The Politics of Vertical Integration in Extractive Industries: Business History and Political Economy

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Abstract

The process of vertical integration by multinational corporations in the extractive sector of poor countries is not only an economic process, but also a political one affected by the host country’s social and political dynamics, the relationship between host country and home country, and the relationship between the multinational and the home country. This essay argues that some of these complexities cannot be fully captured by the quantitative methodology that currently dominates the social sciences, but rather require a detailed historical case analysis. I illustrate this by studying cases of the banana and the nitrate industries in the 19th and 20th centuries in Latin America.

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Abstract

The process of vertical integration by multinational corporations in the extractive sector of poor countries is not only an economic process, but also a political one affected by the host country’s social and political dynamics, the relationship between host country and home country, and the relationship between the multinational and the home country. This essay argues that some of these complexities cannot be fully captured by the quantitative methodology that currently dominates the social sciences, but rather require a detailed historical case analysis. I illustrate this by studying cases of the banana and the nitrate industries in the 19th and 20th centuries in Latin America.

Keywords: Business History, Vertical Integration, Political Economy of Foreign Direct Investment, Banana Industry, Nitrate Industry
Introduction

Over the last two decades, the world has witnessed intensified activity of the multinational corporations operating in the extractive sector of less developed countries. Several key factors have renewed attention to the political relations of extractive multinationals: the dramatic increase in demand for commodities by the Indian and Chinese economies, the rise of better-funded and better-organized non-governmental organizations monitoring the human and environmental costs of the multinationals’ operations in poor countries, and the emergence of a new economic nationalism among important oil and gas producers such as Venezuela, Russia, and Bolivia. The political issues currently affecting the extractive multinationals’ operations in the Third World are not the result of overnight decisions made by governments, but rather are the product of complex political and social developments emerging over extended time periods. Thus, the analysis of a multinational firm operating in the extractive sector in less developed countries will be quite incomplete if it neglects the political and historical component.

Although this might read like a non-controversial and obvious remark, recent decades have not shown much dialogue among historians, political economists, and scholars studying international business. Several scholars have called on academics in international business to place the State back into the center of their analyses (Jeffrey, 1980; Boddewyn, 1998; Scokpol, 1985; Murtha and Lenway, 1994), while others have made a call to bring history back into the analysis of international business (Jones and Khanna, 2006). Some of the more relevant recent contributions on the political economy of foreign direct investment come from scholars using sophisticated quantitative methods with aggregate data to analyze world trends rather than analyzing cases of individual
firms in particular countries (e.g., Jensen, 2003, 2005; Henisz, 2000). These works, however, face an important constraint: by using quantitative methods with mega-databases for dozens of countries and hundreds of companies, they require large amounts of reliable data, which is typically scarce in less-developed countries. Moreover, even for OECD countries these databases usually cover relatively short time periods, whereas vertical integration investments are usually long-term, and international politics are determined by historical trends. Finally, and most importantly, as this paper maintains, individual firms have responded in different ways to similar challenges, so research studies using mega-databases will hardly capture the managers’ strategic responses to political events or political regimes. By using historical case studies, this research paper brings together the achievements of business history and international political economy for a more complete analysis of vertical integration in international business.

An important analytical tool that is widely utilized in research studies of political economy of foreign direct investment is the Polity IV database, which defines the degree of democracy or totalitarianism of the countries they analyze. Polity IV is a remarkable intellectual achievement that has put together and defined the political systems of all countries of the world for a period of two centuries, giving a numerical score to each political system depending on how competitive it is or not. Yet as the cases of the banana and nitrate industries studied below show, if only using Polity IV scores, we get a skewed picture of the ways in which different political regimes have responded to foreign capital. This paper shows the case of a company (United Fruit), which virtually included the host country state as a whole within its vertically integrated structure. In some historical moments, the company even created the dictatorships, who ruled the countries where it
operated. Therefore, the State and the company were not two entities that developed independently and eventually met and negotiated the terms of operations. If we were to rely on Polity scores alone, whose methodology essentially separate types of government from foreign investment, we would not be able to discern that foreign capital sometimes pushed to create the political systems under which they could operate more favorably. Some dictatorships supported by United Fruit had a Polity IV score similar to other dictatorships that were more independent, and the ways they related to the company were clearly different. After studying United Fruit, I turn to the case of the British companies working in the Chilean nitrate sector. Although they came from the same home country and operated in the same industry, their relationships with the government were not the same.

