make it difficult to trace the direct effects of the investment for the flag country. By defining the host country as the country from which the majority of the subsidiary's land-based functions are performed, it will be easier to observe the linkages between FDI, the home country and the host country.

⁸ Another problem is that analysing the effects of Norwegian companies established in such countries could be relatively futile, as one of the advantages of these countries is that they offer little documentation that may reveal the true identity of the owners.

⁹ Due to the use of non-domestic crews, the fact that the vessel is unlikely to be in domestic waters, and the repatriation clauses signed by e.g. American shipowners, it is doubtful whether this aspect is of great prominence.

Second, by removing the focus from the vessel and its flag, we may emphasise other factors of importance for success in the shipping industry. A focus on land-based operations will reveal the extent to which the company chooses to move abroad or outsource functions such as technical management, commercial management and strategic management. We may then analyse to which extent FDI is a means to an international slicing up of the value chain, i.e. transfer of some of the functions to subsidiaries in other countries. Additionally, this approach might increase our understanding of the motivation behind the decision to transfer functions abroad, and will also enable an analysis of the relationship between Norwegian shipowning companies located abroad and other agents in the maritime cluster in the home and host countries.

To see why we advocate a focus on the countries in which the land-based activities are performed, rather than on the country in which the vessels are registered or the subsidiary is incorporated, consider the following example; A Norwegian shipowning company establishes a subsidiary, incorporated in the Cayman Islands, which owns vessels registered in Liberia. However, the vessels are managed by another subsidiary, operating out of Singapore. It is difficult to assess which country to treat as the recipient of FDI in this example. The capital is invested in the Cayman Islands, from where the vessels are officially owned. However, the tonnage, i.e. the main factor of production, is registered and “legally localised” in Liberia.¹⁰

In the example, the incorporation in a tax haven and inclusion in a Flag of Convenience-registry has some, but limited, direct consequences for the Norwegian shipping sector and the shipping sector in the “host countries”. The activity in the subsidiary in Singapore is more relevant for the day-to-day operation of the tonnage, and for the development of the maritime clusters in Norway and Singapore. The kinds of business undertaken in the Singapore subsidiary may vary, and will be further discussed in relation to the company-focus.

The example above illustrates that the economic activity – what we may call “value-adding activities” – takes place in the subsidiary in Singapore, rather than in the country where the ship is owned (the Cayman Islands) or registered (Liberia). In the latter countries, the effects of the investment, through the generation of economic activity, are weak. The minimal taxation in these countries means that the effects on the national economy are

¹⁰ The British Rochdale report (The Committee of Inquiry into Shipping, 1970: 1) presents the complexity of ownership in the following manner: “A ship may be beneficially owned in one country, directly owned by a company resident in another country, registered in the flag of a third country and accordingly subject to its rules, managed by a company in a fourth country, be on long-term charter to interests in a fifth country and even sub-chartered to the interests of yet another country”.

modest, and the entry of Norwegian shipowning companies and vessels does not lead to any substantial increase in employment. In Singapore, however, the presence of the Norwegian subsidiary has direct economic effects; it leads to employment, as well as to demand for office space and a variety of services. The presence of the Norwegian shipowning company also has secondary effects, by its contribution to the strengthening of the maritime cluster.

It should be noted that a maritime cluster could develop irrespective of FDI-flows and foreign registry under the domestic flag. Shipping FDI in the Philippines has been low relative to several other countries in the region, but the country has been an important supplier of crews for international vessels. Several of the Philippine seamen have subsequently become shipowners in their own respect, based on competence and capital acquired when working on foreign registered vessels.¹¹

When evaluating FDI in the shipping sector, we have chosen to shift the main focus from the vessel performing the transport service to the organisation facilitating the transportation. Thus, our concept of FDI is not necessarily related to the investment *per se*, but rather to the international activity of the Norwegian company undertaking the investment. To put it crudely, we have chosen to focus on Norwegian-controlled shipping activities, rather than Norwegian-owned vessels.

FDI and company aspects

To be able to offer an efficient and competitive transport service, shipowning companies perform a series of tasks. Traditionally, the functions performed in shipowning companies have been presented in the following manner:

- *Project management*: denotes the initiation and supervision of specific projects, e.g. the building of new vessels.
- *Technical management*: is concerned with manning, maintenance, inspection and purchase of bunkers, provisions and spare parts.
- *Commercial management*: consists of marketing, “back-office”-functions and issues related to chartering.
- *Strategic management*: is the more long-term activity, involving insurance, financing, budgeting and accounting, as well as asset and risk management.

