

Why do we need
policy?



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Why do we need policy? R. HEILBORNER and L THURROW, (1982).

Main reasons for market failure. 1. Lack of information. 2. ' Pure public goods.

' which cannot be allocated efficiently by private markets. 3. Imperfect competition. Lack of information.

When marketers lack information or have inadequate information, the results of the market will reflect ignorance, luck or accident rather than informed behavior. Typically consumers guide themselves by advertising and casual information e. g. by advertising.

Thus a certain amount of ignorance always remains in all markets, causing prices and quantities to differ from what they would be if we had complete information. Pure public goods. Examples: education, public health, defense, weather service, lighthouses, law and order public institutions.

Characteristics: 1. Consumption of a public good by any one individual does not interfere with its consumption by another. 2.

No one can exclude from the use of a public good. 3. No way that we can, by ourselves buy defense, laws and order services or a weather service.

Accordingly then is no way to set up a market. Externalities. Examples: • Smoke from local factories.

• Sludge pouring from a mill into a lake. • Wastes, dirt, noise, and congestion. • Speed limits. Externalities bring into focus a very serious problem in our economic system: controlling pollution which in the

production of wastes dirt, noise and congestion. Main ways of controlling pollution: 1.

Enforce laws and regulations to reduce pollution. 2. Tax firms which produce waste and dirt (after called effluent charges). 3. Subsidize polluters to stop polluting (e. g.

pay households to return old cans and bottles to factories). Lengthening time horizons. Examples: • Investment in education, infrastructure, research and development(R&D) health care for the elderly and the poor. e. g.

biotechnology and telecommunication internet firms. • The American federal national institute of health started R&D on biotech (called biophysics) in the early 1960. • The internet started (25) years ago as a nuclear-bomb-proof communication system, thereafter as a national science foundation projects. Accordingly investment in education health care R&D infrastructure have at least partly financed by governments.

Imperfect competition. – In a purely competitive market the consumer is king and the rationale for such a market is described as consumer sovereignty, which means: 1. In a pure competitive market the consumer determines the allocation of resources by his or her demand. 2. The consumer enjoys goods that are produced as abundantly and sold as cheaply as possible.

In a monopolistic or oligopolistic markets the consumer loses much of this sovereignty. Although monopolies and oligopoly may charge higher than necessary prices in the short- run, this may not really be failures in the sense that they may potentially yield offsetting benefits if the resulting large profits

are organizational innovation. However monopolies and oligopolies may not undertake such innovative activity because of lack of competitive pressure, in which case their conduct indeed leads to marked failure, which may require policy interventions. CHAPTER (4) Culture, social norms and economics: some implications for policy MARK CASSON 1997. The author argues that: – Many economic theories are based on the assumption that economic agents are only with maximizing their personal and material well being.

– They are supposed to be exclusively materialistic and selfish. But the neo-classical school of economic theory (the dominant discipline of economics) argues that: The working of competitive markets ensures that when such selfish and money-minded, individuals try to maximize their rewards the competitive process generally generates an outcome that is in everybody's collective interest. As ADAM SMITH pointed out in the wealth of nations (1776): our dinner comes not from the butcher's generosity but from his self-interest. Being selfish and materialistic is therefore not bad. CASSON points out that such ideas are based on an incomplete understanding of how market economy works.

For markets to work effectively, a considerable degree of integrity and trust is required. In the absence of honesty and trust for example: – Suppliers may not honour their contracts. – Employees may be deceitful towards their firms (and vice versa). Firms may sell harmful products to mis-informed, ill-informed, ignorant customers. Market imperfections of this sort may be resolvable by: – Instituting and enforcing appropriate laws.

- Some economic agents may overcome lack of integrity by devising appropriate business practices or institutions e. g. by creating brands. But laws for legal systems may be very costly mechanism; moreover, laws are generally inflexible.
- Consequently, an economic system that is able to invoke and make use of a high level of trust is likely to perform far more efficiently and effectively compared with a system that lacks trust. A high level of trust is also conducive to generating a spirit of co-operation both within and between firms, which can be critical for generating superior economic performance. - Economists have generally neglected the great benefits that flow from co-operation between them. - How honesty and trust can be created in a society and maintained? The following institutions play a significant role in a creation and sustainability of trust and honesty: - Religion. - The family. - Cultural institutions. - The media. - Political institutions. CHAPTER(6) International competition policy. The author argues for initial agreement aimed at: - Encouraging all nations to formulate policy with reference to global rather than national welfare concerns where the two conflict. - The legal principles pertinent to this suggestion include: o Non-discrimination. o Transparency. o Due process requirements. National antitrust policy with international trade. - Most of the theoretical basis of antitrust policy consider only a closed economy where all consumers and producers are domestic citizens. But in an open economy where goods and services are traded internationally and producers of consumers may be different nationalities, does the argument against monopoly still hold? The answer is, it depends.

1. If 'global welfare' is the proper criterion for implementation policy, then the analysis does not change at all. 2. But if nations look to the welfare of their own citizens primarily or exclusively (national welfare' criterion) their views of monopoly may change dramatically e. g.

USA considers OPEC more harmful than any USA monopolist. Suppose that the monopolist is domestic and the consumers are foreign. Then from the national perspective, the increase in profit in the monopolist is a national gain and the harm to the consumer is of no concern. because: – Foreign citizens do not in elections.

– They do not pay tax. – They do not donate money to politicians.

Accordingly it can be said national governments acting on their own may tend to make decisions that promote their national interest at the expense of global interest. An example of this is the USA, when competition laws prohibit cartels from operating in the domestic market but contain an exemption (the webb-pomerane act) that permits cartels that operate exclusively in export market. What legal obligations are appropriate? For a useful international competition policy agreement, a central principle should be (the national treatment principle) which should embody: – Non-discrimination. – Transparency.