This paper proposes an historical analysis of vertical integration in the banana and nitrate industries using a conceptual framework organized around recent achievements in the political economy of foreign direct investment. I argue that vertical integration by multinational corporations in the extractive sector of poor countries is largely a historically determined political process whose complexities require detailed analysis of individual firms and the home and host countries’ polities. The key factors that affect a firm’s decision to politically integrate, or not, include the political influence of the multinational’s home country in the host country’s politics, the presence of a national elite involved in the extractive sector in which the multinational is investing in, and the sociological changes the host country experiences over time. I show that if a firm has a disproportionately high economic influence in the host country the vertical integration not only includes market elements, but also non-market, or political factors. Indeed, the
government of a host country with a small economy and with high dependence on the
multinational’s operations may itself become incorporated into the company’s structure.
The integration of a government within the company has proved easier under totalitarian
regimes than under democratic ones. However, this association can change with time if
social forces in the host country force a disintegration of the political system from the
company’s structure.

In past years, business scholars have relied increasingly on aggregate economic
and political data for studying the politics of international business. Yet, as the current
essay emphasizes, relying exclusively upon this methodology at the expense of case
studies can lead to inaccurate analyses. Wide-scale data analysis must, when possible, be
complemented with qualitative, historically grounded case studies in order to grasp the
internal particularities of the firm and the complexities of host countries.

Methodology

I propose an historical analysis of the role played by politics in vertical integration
in the banana and nitrate industries during the 19th and 20th centuries. Following Scokpol
(1985) and Gilpin (2001) I assume the State to operate not only as a political actor, but
also as an economic one. Similarly, I assume the multinational enterprise to be a political
and economic actor. The State can generate the conditions to permit a higher or lower
transfer of wealth from the multinational to the local society (Lipsey, 2002). This ability,
however, depends on the strength of the local institutions and the relative power
differential between the multinational and the local state. This study also assumes that a
State government can be considered a cost the company can minimize (Boddewyn, 1988;
Brewer, 1993, Boddewyn and Brewer, 1994). Finally, this paper assumes that the
company’s organizational structure (vertically integrated or not) is determined not only by the economics of the firm but also by the negotiations between the company and the host state (Gomes-Casseres, 1990).

The economics of vertical integration

During the twentieth century, the question of why and when some firms decide to integrate their operations by putting under the same roof different stages of the value chain was answered in different ways. Scholars like Coase (1937) and Williamson (1971, 1981, 1985) explained vertical integration as a strategy by which firms sought to reduce the uncertainties of the market and transaction costs involved in the different stages of the value chain. Chandler’s (1977) pioneering business historical studies explained vertical integration as a necessary step towards the creation of the modern big business enterprise. The creation of a mass market in the United States was only possible through the creation of hierarchical, coordinated, vertically integrated, gigantic corporations. This integration required completely new managerial organizations, resulting in the creation of the multi-divisional enterprise in the early twentieth century.

This analysis was expanded by Dunning (1971) to explain the existence of multinational corporations. According to Dunning (1971), when a firm vertically integrates its operations, it is internalizing otherwise external markets, endowing it with a power its competitors did not have (what he defined as internalization advantages). Casson and Buckley (1976) add the concept of transaction costs to Dunning’s (1971) analysis, and maintain that vertical integration responds to the specific technical particularities of the industry in which the firm operates. Some industries require closer coordination than
others, and effective coordination is more difficult when operating between different countries.

**International politics and vertical integration**

Dunning (1971), and Casson and Buckley (1976) acknowledge the relevance of politics (in the host and home country) but do not make them a central element of their analysis. During the 1970s, in the midst of heated debates around the expropriation of foreign property by Third World governments, scholars began to place politics and history at the center of analysis of the operations of vertically-integrated multinationals. The first group was comprised of scholars writing from business schools; the second group, from within the disciplines of history and sociology.