The company may choose to move some or all of these functions abroad. When some of the functions are moved abroad, we observe an international slicing up of the company’s value

¹¹ This positive linkage between ship crews and subsequent investments in Philippine shipping is a parallel to the situation in Norway in the mid- and late- 19th Century. Crews, in particular officers, were considered highly-paid in a low-wage economy, and utilised their accumulated resources to fund their own shipowning companies.

chain. Several Norwegian shipowning companies have chosen to maintain the technical management and operation in Norway, while moving chartering, management and commercial functions abroad (Bjørndalen, 1995: 22). This may be motivated by international developments, which make some geographical locations more suitable than others for the performance of certain functions, or by changes in company strategy.

By defining the operation of ships, rather than the physical transport of goods, as the main activity of the shipowning company, it is easier to analyse the shipping sector in a traditional FDI-context. When considering intangible factors of production such as firm-specific knowledge and business relations, we find another argument for using our definition of the host country. If we accept that a company's competitive advantage lies not only in the composition of its fleet, but also in its abilities and the *shipping milieu*, the FDI of shipowning companies may be seen as a mechanism through which this competence may be utilised in new markets.

Shipowning in an FDI-framework

The FDI of shipowning companies may be incorporated in Dunning's eclectic theory of internationalisation (Dunning, 1981). Dunning's theory suggests that FDI takes place when three conditions are present; an ownership advantage, an internalisation advantage and a location advantage. How does this apply to the shipping sector?

Ownership advantages largely take the form of the possession of intangible assets, which are, at least for a given period of time, exclusive or specific to the firm possessing them. This corresponds well with Markusen's definition of *firm-specific assets* as proprietary product and process know-how, reputation and trademarks (Markusen, 1995). In the shipping sector, the firm-specific assets may describe knowledge of the shipping market and its agents, a reputation for efficiency and professionalism, long-standing business relations, a high level of competence, etc.¹²

The *internalisation advantage* implies that the shipowning company benefits from using the ownership advantages themselves, rather than selling or leasing them to a foreign firm. In shipping, the nature of the ownership advantage is very much based on knowledge and reputation, viz. factors that are far less transferable than a particular technology or production process. Accordingly, it is relatively difficult to sell or lease this knowledge, a fact which can explain why shipowning companies tend to have very distinct internalisation

¹² In certain, specialised segments, the ownership advantage may be related to superior technology utilised on the ships, but due to the fast technological diffusion in the shipping industry, this advantage tends to be more short-lived than other types of ownership advantage.

advantages. One element worth noticing, however, is that the existence of management companies to some extent makes “the sale” of this ownership advantage possible.

The last condition, which lies at the heart of the question of FDI, is the *location advantage*. In Dunning’s framework, based on the manufacturing industry, FDI is explained by the profitability of combining the ownership and internalisation advantages with some factor inputs outside the home country. If this profit potential was not available, foreign markets would be served by exports, and domestic markets by domestic production. According to Markusen (1995: 173) the *most obvious* sources of location advantages are tariffs, quotas, transport costs and cheap factor prices. Even though the location advantage in the shipping sector might be explained by local prices, e.g. for office space, office personnel wages, infrastructure etc., it is unlikely that any of the elements presented by Markusen weigh heavily in the localisational decisions of shipowning companies. This does not imply that the question of localisation in the shipping industry is irrelevant, but that other factors than those mentioned above are necessary to explain the location advantage. In fact, these *most obvious* sources of location advantage are not necessarily the *most important* in the industrial sector either.¹³

By focusing on the land-based operation of the company, and the interaction between the company, their customers and other agents in the maritime sector, we might get an understanding of why shipowning companies choose to transfer their land-based activities abroad. However, it is again important to emphasise that the diversity of the shipping sector does not correspond well with our need for generalisation, as the forces behind the internationalisation may differ, depending on the companies’ field of operation.

Sletmo and Holste (1993: 244) claim that the flagging out in the 1970s “*combined capital from the OECD countries with labour from the developing countries, not unlike the establishment of subsidiaries for foreign production.*” They focus on the existence of management companies, which have taken over some of the traditional activities of the shipowners. The existence of management companies implies that companies with particular competence, e.g. with regard to chartering, technical management of vessels etc., may “sell” their abilities to the owners of ships.