– Due process requirements. A dispute resolution system is required to afford some avenue for nations to enforce their rights under the agreements. World trade organization (WTO) is a case in point. CHAPTER(7) science policy and technology policy. Science: is generally academic and open, with its outputs widely diffused in international local, and regional publication.

Science as universities and research institutions often carry scientific research financed thru taxation. Technology: technology is practical. Closed and often carried out by private firms that is compensated thru the market mechanism. The incentives and motives, which organize scientific research, are largely different from that which motivates technological research.

Despite the distinction between science and technology the two bodies of research are often:

- Highly interdependent.

- The relationship between science and technology is of interaction and feedback. Technology does not necessarily rank below.
- Science and technological development can occur independent of scientific advance and can motivate scientific progress.

Technology policy. Rational: 1-Economic market failures caused by:

- Externalities.
- Indivibility.

- Uncertainty.
- Public-good nature of kind of technology.

-Evolutionary theory of innovation:

- Uncertainty.
- Cumulative.
- Path-dependence.
- Firm specific nature of technological progress.

Aims of technology policy:

- To provide a support system to firms.
- Public support of science.
- Information flows between all the participants involved in technology creation (univ. , industry, and between firms)

The government role: 1. To foster technology networks to exchange information and to forecast broad areas in which technological possibilities are likely to materialize in future.

2. Given the ever-increasing multidisciplinary base of modern technology, flow of information can help co-ordination of science and technology efforts.

3. Government policy should give general support not to provide specific support to winners or national champions. Policy dichotomy.

Based on innovation opportunities: technological policy can be divided into two categories: 1- Policy concerned with resources and incentives, taking technological capabilities of firms as given. – These policies include.

Encouraging firms thru: • Tax allowances for R&D. • Specific innovation subsidies.

Public purchasing of innovation product. • Extending duration of patent protection. • Relaxing regulatory policy on health and safety measure. 2- The second category of policy is quite different with the purpose of enhancing innovation possibilities. This policy emphasizes support system for a particular technology.

This policy has been implemented with increasing frequency in the past 15 years. Example: Swedish factory automation industry: • Giving support to academic infrastructure. • Bringing institutions and user supplies linkage to ensure effective transfer of knowledge to sham research agenda. Technology foresight programme: U.

K. switch in technology policy from emphasis on: Resources and incentives to: • Opportunities. • Capabilities. The objectives are: Scientific and technological development showed have strong impact on: • Industrial competitiveness. • Wealth-creation.

• The quality of life. It is a large scale foresight programme under the title of: Exploitable areas of science. The intention was to support: Creation of

opportunities and capabilities via a reservoir of knowledge from which underdeveloped product and process will emerge. Science is considered investment. Thus effective interaction between the scientific community and industry is considered vital. The framework for identifying exploitable areas of science can be summarized as follows: 1.

Identifying the link between areas of technology and the underpinning scientific knowledge base. 2. Identifying the product classes, which would be significantly, affected by technological development over 20 years horizon. 3. Identifying relevant markets and related pressures for change as influenced by commercial incentive. Chapter (8) The national systems of innovation C.

FREEMAN. 1. The present state of the nations is the result of the accumulation of all discoveries, inventions, improvement, perfections, and exertion of all generations, which have lived before. 2. The idea of “ national system of innovation” goes back to FRIEDRICH list concept of “ the national system of political economy” (1841) list was concerned with the question of how Germany in the middle 19th century could catch up technologically and commercially with Britain.

. Due to the advocacy of list that science is a key factor in advancing the technological and innovative capability of firms, therefore, industry should be linked to formal institution of science and education, Germany developed one of the best technical and training system in the world. 4. List did not anticipate the major institutional innovation of the in-house industrial R&D department in firms. The rise of specialized research and development (R&D) 1.

Germany introduced in-house R&D department in 1870. 2. German dyestuffs industry was the first industry that realized it could be profitable to adopt in-house R&D, HOEDNST BAYER AND BASF have strengthened this tradition down to the present day. 3.

The enormous success of the Germany chemical industry led to other industrial countries adopting in-house R&D e. g. CIBA in Switzerland in-house R&D also emerged in other countries e. g. in USA.

4. Radar, computers, rockets and explosives resulted from R&D projects. 5. Similar rapid expansion of R&D occurred in all industrial countries in 1950 and 1960 (see table8.

1) p. 4. 6. It seems that most of the big technological innovations were outcome of a drain reaction: Basic physics (large-scale development in big R&D labs(applications and innovation.

– Some contrasting features of national systems of innovation in the 1970 and 1980. 1. Table 8. 2, 8. 3, and 8. 4 are self-explanatory.

2. The contrast between the innovation performance of the Japanese economy and the socialist economies of Eastern Europe vein forced the importance of in-house R&D. 3. Some major differences between the two national system of Japan and USSR.

s were functioning in the 1970 are summarized in table 8. 2. the most striking contrast was the huge commitment of USSR to military and space R&D. 4. Table 8.

3 gives a clear picture of the differences between the national systems of innovation in south America and those in the newly industrialized countries (NICS). 5. Some of the ASIAN countries (the 4 dragons of east Asia namely: SINGAPORE, HONG KONG, TAIWAN, AND SOUTH KOREA) introduced more reform and education than did most Latin (south) American countries. 6. Some more details are given in table 8.

to reflect some quantitative indications of contrasting nature of BRAZIL (representing south America) and South Korea (representing NICS in ASIA). 'Globalization' and national systems. 1. It is argued that the growing scale of operation of multinational firms is growing. 2. Internationalization of the process of innovation is reducing the importance of national factors in innovation, but regional and national factors are still likely to remain important.