*Obsolescing bargaining power*

The best scholarly representatives of the business school group are Raymond Vernon and Louis Wells, who developed the concept of “obsolescing bargaining power” to describe the situation multinational corporations face after investing in the extractive industries: with an investment in fixed assets already made, they maintain, the multinational faces an increasingly vulnerable bargaining position with respect to the host government (Vernon, 1971a, 1971b; Wells, 1977; Fagre and Wells, 1982). For business school scholars, the nationalization wave of the 1970s was a rational move by the host governments because they had already acquired the knowledge the multinationals could provide them and as a result they no longer needed the multinationals (Kobrin, 1980, 1984; Minor, 1994).
**Dependency Theory**

The second intellectual tradition was Dependency Theory, which linked the expansion of multinational corporations with the creation of economic imperialism. Following contributions by Lenin ([1916] 1970), Baran and Sweezy (1968), and Wallerstein (1979), Dependency Theory scholars saw the multinational corporation as one of the many arms of domination of the world’s economic powers over poor countries (Castells, 1973; Frank, 1971; Dos Santos, 1973; Cardoso and Faletto, 1979; Evans, 1979). In this way, vertical integration was one of the means by which world powers assured their economic dominance of the host country.

**Political Economy of FDI since the 1990s**

Dependency theory flourished in the 1970s and 1980s, but faced a crisis in the 1990s partly as a result of the Latin American debt crisis and the adoption of free-market policies in the Third World. This change left a vacuum on historical studies of the political economy of multinational corporations in the Third World. The interest in the political economy of foreign direct investment was revived by a new generation of scholars who relied heavily on quantitative methods to study the relationship between democracy, dictatorship and foreign direct investment. Following North (1990), some of them found that democratic regimes in which the government could not change the rules at its will, created a better environment for foreign investors (Henisz, 2000; Feng, 2001; Jensen, 2003, 2005, 2006), others found that multinationals benefited from repressive governments (Oneal, 1994; London and Ross, 1995; Durham, 1999; Ross, 2001; Barndt, Gerring, Bond and Moreno, 2005), and others found that the stability of the regime (either democracy or dictatorship) is more important for foreign investors than the type of
regime (Clague, Keefer, Knack, and Olson, 1996, Li and Filer, 2007). Regarding the specific issue of vertical integration, research studies by Boddewyn (1988), Brewer (1993), and Boddewyn and Brewer (1994) made important contributions by introducing politics into Dunning’s (1971) internalization theory, maintaining that the host country’s political system generates transaction costs that the firm will want to minimize. One way to do so is by internalizing the government, something possible for some large firms in small poor countries. Frynas (1998) found that firms operating in the extractive industries that internalize the local government will not benefit from a more pluralistic system, while other scholars maintain that foreign direct investment in extractive industries tend to generate more political instability and violence (Kobrin, 1979; Karl, 1997; Le Billon, 2001; Alfaro, 2003; Li and Mihalache, 2006).

**The Banana Republics: Vertical integration and dictatorships**

The banana sector provides an excellent example of the vertical integration of the local polities within the structure of the foreign company itself. In the banana sector a single company (the United Fruit) dominated most of the market. The need for a close and coordinated control of the industry led the company to build a vertically-integrated network from the Caribbean Basin to the United States that included plantations, railways and ships, a process facilitated by the particular political conditions of the region (US-dominated and ruled by dictators). Previous studies of United Fruit’s vertical integration used the Chandlerian paradigm to explain the company’s integration process (Read, 1983): the company integrated backward and forward to create a mass market of bananas in the United States. Although this interpretation is correct, its neglect of politics does not permit us to understand why the company vertically de-integrated in the 1960s.
In what follows, I show that the enormous power the company had in the region during the pre-WWII period permitted it to informally integrate local polities within its vertically integrated structure. The company had to abandon its vertical structure in the 1960s, when it could no longer control the region’s local polities.

Creating the Banana Empire in the American “Mare Nostrum”

The creation and growth of the banana industry was led by United Fruit Company (established in 1899 in Boston), considered the first and most successful firm at vertically integrating its operations in the agricultural sector at the international level (Wilkins, 1974). Imports of bananas to the United States started in the 1860s, but most companies failed to remain in business because of the very nature of bananas: they rot quickly, they require careful handling, and they cannot be stored or frozen, so a close coordination between producers, transporters, and retailers was crucial. This lack of coordination led to a very high mortality rate among the banana companies: from 114 banana companies established between 1870 and 1899, only 22 survived by 1899 (Read, 1983).