¹³ It is particularly in this area that we find large differences between firms and industries. The elements presented by Markusen are of great significance in two instances; with regard to vertical integration and in connection with industrialised countries’ FDI in developing countries. However, horizontal investments between developed countries are the most important in industrial sector FDI, and the elements presented by Markusen are not particularly relevant in this respect.

Management companies facilitate, and are a result of, the specialisation in the maritime sector. The company owning the vessel, which might be a traditional shipowning company or a bank or investment fund with no tradition in the maritime industry, provides the capital, while the management company provides the expertise necessary for the profitable operation of the ship. Thus, management companies make it possible for agents in the Norwegian maritime sector to utilise their knowledge and resources – at home or abroad – without owning vessels themselves.

We have previously stated that one explanation of Norway's position as a major shipowning nation was the low opportunity cost of investment capital and a tax regime that favoured shipping investments. If these conditions no longer apply, the shipping companies' competitive advantage, resulting from e.g. knowledge and experience, may be utilised without necessarily involving ownership of vessels. By focusing on ship management, rather than shipowning, the Norwegian shipping sector can specialise in the activities that maximise the return on Norwegian resources. Investment capital may e.g. be transferred to the oil sector, if the expected return there is higher than in the shipping sector. The human capital may still be utilised in the shipping sector, though without actual ownership of the managed fleet. The separation of ship management from vessel ownership has been a dominant feature of the development of international shipping, and has been particularly prominent after crises in the shipping sector. It is a theme that deserves closer analysis, but in this working paper the focus is on shipowning companies.

One approach to an analysis of the FDI of Norwegian shipowning companies is to focus on the motivation for FDI. The analysis may be organised by a categorisation of some of the possible reasons for the FDI of Norwegian shipowning companies, and their implications:

- *Transfer of tonnage to companies incorporated in tax havens, encouraged by a wish to minimise taxes.* This does not necessarily lead to a reduction of the company's activities in Norway, so the domestic short-term effects are mainly fiscal. However, as the legal links between the company and the home country are severed, the possibility of a transfer abroad of some or all of the company's activities may increase in the long run.¹⁴
- *Registry in foreign countries due to national preference arrangements* is an important reason for the registration of vessels under foreign flags. For the shipowning company, the

¹⁴ It is evident that the Norwegian authorities see this as an actual threat. In 1997, special taxation rules were introduced for shipowning companies, justified by the fact that other countries provided a no tax-regime, and the

alternative to foreign registry in this case would be exclusion from the trade in question. The fact that the company wants to operate under a foreign flag indicates that the expected return is higher than alternative employment of the ship. A similar situation is registration based upon access to cargoes, e.g. in relation with close co-operation between the shipowning company and the shipper. In these cases, foreign registry gives Norwegian shipowners profit opportunities which they in the absence of foreign registration would have to forego.¹⁵ The existence of national preference arrangements may, or may not, lead to the transfer of some of the company's land-based operations to other countries.

- *Transfer of some or all of the land-based operations to other countries in order to minimise costs.* This aspect can be dealt with in two settings, and deserves closer examination, as this is the aspect we think will have the most important long-term effect for Norwegian shipowning companies.

First, we might look at the most obvious sources of cost reduction, i.e. factors that are directly influenced by local prices, e.g. rent for office space, wages to administrative personnel etc. In this case, companies establish subsidiaries abroad as the result of an economic consideration, based upon differences in costs between the home and host countries. The savings incurred by moving abroad must, however, be relatively large, due to the substantial costs of transferring activities from one location to another. This is particularly relevant if key employees are moved abroad as part of the relocation.

Second, there is another, less straight-forward mechanism through which the establishment of a subsidiary abroad can lead to reduced costs. Transfer of some or all of the land-based operations to other countries can be caused by changes in the company's strategy, or by a wish to be closer to "the market". The explanation may be that the company wishes to reduce what we might call *communication costs*.

In some cases the wish to reduce communication costs may be induced by FDI which in itself is not necessarily motivated by costs. One example is registry under foreign flags, necessitated by national preference agreements. Operation in a geographically concentrated market segment may induce the company to move some of their land-based operations to the region. Thus, the effect may be the transfer of company activities, even though the primary reason for the registration under a foreign flag is the discriminative policy of the host country.

fact that Norway had to offer similar conditions to secure that the shipowning companies continued their Norwegian activities (Schjelderup, 1999: 202).