CHAPTER(9) M. E. porters : the competitive advantage of nations. Main concept: National competitiveness: productivity Productivity is the value of the output produced by a unit of labor or capital.

- Productivity depends on both the quality and feature of products. •
- Productivity is the prime determinant of a nations long-run standard of living. (For more details on the concept of national competitiveness read appendix of the reader) Determinants of national competitive advantage (the diamond of national advantage) Main determinants: 1. Factor conditions. 2. Demand conditions. 3. Related and supporting industries.

4. Firm strategy, structure, rivalry. These four sets of factors in turn to work as parts of a “ system” in order to have maximal effect, and this system is referred to as a system (see figure 9. 1in the reader). 1- By factor condition: it is meant the nations position in terms of factors of production such skilled labor or infrastructure necessary to compete in a given industry.

Most of the factors of production that are required in today’s sophisticated and knowledge-intensive industries are created factors (such as skilled human resources or a scientific base). thus a nation does not inherit but instead creates the most important factors of production. This is in contrast to the old doctrine of factors of production labor, land, natural resources, capital, infrastructure. Even educated workforce is not enough what matters most is specialized workforce e. g. in chemical industries, optics.....

etc. Governments may have an important role in creating or supporting the creation of factors of production by funding training and support specialized scientific institutions. 2-Demand conditions: demanding and sophisticated consumers in the home market can put pressure on companies to meet high standards and innovate faster than their foreign rivals. Government policy can aid this process by instituting and strict product safety and environmental standards. 3- Related supporting industries: Innovation may require consideration interaction between, a firm, and its users or supplies and between firms themselves. Geographies and cultural proximity can be crucial factors in this process: agents located near each other can take advantage of shorter lines of communication and an ongoing exchange of ideas and information which may also be helped by the development of close and high-trust working relationship.

The illustration of the Italian footwear cluster (fig. 9. 2) offers a graphic example of how a group of close-by, supporting industries creates competitive advantage in a range of interconnected industries that are all internationally competitive. Shoe producers, e.

g. interact regularly with leather manufactures on new styles and manufacturing techniques and learn about new texture and colors of leather when they are still on the drawing boards. The interaction as reflected in fig. 9.

2 is mutually advantageous and self-reinforcing but it is helped by proximity. To innovate: companies must have: • Access to people with appropriate skills. • Home-demand conditions that send the right signals. • Active domestic rival who create pressure to innovate. • Companies goals should lead to sustained commitment to the industry. -Firm strategy, structure and rivalry.

A firm's strategy and structure and the degree and kind of competition it faces all have an impact on its motivation and ability to innovate. Different industrial countries have different firms strategies. In Italy, e. g. successful international competitors are often small or medium sized companies that are private owned and operated like extended families. In Germany in contrast, companies tend to be strictly hierarchical in organization and management practices and top managers usually have technical backgrounds, no one managerial system is universally appropriate.

– Italian companies that are world leaders (such as lighting, furniture, footwear, woolen fabrics, and packaging machines) companies' strategies emphasize the following: 1. Customized products. 2. Niche marketing. 3.

Rapid change. . Breathtaking flexibility fits both the dynamic of the industry and the character of the Italian industry. -The German management system, in contrast works well in technical or engineering-oriented industries, Optics, chemicals, complicated machinery, After-sale services.

German success is much rarer in consumer goods and service. The presence of strong local rivals is a final and powerful stimulus to the creation of competitive advantages. Examples: SWITZERLAND: pharmaceutical companies: Hoffmann- la roche. Ciba-geigy. Sandoz. Contributes to a leading worldwide position.

USA: computer and software industries. JAPAN: see table (9. 1) 112 companies competing in machine tools. 34 in semi-conductors. 25 in auttiao equipment.

15 in cameras. In all industries with double figures in table (9. 1), Japan is playing a dominant role in the world market, and a dominant role in the industry. – The diamond as a system.

1. The four determinants of national competitive advantage constitute a system because are self-reinforcing. 2. Two dements, domestic rivalry and geographic concentration have especially great power to transform the diamond into a system. -The role of government.

Government policy needs to take account of how the four elements of the diamond interact with each other, and try to ensure that they reinforce and complement each other. The whole is more than the sum of its parts. Please read p 127-132. CHAPTER (10) Imperfect markets and fallible governments: the role of the state in industrial development This chapter addresses the case of government interventions in promoting industrialization for industrial policy. It considers for success of the Asian newly industrialized economies (NIES), which have produced a strong case for non-interventionist strategies.

It argues that interventions may be justified where: 1. Market failures significantly retard industrial development. 2. Market-driven solutions fail, or take too long to emerge. Approached to industrial competence.

The basic contention of this chapter is that different approaches to industrial policy have been driven from different conceptualization of the enterprise-level process of gaining competence and efficiency. This chapter focuses on the technological rather than the managerial and organization aspects. And the emphasis is on two approaches: 1. The neoclassical approach. 2. The capabilities approach.

- The neoclassical approach: is based on neoclassical economics, where an anonymous unit optimizes resource allocation and production it is assumed to operate with full knowledge of all possible technologies given the right prices for inputs and output it picks the one that is appropriate to the factor endowments of the country. This approach is a static framework, where comparative advantage evolves according to the gradual accumulation of factor endowment, rather than by the deliberate efforts of industrial

enterprises. Thus it leads to policy prescription for non-intervention and the basic underpinning of this approach is that efficient production can be launched in response to “right prices” – The capabilities approach: is based on acquisition of new technological capabilities (TCS) that allow productive enterprises to utilize equipment and information efficiently. These (TCS) include: Information and skills, technical organizational and institutional capabilities.