The problem of coordination in the banana industry was solved after the creation of United Fruit. The company was the result of a merger between the businesses of US entrepreneurs Minor C. Keith and Andrew Preston, whose interests complemented each other perfectly: Keith owned lands and an extensive railway line in Central America, and controlled the US South West banana market; Preston, on the other hand, owned the Great White Fleet (which eventually became the largest privately owned steamship fleet in the world), plantations in the West Indies, and controlled the US North East banana market (May and Plaza, 1958). By the 1920s, the company had an extensive network of plantations (which included housing, schools, and hospitals), railways, and the Tropical
Radio & Telegraph Company to keep in constant communication with its ships and plantations (Wilkins, 1970, 1974; Taylor, 2003; Bucheli, 2005). The company also integrated forward by acquiring the Hamburg Line and the British banana company Fyffes to market the fruit in Europe and by establishing the Fruit Dispatch Company to distribute and market bananas in the United States (Bucheli and Read, 2006; Jenkins, 2000). Until the late 1950s, United Fruit controlled 70% of the US banana market (Bucheli, 2005).

The politics of the region also played an important role in United Fruit’s vertical integration process. Its expansion coincided with the consolidation of the United States as the main political and economic power in the Caribbean Basin. The small and impoverished Central American republics adopted accommodating policies towards the United States and competed with each other for American capital and political approval (Coatsworth, 1994). They also had convincing negative incentives to not challenge American power: before 1945, the United States had already invaded Honduras (in 1903, 1907, 1912, 1919, and 1924), the Dominican Republic (1903, 1914, 1916), Haiti (1914, 1915), Nicaragua (1907, 1909, 1915), Cuba (1906, 1912, 1917), Panama (1912, 1918, 1925), Guatemala (1920), and El Salvador (1922) (Coatsworth, 1994). The Caribbean had become an American *Mare Nostrum*, providing the US firms confidence to expand their business in that region.

*The Era of the Banana Republics*

Before WWII, the banana producing countries depended heavily on the US and United Fruit. The percentage of exports to the United States of total exports was 49% for Costa Rica, 27% for Guatemala, 87% for Honduras, and 94% for Panama. Moreover, the
percentage of bananas total exports was 50% for Costa Rica, 27% for Guatemala, 50% for Honduras, and 65% for Panama (Bulmer-Thomas, 2003).

Political instability and the existence of totalitarian regimes facilitated United Fruit’s operations in Central America. For the case of Honduras -- the quintessential Banana Republic -- United Fruit benefited from acquiring the properties of Cuyamel Company, a US corporation that got its banana concessions after financing a military coup in that country in 1913. Before merging, United Fruit tried to eliminate Cuyamel through a price war and by driving the Guatemalan government (where United Fruit had its plantations) to the brink of war with Honduras over the control of the Montagua River region, a place crucial for Cuyamel’s operations in 1917, and to an open war in 1929. The conflict was settled by the US government, and in 1930 both companies agreed on merging, with United Fruit inheriting Cuyamel’s concessions in Honduras (Dosal, 1993).

In 1930 and 1932, United Fruit faced its first big labor strikes in Honduras. The strikes failed because of lack of organization and repressive measures by the government (McCameron, 1983). In 1932 United Fruit financed the presidential campaign of Tiburcio Carías, who became a dictator and ruled for sixteen years (Posas, 1993). During the first years of Carías administration, United Fruit tried to compensate the losses generated by the Great Depression by reducing wages and cutting prices paid to local providers. The company’s action led the workers to strike, but United Fruit found in Carías a strong ally. The president, who had banned the Communist Party, repressed the strike and permitted the company to reduce wages (Bulmer-Thomas, 1987, 1993). In 1949, Carías retired and appointed former United Fruit’s lawyer, Manuel Galvez, as his successor.
Between 1898 and 1921, one single dictator, Manuel Estrada, ruled Guatemala. Between 1901 and 1904, he granted United Fruit a concession for transportation between Guatemala and New Orleans, a 99-year railway construction and management concession, and banana production concessions (Taracena, 1993). Estrada fell from power in 1920 and was succeeded by a series of short-term rulers until 1931, when General Jorge Ubico -- one of the most infamous Central American dictators -- took power. After taking power, Ubico signed a contract with United Fruit in which the company committed to build a port in exchange for land. However, by 1936 United Fruit dropped the port project so as not to compete with its own railway. The port was never built, but Ubico permitted the company to keep its land and not pay any reparations. Ubico remained in power until 1945, and during this period he gave full support to United Fruit when conflicting with its workers (Schlesinger and Kinzer, 1990; Gliejeses, 1991).