¹⁵ The fact that shipowning companies are willing to "buy flags", i.e. pay a premium to be able to operate on certain regulated routes, indicates that there are opportunities for profit in trades where the market access is restricted by the maritime policies of the importing or exporting countries.

However, relocation as a means to reducing communication costs is not necessarily connected to the maritime policy of the flag country. Advantageous market conditions may incite firms to operate in specific geographical segments. We have, for instance, seen that several Norwegian shipowning companies have established themselves in Southeast Asia, encouraged by the considerable growth of shipping in this region. It is likely that a strategy based on growing regional markets will involve the transfer of some of the land-based activities to the region in question. The communication costs involved when operating the service from Norway could be relatively high, and may be reduced through presence in the local market. Similarly, shipowners who have a relatively limited number of customers, e.g. within industrial shipping, may find it advantageous to reduce communication costs by establishing subsidiaries near their most important customers or important transport hubs.¹⁶

Markusen (1995: 175) claims that multinationals tend to be important in industries and firms with high levels of research and development (R&D) relative to sales, a large share of professional and technical workers, products which are new and/ or technically complex and where there are high levels of product differentiation and advertising. Several of these aspects fit the shipping industry, and may be used to describe the companies' firm-specific assets:

- The amount and importance of R&D in the shipping industry are difficult to measure, but it is evident that competence and knowledge – based on research or experience – are factors of great significance for the success of shipowning companies. This applies to technical, judicial and commercial competence.
- If we focus on the shore-based employees, we find a relatively large share of professional and technical workers.
- In some segments of the shipping industry, the product – or, rather, the service and the technology facilitating this service – is technically complex. This is particularly important for some market segments where Norwegian shipowners have been dominant, e.g. chemical shipping. However, other segments of the shipping industry can be characterised as mature, with a considerable degree of standardisation.
- Product differentiation has been suggested as one of the *generic strategies* for maritime transport (Sletmo and Holste, 1993: 253). Norwegian companies have been pioneers in the exploitation of niches in the shipping industry, e.g. car carriers, open hatch bulk carriers and cruise shipping.

¹⁶ One example of this is the shipowning company Odfjell's subsidiary in Houston; see Lorentzen (1995: 44-47).

The elements emphasised by Markusen in his characterisation of multinational enterprises in the industrial sector are evident in the shipping industry as well. The critical factor, which links the elements presented above, is the firm-specific assets of shipowning companies, particularly with regard to *knowledge capital*. According to Markusen (1995: 174), knowledge-based assets are more likely to lead to FDI than physical capital assets because they can be transferred easily back and forth at a low cost, and because of the joint character of knowledge. A Norwegian shipowning company may thus to some extent utilise its firm-specific assets – knowledge of the market, reputation etc. – simultaneously in the home and the host countries.

Consequently, we see that multinational enterprises are exporters of the services of firm-specific assets, many of which are based on knowledge capital. Their foreign subsidiaries may be described as importers of these services. FDI is therefore a mechanism through which the firm-specific assets can be utilised in new markets. When companies establish themselves in a foreign market, their motivation is to reap the profits resulting from their firm-specific advantages. By utilising these advantages, they attempt to compete successfully with existing companies in the host country.

The term *communication costs* can be used to describe the costs of utilising the firm-specific assets. By their active presence in the foreign market, they may get a closer relationship to the company's customers and other business associates than they would get by operating out of Norway.¹⁷ Closer co-operation with business associates – both on the demand and the supply side – may be important for the performance and development of the company. In the short run, the establishment of a subsidiary may lead to better contracts and higher profits, at a cost which is lower than if the company operated solely out of Norway. In the long run, the presence of the company in a foreign market may strengthen the company's competitive position, as it will receive impulses from the maritime environment in the host country, which in fact might have positive connotations for the activities in the home country. These impulses may originate with customers, suppliers or other institutions in the host country.¹⁸ Indeed, the existence of a more favourable maritime cluster in another country, and a wish to reap the benefits of belonging to this cluster, may in itself be motivation for the

¹⁷ In addition, the international character of the shipping industry can explain the relocation of some of the shipowning companies' functions. The establishment of a manning office abroad will for instance make sense in a situation where the crews are of foreign origin.