– The growth of capabilities may be defined as “industrial technological development ITD” – ITD, is evolutionary and depends on the conscious purposive efforts undertaken by every enterprise. Successful transfer of a new technology to a developing country has to include a major element of capability building, providing patents, designs, blueprints, is not enough to acquire (TCS). –Therefore “getting prices right” in developing countries may not be sufficient to promote (ITD). The case for intervention in trade. –This section deals with trade regime, it is generally accepted that import-substitution industrialization strategy may have been inefficient and that export oriented (EO) strategy is relatively successful. But a commitment to (EO) strategy may not ensure a successful free trade policy because trying to enter foreign markets in new and developing industries coexist with protection of these very industries at home from unrestricted international competition.

– Firms embarking on the learning curve in the developing world need greater support than their competitor in the developed world, if they are to have a chance of becoming internationally competitive, such support may include selective subsidization of industries or temporary protection from

international competition (e. g. infant industries). An alternative strategy that developing countries may purpose to acquire (TCS) is to rely on the entry and operation of multinational firms that process such capability. But this strategy may reduce the development of domestic capabilities.

The East Asian (NIES) – Table 10. 1 shows the performance of the four (NIES) and measures of their education levels, technical effort and reliance on foreign technology in different forms. – Policy intervention was more successful in some nations than others. -In companies S. KOREA with INDIA both countries rejected LASSEZ- FAIRE policies and provide protection to infant industries. But S.

KOREA was far more successful in the development of world-class industries than INDIA. Important factors responsible for this divergence in performance include: -White S. KOREA managed to discipline its protected industries through pressuring them to generate foreign markets, the protected firm in INDIA lacked any incentive to upgrade and develop domestic capabilities. SALL suggest that INDIA should adopt the World Bank structural adjustment programme of rapid liberalization of the Indian economy with minimal government intervention. For developing countries LALL suggest: 1.

Policy reform should be gradual. . Should retain a crucial role for government to overcome market failures. 3. Should retain the instruments of intervention in trade and technology needed to set new industries.

Given imperfect markets, the costs of non-intervention may be very high agrues LALL. Chapter 12 Themes in Trade and Industrialization. Introduction:

In the post-colonial era, most developing countries adopted strategies of development of the following nature. 1.

Limited degree of openness. 2. Limited degree of integration with the world economy. 3. More autonomous development with emphasis on self-reliant approach of development policies. 4.

More involvement of the state in the working of the economy. The above framework represented points of departure from the colonial era, which was characterized by: • Open economies. • Unregulated markets. Since the early 1990s most developing countries are reshaping their domestic economies so as to integrate much more with the world economy and to enlarge the role of the market vis-a-vis the state. This approach has come to be known as the Washington consensus.

Yet the themes of trade and industrialization have remained central to the debate throughout this period it was then. It is now. • Economic theory and the free trade doctrine. NAYYAR, argues for the inadequacies of the neo-classical theory in international trade, because the theory is based on: • Simplifying assumptions that do not conform to what happens in the real world, e.

g. perfect competition assumptions in all industries when that is clearly not the case. • The neo-classical trade theory takes the pattern of comparative advantage as given. For these reasons, among others, all countries particularly developing countries may need temporarily to protect their infant industries through tariff, subsidies or other measures. The argument of infant industries and tariff is based on import substitution strategy.

Openness intervention and industrialization. • The actual experience of industrialization in Asia, Africa and Latin America led to question of industrialization strategy of import-substitution which has been in operation since the early 1950's.

- In the early 1990's what is referred to as " Washington consensus" came into being. This consensus provides the basis of policy reform advocated by the international monetary fund (IMF) and the World Bank (WB) in their industrialization and structural adjustment programmes. The bottom line of this programme is: o More openness and less government intervention.

Openness of the economy is extended to: Investment flows.

Technology flows. Financial flows. Besides trade in commodities and services policies administered by the IMF and the World Bank are on the neo-classical theory of international trade. 1. These policies: tend to completely ignore the insights from alternative theories of trade.

2. And ignore the arguments for capability building and protection of infant industries. 3. According the policy recommendation of these two institutions (IMF, WB) are wrong and often end up doing more harm than good to developing nations. 4.

NAYYAR also questions the motives behind the policy prescriptions of the IMF and the World Bank. Have these institutions got their analysis wrong? On are they acting to serve the interests of the developed nations at the expense of the developing ones? Globalization. Globalization is defined as: The expansion of economic activities across political boundaries of nation states.

In a positive sense: globalization used to describe a process of increasing

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integration into the world economy. In a normative sense: globalization is used to prescribe a strategy of development based on a rapid integration with the world economy (some see this as salvation while other sees it as damnation). Because globalized is used in two ways (positive and normative senses) confusion and controversy over the meaning of globalization came into being.

The three main dimensions of the process of globalization are: •

International trade. • International investment. • International finance. When considering trade among developed nations, the position of the trading partners with respect to ownership or control of strategic industries is likely to be symmetric. E. g.

while say USA may own the bulk of the global aircraft industry, another say Japan may be strong in some other strategic industry such as consumer electronics. However, when it comes to trading between developed and developing nations, the situation is likely to be asymmetric with for example the USA selling aircraft to Sudan or any other sub-Saharan African countries, while say Sudan sells sugar , or vegetable to the USA. While the aircraft industry is a strategic industry in USA, the sugar or vegetable industry in Sudan is not likely to be strategic. Thus the trading relationship between the industrial countries, (USA, JAPAN, U. K. , GERMANY, FRANCE.....

etc) and developing countries, is likely to be un-equal one. Because of this asymmetry the process of globalization is uneven. There is exclusion in the process. Sub-Saharan Africa, west Asia, central Asia. And south Asia and many countries in Latin America and the pacific are simply left out of

globalization process. For comparative statistics on globalization between 1970 the early 1990, see p.

p. 200-201 of the reader. CHAPTER 14 FOREIGN DIRECT INVESTMENT AND THE CHALLENGE OF DEVELOPMENT The new more competitive world economy imposes pressures on developing countries to upgrade their resources and capabilities if they are to prosper. In a liberalizing and globalizing world, growth can be sustained only if countries can foster new high value added activities.