United Fruit also had a strong presence in Panama. Indeed, it built the telegraph lines in a contract that committed the Panama government not to build more telegraph infrastructure (Ricord, 1974).

United Fruit had a harder time controlling the more democratic government of Costa Rica, but the country’s dependence on the company did not give the local government much room for maneuvering. Before establishment of United Fruit, Minor Keith (one of the company’s founders) was one of the most influential persons in Costa Rica. Keith had successfully renegotiated Costa Rica’s foreign debt and had built the country’s railway system, which permitted him to monopolize banana production (Taracena, 1993). The concessions, however, were hardly criticized in Congress,
particularly by Ricardo Jimenez, who approached both the workers and the planters, showing his support and promising a change in the policy towards United Fruit (Chomsky, 1996). In 1910, Jimenez was elected president, but once in power, his opposition to the company was neutralized by a United Fruit loan that permitted Costa Rica pay its foreign debt. Jimenez was succeeded by a reformist president (Alfredo Gonzalez, 1914-1917) who attempted to increase taxation to land owners and big companies and was overthrown by a coup that started a short dictatorship (Taracena, 1993). In the 1930s, as a result of protests against United Fruit’s power in Costa Rica from both the landowning elite and the working class, the government made some timid reforms that forced United Fruit to allow local planters to work in the company’s lands (Bulmer-Thomas, 1987; Chomsky, 1996).

Social Changes and Vertical De-integration

The system created by United Fruit in the first half of the twentieth century started to collapse in 1945. In that year, a military junta overthrew Guatemala’s Ubico, installing a democratic system. The new government made important social reforms and legalized union activity. In the 1951 presidential elections, Guatemalans elected Jacobo Arbenz, who came with an ambitious social agenda, which included an agrarian reform to distribute lands among poor peasants. This plan clashed with United Fruit’s and Guatemalan landowners’ interests. In 1954, after long debates with the government, a group of Army rebels backed by the United States ousted Arbenz (Schlesinger and Kinzer, 1990; Gliejeses, 1991).

Even though Arbenz was defeated the company realized that the political environment was changing: first, although the US government opposed Arbenz, it also
opposed United Fruit’s monopolistic practices. Second, Central American societies were themselves changing: they had a larger nationalist middle class and more sophisticated and demanding labor unions. Even the dictators and the US government were aware that they had to adapt to the changing times to some degree by accepting social reforms. In 1959, the Cuban revolutionary government expropriated United Fruit’s lands and the Costa Rican government passed a law that forced the company to increase wages. Fearing a domino effect, institutional investors pressured the company to change its strategy, something the company did by gradually divesting its lands and concentrating its operations in international marketing (Bucheli, 2005).

The end of the close relationship between the Central American dictators and United Fruit came with the 1973 oil shock. As net oil importers and with economies heavily dependent on banana exports, the “Banana Republics” faced economic hardships that led them to seek new sources of income. The banana-producing countries joined forces and created an OPEC-style cartel called UPEB (Union of Banana Exporting Countries), in which they agreed to increase taxes paid the multinationals, and to facilitate greater local participation in the industry. United Fruit opposed this initiative and threatened to interrupt its export operations, an attitude that only generated more unity among UPEB’s members. By 1975, the company accepted the new terms from the local governments, and informed the shareholders that the new agreements with the local governments were going to mean higher taxes and fees, and less property in Central America. The company added, however, that it “is proud of the long working relationships it has had with the nations of Latin America. We look forward to continued associations, which are mutually beneficial both to our company and to the peoples of the
nations in which we work. We further have pledged to those nations our support as a responsible corporate citizen” (United Brands, 1975). Just one year after this pledge, the Securities Exchange Commission discovered a bribery scheme organized by the company in Central America to receive tax benefits. The SEC’s investigations led the company’s president, Eli Black, to commit suicide. The company was involved in another scandal in 2007, when the US Department of Justice accused it of financing paramilitary terrorist groups in Colombia.