¹⁸ One of the shipowning companies interviewed in connection with this project claimed that the company's presence in Southeast-Asia enabled them to adapt to the Asian crisis earlier than they otherwise would have done (Hauge & Stokke, 1999: 51-52).

transfer of activities. This might lead to a downward spiral with regard to the maritime cluster in the home country, which gradually might lose its foundation.

We can return to Dunning's framework to answer three basic questions about the FDI of Norwegian shipowning companies:

1. *What is the ownership advantage?* The ownership advantage can be described by the shipowning companies' firm-specific assets, such as their knowledge of the shipping sector and their proficiency in operating vessels, their reputation etc.
2. *What is the internalisation advantage?* The internalisation advantage stems from the fact that it is difficult, costly and not necessarily desirable to sell or lease the firm-specific advantages.
3. *What is the location advantage?* The location advantage is a result of the exploitation of the firm-specific assets in a new market.

Essentially, FDI in the shipping sector can be explained by the fact that shipowning companies have firm-specific assets that are difficult to sell, but create profit opportunities when utilised in new markets.

Summary

In this working paper we have argued that the definition of FDI in a shipping context should be pragmatic. In some contexts, e.g. when analysing the motivation for FDI, the focus may be on the registry of ships under foreign flags or on companies incorporated in tax havens. Indeed, a large degree of Norwegian shipping FDI seems to be explained by these aspects. However, for a broader analysis of the FDI of Norwegian shipowning companies, its motivation and its home and host country effects, we suggest that the analysis should focus on land-based activities, rather than legal linkages.

A focus on the land-based operations is more fruitful for an analysis of the long-term direct and indirect consequences of FDI. By defining the operation of tonnage, rather than the performance of a particular transport service, as the main activity of shipowning companies, this view can be justified. The success of shipowning companies can then be explained by intangible factors, the utilisation of which will be decisive for the company's ability to compete and survive in an internationally competitive environment. How the companies choose to utilise their advantage – by operating from Norway, by dividing the operation of ships between different locations or by operating from a foreign base – are elements that are central to the question of FDI in the Norwegian shipping sector.

Despite the fact that we have illustrated some of the effects of FDI for the Norwegian maritime cluster, we have not analysed the significance and viability of this maritime cluster. The conclusions in this working paper should therefore not be used as arguments for specific policies. Sjørgard (1996: 2-6) has convincingly argued that the existence of a maritime cluster *per se* is not necessarily a reason for the introduction of policies supporting this cluster, and that the importance of shipowning companies for this cluster is uncertain. In a similar vein, Strandenes (1986: 7) claims that “*it is not evident that we need an integrated environment which is engaged in all parts of the shipping industry, including ships flying the Norwegian flag, for the various parts [of the shipping environment] to be competitive in the international markets.*” Thus, even though we have said that the transfer of land-based operation may reduce the potency of the maritime cluster, the implications of this reduction have not been discussed.

Several questions can be raised about FDI and the shipping sector:

- To which extent is the increase in FDI a result of an internationalisation process due to the maturity of the shipping industry, along the lines suggested by Bauchet (1990) and Sletmo (1993), and to which extent is this process “inevitable”?
- If Norwegian shipping expertise to a larger degree is “sold” through ship management companies, rather than utilised through vessels owned by Norwegians, what are the effects on the Norwegian economy and the domestic maritime cluster?
- Which social and political consequences does the existence of multinational shipowning companies have? Have they, as Forsyth (1993) claims, “*become entities with an existence above and beyond the nation-state in which they operate*”?
- Is the relationship between FDI and shipowning in Norway characterised by competition or complementarity, i.e. does the FDI of Norwegian shipowning companies supplement the companies’ activities in Norway, or is the activity in Norway reduced as FDI increases?
- Do flagging out and FDI threaten the potency of the Norwegian maritime cluster, or are these factors contributing to a consolidation or strengthening of Norway’s position as one of the major maritime nations?
- What are the possible responses to the internationalisation of the shipping industry? Will the future bring more government intervention, increased specialisation among firms, concentration of the geographical localisation of shipowning companies or stronger links between shipowners and shippers?

- To which extent will the development in other sectors, where capital is becoming more mobile, replicate the experiences from the shipping sector, with special demands on national tax legislation as a result of competition from tax havens?

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