FDI and TNCs can play an important role in complementing the efforts of national firms. However, the objectives of TNCs differ from those of host governments: governments seek to spur national development, while TNCs seek to enhance their own competitiveness in an international context. TNCs have to change their relations with suppliers, buyers, and competitors to manage better the process of technical change and innovation. The spread of technology to, and the growth of skills in different countries means that new TNCs are constantly entering the arena to challenge established ones.

A striking feature of the new environment is how TNCs shift their portfolios of mobile assets across the globe to find the best match with immobile assets of different locations. The ability to provide the necessary immobile assets thus becomes a critical part of an FDI- and competitiveness- strategy for developing countries. TNCs are increasingly looking for world class infrastructure, skilled and productive labor, innovative capacities and an agglomeration of efficient supplies, competitors, support institutions and services. Low cost labor does not provide a base for sustainable growth since

rising incomes erode the edge it provides. The same applies to natural resources. In addition to exploiting static sources of comparative advantage new dynamics are needed to be developed to achieve sustained growth.

Hence a policy framework is needed to facilitate and accelerate the process. This is the essence of competitive strategy. In presence of market failures, intervention is necessary provided governments have the capabilities to design monitor and implement policies that overcome market failures. More specifically, government policies and FDI need to counter two sets of market failures. The first arises from information or coordination failures in investment process, which can lead a country to attract insufficient FDI, or wrong quality of FDI. The second arises when private interested investors diverge the economic interest of host countries.

This can lead FDI to have negative effects on development, or it may lead to positive but static benefits that are not sustainable over time. Some divergence may be specific to foreign investment. FDI may differ from local investment because decision making and sources of competitiveness lie abroad, because TNCs pursue regional or global competitiveness-enhancing strategies, or because foreign investors are less committed to host economies and are relatively mobile. Thus the case for intervening with FDI policy may have a sound economic basis. FDI comprises a package of resources. The economic effects of FDI are almost impossible to measure precisely.

FDI comprises a bundle of assets, some proprietary to the investor. The ownership advantages of TNCs can be obtained only from firms that create

them. They can be copied or reproduced by others but at high cost part and only in developing countries and where advanced technologies are involved. Non proprietary assets finance, many capital goods, intermediate inputs can usually be obtained from the market also.

Most prized proprietary asset is probably technology, others are brand names, specialized skills and the ability to organize and integrate production across countries, to establish marketing networks. Taken together, these advantages mean the TNCs can contribute significantly to economic development in host countries if the host country can induce them to transfer their advantages in appropriate forms and has the capability to make good use of them. The assets in the FDI bundle are: – Capital: FDI brings in investible financial resources to host countries. – Technology: TNCs can bring modern technologies, they can adapt technologies to local conditions and may in some cases, setup local R&D facility.

They can stimulate technical efficiency at technological change in local firm suppliers, clients and competitors by providing assistance, by acting as a role models and by intensifying competition. – Market access: TNCs can provide access to export markets both for goods and services that already produced in host countries, helping them to switch from domestic to international markets, and for new activities that exploit a host country's comparative advantages. The growth of exports itself offers benefits in terms of technological learning, realization of scale economics, competitive stimulus and market intelligence. Skills and management techniques: TNCs employ and have worldwide access to individuals with advanced skills not knowledge in experts and by setting up state- of-the-art training facilities.

Improved and adaptable skill and new organizational practices and management techniques can yield competitive benefits for firms as well as help sustain employment as economic and technological conditions change.

– Environment: TNCs are in the lead in developing clean technologies and modern environmental management systems. They can use them in countries in which they operate. Spillovers of technologies and management methods can potentially enhance environmental management in local firms within the industries that host foreign affiliates. While TNCs offer the potential for developing countries to access these assets in a package, this does not necessarily mean that simply opening up to FDI is the best way of obtaining them.

Governments may have to intervene in the process of attracting FDI with measures to promote FDI generally or measures to promote specific types of FDI. The complexity of FDI package means that governments face trade offs between different benefits and objectives. The principal issues to be addressed by governments fall into the following four groups: – Information and coordination failures in the international invest process – Infant industry consideration in the development of local enterprises, which may be affected negatively with inward FDI. – The static nature of advantages transferred by TNCs, where domestic capabilities are low and do not improve over time, or where TNCs fail to invest sufficiently in raising the relevant capabilities. – Weak bargaining capabilities of host governments which can result in an unequal distribution of benefits or abuse of market power by TNCs. The benefits of FDI can be reaped through policy measures – The FDI approval process can be long and costly compared to other countries.

An important part of competitiveness strategy thus consists of reducing unnecessary distorting and wasteful business costs including administrative and bureaucratic costs. Attracting TNCs requires more than lowering transaction costs but also increasingly that they be benchmarked against other of competing host countries. – TNCs face market failures in information : Countries that receives lower FDI than desired should invest to establish its image and provide better information. Experience shows that promotive and targeting can be quite effective in raising the inflow of investment and its quality. – Effective promotion should go beyond marketing country into coordinating the supply of a country's immobile assets with specific needs of targeted investors. That also minimize the adverse effects on domestic enterprise development.