Vertical Integration and Politics in the Banana Industry

United Fruit followed a process of vertical integration of the banana industry and the polities of the producing countries in the WWII period, but changes in the region’s political environment reversed this process after the 1950s. The Polity IV scores for this period for Guatemala vary between 1 (full dictatorship) and 3, and for Honduras between 3 and 5 (with 7 being the highest possible score for democracy). For the Honduran case, the governments that challenged United Fruit in the 1970s have the same score as that of Tiburcio Carías, hiding crucial differences among them. The lack of political channels for the opposition was certainly similar, as were the countries’ dependence on banana exports. However, the social changes were going and a close reading of the company’s reports shows that United Fruit was very well aware of them (United Fruit Company, various years). This perception however cannot be captured in quantitative scores, but with a detailed analysis of the country and the firm over a long period of time.
The Nitrate Industry: Integration through Cartelization and Government Intervention

The British nitrate companies operating in Chile in the late 19th century and early 20th century faced a different situation from that of United Fruit in the Caribbean Basin. First, although highly dependent on British markets, Chile was not subjected by Britain to the semi-colonial status of the Central American republics vis-à-vis the United States. Second, the industry was not dominated by a single foreign company, but by several of them. And third, the Chilean government was more democratic than its Central American counterparts. Polity IV gives the same score to all the Chilean governments in this period; yet this score is unable to capture, as in the case of the banana industry, the Chilean state’s divergent approaches to the nitrate sector. These circumstances limited the firms’ capability to internalize its operations or to internalize politics in the way United Fruit did in Central America. The companies’ strategy, instead, was to create a producers’ cartel. This organization, however, did not manage to successfully challenge the government, mainly because of the lack of mutual trust among the cartel members.

The Arrival of the British Firms in the Guano Era

Before the nitrate boom the world’s main fertilizer was guano, and Peru was its main producer since 1840. An industrializing and urbanizing Europe with limited land demanded fertilizers for its countryside, making guano one of the great businesses of the 19th century (Miller and Greenhill, 2006). Contrary to many raw materials produced in poor countries in the same period, guano was not privately owned. Shortly after its discovery, the Peruvian government nationalized the mines and established a monopoly. Firms willing to trade guano purchased it from the Peruvian government and marketed it abroad (Greenhill and Miller, 1973; Miller, 1977).
The main company involved in the international trade of Peruvian guano was the British firm Antony Gibbs and Sons. Gibbs established a very close relationship with the Peruvian government through its guano activities. The unstable government of Peru was in urgent need of cash and Gibbs’ operations became a good source of it. The purchase contracts of guano with Gibbs were always conditioned by loans Gibbs would provide the government at favorable rates. The Peruvian government paid back with its guano sales. This operation freed the Peruvian government from negotiating loans abroad and impeded a vertical integration of Gibbs’ operations in guano (Greenhill and Miller, 1973). The Peruvian opposition harshly criticized Gibbs’ strong influence in Peru’s finances, and pressured the government to not sign more new contracts with Gibbs after 1861. Afterwards, the government marketed the guano directly with some consumer markets (Miller and Greenhill, 2006).

In the 1860s, discoveries of nitrate mines in the Atacama Desert in Southern Peru led to a rush of foreign investors in the region, particularly Chilean, British, and Germans, including Gibbs and British entrepreneur John North. Privately owned nitrate exports started to compete with the government-owned guano. So in 1872, the Peruvian Congress started considering an expropriation of nitrate works, which private investors opposed (Greenhill and Miller, 1973; Matthew, 1977; Amayo, 1988). In 1874, due to a fall in the international nitrate prices and the Peruvian government’s desperate financial situation, the government intervened in the sector, establishing a state monopoly in charge of controlling production and amounts exported. Although this action is known as the “expropriation” of nitrate, private companies were not expropriated, but rather subjected to quotas established by the Peruvian government. Moreover, those companies
not interested in selling to the government were free not to join, but the falling prices were an incentive to join. In addition, the government hired Gibbs to manage the scheme (Greenhill and Miller, 1973). The foreign companies complained about the new taxes in production and export; many of them, fearing expropriation, sold their properties to North at very low prices (Blakemore, 2004).