Domestic enterprise development is a priority for all developing countries. In this regard, the possible “ crowding out” of domestic firms by foreign affiliates is frequently an issue of concern. Crowding out due to FDI could occur in two ways: first, in product market by adversely affecting learning and growth by local firms in competing activities, second, in financial or other factor markets by reducing the availability of finance or other factors, or raising costs for local firms or both. The first issue reflects infant industry consideration; FDI can abort or distort the growth of domestic capabilities in competing firms when direct exposure to foreign competition prevent local enterprises from undertaking lengthy and costly learning processes. However, the case for domestic enterprise protection differs from the infant industry argument for trade protection.

When trade protection is eliminated, consumer benefit from cheaper imports and greater product variety, but some domestic production and employment can be lost. In contrast, in the case of local enterprise protection, the absence of such protection from FDI competition does not lead to loss of domestic production and employment in exchange for enhancing consumer benefits; but indigenous entrepreneurial development may be hampered, particularly in sophisticated activities. The net cost of this is that linkages may be fewer and technological deepening may be inhibited. Crowding out is economically undesirable if three conditions are met.

1. Infant local enterprises are able to mature to full competitiveness if sheltered against competition that takes place through FDI. 2. The maturing process does not take so long that the discounted present social costs outweigh the social benefits.

3. Even if there are social costs, there must be external benefits that outweigh them. Crowding out can impose a long term cost on the host economy if it holds back development of domestic capabilities or retard the growth of local innovative base. This can make technological upgrading and deepening dependent on decisions taken by TNCs, and in some cases hold back the host economy at lower technological levels than would otherwise be the case.

However, it is important to distinguish between affiliates crowding out potentially efficient domestic enterprises and affiliates out competing inefficient local firms that cannot achieve full competitiveness. One of the benefits of FDI can be the injection of new technologies and competition that

leads to the exist of inefficient enterprises and the raising of efficiency in others. TNCs can also “crowd in” local firms if they strike up strong linkages with domestic suppliers, subcontractors and institutions. Crowding in can take place when foreign entry increases business opportunities and local linkage, raises investible resources or makes factor markets more efficient. Such stimulating effects are most likely when FDI concentrates in industries that are underdeveloped in host countries. A second variety of crowding out reflects an uneven playing field for domestic firms because of a segmentation in local factor markets.

TNCs may have privileged access to factors such as finance and skilled personnel because of their reputation and size. They can thus raise entry costs for local firms, or simply deprive them of the best factor inputs. Both forms of crowding out raise policy concerns. Most governments wish to promote local enterprises, particularly in complex and dynamic industrial activities. Many feel that the deepening of capabilities in local firms yields greater benefits than receiving the same technologies from TNCs: linkages with local suppliers are stronger. There is more interaction with local institutions and where innovatory activities take place, knowledge developed within firms is not “exported” to parent companies and exploited abroad and so on.

The few developing countries that have developed advanced indigenous technological capabilities have restricted the entry of FDI (generally, or into specific activities). The possession of a strong enterprises – it is also important for attracting high technology FDI and for R; D investments by TNCs. At the same time, there are the risks in restricting FDI to promote local

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enterprises. For one reason, it is very difficult in practice to draw the distinction between crowding out and legitimate competition.

If policy makers cannot make this distinction, they may prop up uneconomic local firms for a large period, at heavy cost to domestic consumers and economic growth. The danger of technological lag if TNCs are kept out of sophisticated activities in a country is much greater now than several decades ago. It is important to strengthen the opportunities for domestic firms to crowd in after the entry of FDI by building up local capabilities and a strong group of small and medium sized domestic firms that could develop linkages with foreign affiliates. The right balance of policies between regulating foreign entry and permitting competition depends on the context. Only a few developing countries have built impressive domestic capabilities and world class innovative systems while restricting the access of TNCs. Some others have restricted foreign entry, but have not succeeded in promoting competitive domestic enterprises in high-technology manufacturing activities. In sum the infant enterprise argument remains valid and can provide a case for policy intervention to promote local capability development, but interventions have to be carefully and selectively applied, monitored and reversed where necessary. Similar consideration to those highlighted above to mergers and acquisitions (M; As) of local firms by TNCs, including privatization by sale of state enterprises to foreign investors. Some M; As that entail a simple change of ownership akin to portfolio investment can be of lesser developmental value. Some take-overs lead to asset stripping and large M; A-related inflows can become large outflows when investments are liquidated, possibly giving rise to exchange

rate volatility and discouraging productive investment. There may also be adverse effects on local innovatory capacity and competitiveness in trade, like scaling down of R; D activities in acquired firms. Reduced reliance on locally produced high technology inputs, increase import penetration, reduce the number of competitors in domestic market, adverse effects on employment. M; As may yield economic benefits. Where the investor makes a long-term commitment to the acquired firm and invests in upgrading and restructuring its technology and management, the impact is very similar to a greenfield investment. FDI related to M; As can play an important role in modernizing privatized utilities such as telecommunications and public utilities. The benefits of M; As (including privatization) depend on the circumstances of a country and the conditions under which enterprises are acquired and subsequently operated. However, there may be value in monitoring M; As, instituting effective competition policies and placing limits on them if the macroeconomic situation justifies it. How FDI affects market structure: Entry of large TNC, raises concentration levels and can lead to abuse of market power. Hence effective competition policy is becoming more important in a world in which large TNCs can easily dominate an industry in host country. Positive dynamic FDI effects on host countries Require appropriate skills and policies. TNC, can be efficient vehicles for the transfer of technologies and skills suited to existing factor endowments in host economies. They can use local endowments to expand exports from host countries. This can create new capabilities in host economies and can have beneficial spillover effects. One of the main benefits of TNCs to export growth is their ability to provide not simply the technology and skills to complement local resources, but access to foreign market. TNCs already have established brand names and