The relationship between Gibbs and the government were not easy after the creation of the quota system. While Gibbs wanted to sell the nitrates on world markets at relatively low prices to stimulate demand, the Peruvian government wanted to sell it at the highest price possible to maximize revenue. Gibbs also wanted the industry to be concentrated in a few companies, while the government wanted to give concessions to many. In the end, the high prices the Peruvian government wanted encouraged competition from Bolivia and Chile, as well as the search of substitutes in Europe. By 1879, Gibbs and the government were on bad terms, and the contract was terminated (Greenhill and Miller, 1973).

Around the same time, the government of neighboring Bolivia increased taxes in the nitrate sector. Arguing that this tax increase violated an agreement previously signed between Bolivia and Chile, Chile invaded Bolivia in 1879. Peru allied with Bolivia in the War of the Pacific (1879-1884), in which Chile permanently annexed the Peruvian and Bolivian nitrate territories.

*The War of the Pacific and the Rise of the Nitrate Industry*

In 1881, before the armistice, anxious to show its sovereignty in the nitrate regions, Chile dismantled the Peruvian expropriation and auctioned off the nitrate mines and factories, generating a speculative rush among investors including Gibbs and North
The concentration of nitrate in foreign hands took place very quickly: before the war 123 companies operated in the region, and after the war there were just thirty; Chilean participation in production went from 10% in 1884, to none in 1886 (O’Brien, 1982). The Chilean elite did not oppose this process because they were for the most part landowners who produced agricultural goods, and saw the nitrate mines as consumers of their products (O’Brien, 1982).

The new political conditions led the companies to expand their operations. Before the war Gibbs had focused on trading, but after the conflict it started investing in nitrate production and finance (Jones, 2000). North quickly expanded his operations by monopolizing the region’s water—a precious good in the Atacama Desert—with his Tarapaca Waterworks Company, and transportation with the Nitrate Railways Company (Monteón, 2003). In addition, he established the Nitrate Provisions and Supply Company to supply merchandise (foodstuffs and others) to the nitrate areas (O’Brien, 1982). With time, North’s monopoly on transportation became a point of conflict between him, the Chilean government, and Gibbs.

**Cartels and Politics after the War of the Pacific**

Fluctuations in international prices led North, Gibbs, and the other producers to organize themselves in cartels or “combinations,” which were created when prices fell but dismantled when they rose again. The companies organized combinations in 1884-87, 1891-94, 1896-97, 1901-06, and 1906-09 (Greenhill, 1977). The combinations had several weaknesses: first, they were integrated backward, and not forward. Second, nitrates had to compete with other goods on the world market like guano. And third, its members did not trust each other, since there were frequent problems of cheating among
the smaller producers (Brown, 1963; Greenhill, 1977). However, the combination was the best option possible for companies not fully integrated and without a monopoly in the sector. In fact, Gibbs, Campbell and Co. (another British firm), and the smaller producers resented North’s transportation monopoly (Blakemore, 1977; O’Brien, 1982). These facts explain why the combination could not be permanent.

After the election of President Balmaceda in 1886, the government attacked North’s transportation monopoly. A market-oriented economic nationalist, Balmaceda wanted to increase Chilean participation in the nitrate sector (Amayo, 1988). The members of the combination were divided regarding Balmaceda’s initiatives. North opposed them and requested help from the British government, but Campbell and Gibbs did not dislike the idea of breaking North’s transportation monopoly, and Campbell took the opportunity to apply for a railway concession the government granted them. By 1888, Campbell and Gibbs were lobbying Balmaceda’s government to get new concessions, while North lobbied the opposition and the British government (O’Brien, 1982). The British government rejected Balmaceda’s attacks on North, but the British firms’ rivalry did not lead to an open attack against the president (Blakemore, 1977). Balmaceda faced more open and hostile opposition from the Chilean elite, who did not want the government to disturb the nitrate companies, the main customers of their agricultural products (O’Brien, 1982).