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distribution channels with supply facilities spread over several national locations. The development impact of FDI is more than just these static benefits, it depends on dynamics of the transfer of technology and skills by TNCs. How much upgrading of local capabilities takes place over time, how far local linkages deepen, and how closely affiliate, integrate themselves in the local learning system. TNCs may simply exploit the existing advantages of host economy and more on as those advantages erode. Static advantages may not automatically transmute into dynamic advantages. This possibility is large whose host economy's main advantage is low-cost unskilled labor and the main TNC export activity is low-technology assembly. The extent to which TNCs dynamically upgrade their technology and skills transfer and raise local capabilities and linkages depends on the interaction of the trade and competition policy regime, government policies on the operations of foreign affiliates, the corporate strategies and resources of TNCs, and the state of development and responsiveness of local factor markets, firms and institutions. The trade and competition policy regime In general the more competitive and outward oriented a regime, the more dynamics is the upgrading process. However, infant industry suggested that some protection of new activities could promote technological learning and deepening. ? Policies regarding the operations of foreign affiliates. Including local content requirements, incentives for local training or R; D, and pressures to diffuse technologies, when used as part of a coherent strategy, the results have been beneficial as in the case of NICs. ? TNC strategy Host country government can influence aspects of TNC location decisions by measures such as targeting investors, inducing upgrading by specific tools and incentives and improving local factors and institutions. This required them to

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have a clear understanding of TNC strategies and their evolution. ?

Responsiveness of local factor markets, firms, institutions. This is probably the most important one. TNC's upgrades their affiliate to where it is cost-efficient to do so. Moreover since firms in most industries prefer their suppliers to be nearby, they will deepen local linkages if local suppliers can respond to new demands efficiently. Both depend upon the efficiency and development of local skills and technological capabilities, suppliers' networks and support institutions. At the same time, there are risks that the presence of TNCs inhibits technological development in a host economy. TNCs are highly efficient in transferring the results of innovation performed in development countries, but less so in transforming the innovations process itself. Foreign affiliates also tend to do relatively little R; D. As well as strong bargaining capabilities, regulatory regimes and policy-making capacity. In some cases, the outcome of FDI depends significantly on how well a host economy bargains with international investors. However, the capacity of developing host countries to negotiate with the TNCs is often limited. The negotiating skills and information available to TNCs tend to be of better quantity. Where the outcome of an FDI project depends on bargaining process developing host countries may sometimes do rather poorly compared to TNCs. The risk is particularly great for major resource-extraction projects or the privatization of large public utilities not other companies. To strengthen the bargaining capabilities developing countries, legal advice is often required but usually costly option for developing countries. With respect to regulatory frameworks with liberalization and globalization, there are fewer policy tools available to countries left to influence the conduct foreign and local firms. The capacities of host

developing countries to regulate enterprises in terms of competition policy and environment policy is therefore an absolute necessity. However, most developing countries lack such policy similar concerns arise with respect to environment. Many developing host countries have only limited regulations on the environment and often lack the capacity to enforce them effectively. Some host developing countries are accusable of using lax enforcement to attract FDI in pollution intensive activities. Another important regulatory problem is that of transfer pricing to evade taxes or restrictions on profit remission. TNCs can use transfer pricing over large volumes of trade and services transactions. The problem is not restricted to dealings between affiliates; it may also arise in joint ventures. Managing FDI policy effectively in the context of a broader competitiveness strategy is a demanding task. A passive laissez-faire approach is unlikely to be sufficient because of failures in markets and deficiencies in existing institutions. Such an approach may not attract sufficient FDI, extract all the potential benefits that FDI offers, or induce TNCs to operate by best-practices standards. There is no ideal universal strategy on FDI. Any strategy has to suit the particular conditions of a country at any particular time. And evolve as the country's needs and its competitive position in the world change. Also it has to take into account that international investment agreements leave them the policy space they required to pursue their development strategies. In conclusion, TNCs are principal drivers of the globalization process, which defines the new context for development. TNCs enjoy more rights but should be complemented by increasing firms' social responsibility (toward environment labor rights). Past experience shows there is striking and growing differences between countries in their ability to compete and grow. They also show that markets by

themselves are not enough to promote sustainable and rapid growth, policies matter, as do institutions that formulate and implement them. There is an important role for government policies but not in the earlier mould of widespread intervention behind protective barriers. Rather in a global world economy, governments increasingly need to address the challenge of development in an open environment. FDI can play a role in meeting this challenge.

Section 5 Regional Policy Chapter 16 Towards a Competence Theory of the Region Clive Lawson

The central thesis of this chapter is that there is much value extending the firm's competence perspective to the analysis of the region. The Competence Perspective To illustrate the competence perspective we compare it with both the contracted theory of the firm and the portfolio based management strategy approach.

Contractarian perspectives focus upon the cost of making and monitoring transactions, and the reduction of these costs by the organizational hierarchies that constitute the firm. Exchange is primary and the main concerns are problems of forming and maintaining contracts between input owners. Competence theories, in contrast, focus more upon production viewing the firm as a " repository of productive knowledge", rather than as a " nexus of contracts". Contractarian approach is criticized for their neglect not only of production but of dynamic features of firm behavior. It is inappropriate for more dynamic processes central to innovation and technological change. For competence theories learning is center stage, as are the relationships (non contractual such as trust, loyalty and cooperation) which surround and facilitate different types of learning and the dynamic processes of change which follow. In short, the competence perspective is much more concerned with a realistic conception of what a firm is and does.