The opposition accused Balmaceda of abusing his power, and in 1891 some members of the navy rebelled, starting a civil war that ended with Balmaceda’s suicide that year. During this brief conflict North and the British government unofficially supported the triumphant rebel forces (Monteon, 1982, 2003). Despite the British
intervention, the new government was not a puppet of the foreign companies. After the war the differences between the companies continued and the new government continued opposing the railway monopoly and imposed new duties on nitrate exports. The combinations created after the war faced as many challenges from the government as in Balmaceda’s times (Brown, 1963). In the decade following the war, the Chilean participation in production increased, as did the government’s income from nitrate exports. The companies continued lobbying the government and creating and dismantling combinations (Blakemore, 1977; Monteon 2003). In short, the existence of conflicting interests among the companies did not permit a process of integration of the government within any of the companies’ structures, despite North’s attempts to do so. Between 1892 and 1894, North sold his Chilean interests and reoriented his investments to rubber ventures in the Congo (Monteon, 2003).

The Decline of the Nitrate Industry

During the twentieth century, British investments in Chilean nitrates steadily declined and to be replaced by those of Chilean and US corporations (Monteon, 1982). Before World War I, however, these companies were making handsome profits thanks to the organization of combinations and the protection of the nitrate sector by the government (O’Brien, 1989). However, they increasingly shared this wealth with the Chilean government and the local companies (Rippy, 1948; Monteon, 1982). Gibbs remained in Chile during WWI, forming part of a cartel the Allies created to assure nitrate production during the conflict (Centner, 1942). Since 1900, aware of a relative technological stagnation in the industry that increased production costs, Gibbs decided to abandon nitrate refining in Chile and focused its efforts on marketing (O’Brien, 1989).
The end of the war, however, generated a difficult crisis for the nitrate sector and, therefore, in the Chilean economy: the cartel created by the allies was dismantled and synthetic nitrate had been improved (Centner, 1942). By the end of the war, the number of nitrate plants in Chile fell from 134 to 43. In the 1920s, the government tried to rescue the sector through different kinds of interventions (including the unsuccessful creation of new cartels and the creation of a state-owned nitrate company) and the participation of American interests (like the Guggenheims and W. R. Grace) (McConnell, 1935). Before the collapse of the nitrate sector after 1930, the Guggenheims approached Gibbs to form a vertically integrated trust. Gibbs, however, rejected the idea, considering that it would antagonize the Chilean government and would encourage more synthetic nitrate production (O’Brien, 1989). In the 1930s, the Guggenheims focused their Chilean operations in copper.

*Foreign Investment and Nitrate Politics*

Political competition in the Chilean government and competition between the foreign companies did not permit a vertical integration of the local polities by any single company. Although Gibbs, Campbell, and North came from the same home country and operated in the same sector, they had very different approaches to the national government, something we could not have perceived by grouping them together as British nitrate companies operating with a series of governments with a Polity score of seven. In addition, Chile did not have the semi-colonial status with Britain the Central American republics had with the US, so the companies used the local political lobbying mechanisms to protect their interests.
Conclusions

Vertical integration in international business is a historically determined political process. The political complexity of this process is greater when analyzing firms from rich countries operating in the extractive sector of poor countries. No sector generates more economic nationalism than the extractive sector in less developed countries. Nor does any other sector require higher levels of investments in infrastructure by the foreign company. In no moment in history, from the nineteenth century onward, has the entry of foreign multinationals into poor countries been a smooth process, and the political conditions of the twenty-first century do not show signals that this will change. Thus, an accurate analysis of the operations of multinational companies in Third World countries requires including the political element in a historical perspective.

The perceptions the companies have on the host country’s polities can hardly be captured with quantitative methods. This argument is particularly warranted for long periods of time in less developed countries where no quantitative information exists. Many countries in the world still lack accurate quantitative information and their internal political dynamics have not been fully understood by scholars, multinational managers, or officials of multilateral institutions. A return to the case study that uses the achievements of political science, international business, and business history are useful for more sophisticated analyses of the present day expansion of multinational companies in the extractive sector in less developed countries.
REFERENCES