The portfolio approach has emerged from the management strategy and is concerned with the particular risks involved in managing some portfolio of businesses. Strategic decision-making is related to the allocation of capital across business units, with success depending ultimately upon the market position occupied by a corporation. The competence perspective is instead concerned with the abilities of business units to do certain things – to learn, produce, occupy certain market positions etc... At the heart of the contrast is the idea of a deeper level of analysis. Specifically the portfolio approach concentrates on the surface phenomena of everyday experience, such as turnover, profits, products, etc... while the competence approach is concerned with factors which lie below the surface but condition these everyday phenomena. According to Rumelt (1994) the following features of core competences illustrate the deeper level of competence approach: 1- Corporate span: Core competences span businesses and products within a corporation. (It supports several products or businesses). 2- Temporal dominance: Competences are more stable and evolve more slowly than do products. 3-Learning by doing: Competences are gained and enhanced by work. Competences are collectively learned in organization and enhanced as they are applied and shared. 4-Competitive locus: Product-market competition is merely the superficial expression of a deeper competition over competences, conceiving firm as portfolio of some competences suggests that inter-firm competition as opposed to inter-product competition is essentially concerned with the acquisition of skills. Each point contains the idea that competences exist at some deeper level explaining the basic portfolio accounts such as products market positions and sustained competitive advantage or disadvantages. The competence approach is closely related to the resource –

based approach. The main distinction between resources and competences is that whereas resources are both tangible and intangible (human capital), competences are always intangible. System of competences and social interaction: Social systems such as firms, trade unions, national and regional economies can be understood as an “ ensemble of networked internally related positions with their associated rules and practices. ” The region as a productive system may be differentiated as an ensemble of competences that stretches both through space and across organizations and contains a degree of coherence in virtue of the nature of interaction constitutive of it. Although firms and regions are not the same things, both are ensembles of competences that emerge from social interaction and so there appears to be no reason at all why the competence perspective should not be as relevant to the study of the region as to the study of the firm. Regional Competences: Some recent points of convergence contributions to regional competences, although different, we focus here upon similarities, in particular: 1- Convergence. 2- The importance of competence perspective and 3- Examples of forms of regional competences. – The California School of Economic geography viewed regional business clustering in terms of the relationship between the division of labor, transaction costs, and agglomeration. The vertical disintegration of production leads to increased transaction costs, which leads to agglomeration as agents attempt to reduce extra transaction costs arising from geographical distance. The focus in these early contributions is predominately on ‘ traded’ relations. More recently, Storper, has argued that it is untraded interdependencies that explain the observed spatial patterns, and that these can’t be easily accommodated within transactions–cost based theories. These untraded

interdependencies cannot be captured by reference to input-output transactions or contract exchanges, but involve technological spillovers. According to Marshall, a firm's survival is taken to depend upon increased differentiation and more complex or sophisticated coordination. The experience of Italy industrial districts reveals concentration on transactions between firms in sequential stages in supply chains: frequent sharing of equipment, the possibility of jointly taking on larger orders, large pools of appropriately skilled labor etc...In explaining these linkages two different approaches. The first, simply relates to the existence of external economies (economies of scale). The second, related to general climate or industrial atmosphere. A third approach found in GREMI literature emphasized the local environment or milieu which is seen as the relevant unit of analysis, with focus on the ability of the milieu to foster innovation. In particular, it focused on complex network of mainly informal social relationships. Innovations result from " collective interactions" linking a system of production to a particular technical culture. The ' dynamic' aspect of GREMI, the milieu can facilitate collective learning, and can reduce dynamic uncertainty. The convergence of all above approaches is upon set of relationships which emerge from social interaction and exist at a different level to the units, such as practices, products etc..., that they explain. These factors that underlie, or constitute, the region's competences on capabilities. Hence firm-based competences and capabilities can be generalized to regional competences.

1. Regional / corporate span: competences span not only products but firms themselves at any point in time. Competences support not only many products or business within a corporation, but also many corporations.
2. Temporal dominance: competences may not only be more stable and evolve

more slowly than products but may be more stable and evolve more slowly than firms themselves. Thus firms, like products, may be only the temporary expression of a region's competences. 3. Learning by doing: competences are gained or enhanced not only by work but also by trade out other inter firm interaction. Competences are not diminished with use and are enhanced as they are applied and shared. However, this now involves not only the activity of some established firms, but also attempts to set up firms and form links to other organizations. 4. Competitive locus: the relative performance of regions as well as the relative performance of firms is merely the superficial expression of a deeper competition over competences. Thus regions may maintain their comparative position, even though firms or sectors may come and go, in much the same way that a firm may maintain its competitive position while at the same time significantly changing the nature of its products.

Combining firm and regional competences – An Illustration: This section focuses on the nature of regionally significant relationships to indicate the kinds of things regional competences are likely to involve. The Cambridge High Technology Cluster The region's success in R&D combined with largest volume of high technology employment growth of all the UK countries during the period 1980-90. It contained over 1000 firms overwhelmingly small and medium sized firms. However, Cambridge failed to produce large multinational firms to rival those of Silicon Valley. Furthermore, growth has been accompanied by firm take over by an external source, mainly due to region lack of "real network". Three main forms of link: 1. The first between local firms and the university, apart from providing highly skilled pool of labor, the university acts as a very important source of ideas and knowledge. Formal knowledge transfer relationships between the

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university and local firms exist in the form of consultancy, collaborations, etc... A crucial form of transfer, after neglected, is the significant spin-off activity in the region, where individuals, encouraged by, among other things, a conducive attitude towards intellectual property rights in the university, set up their own firms to realize their ideas, innovations etc... directly in the market. The university presence helps to create an academic type culture and atmosphere in terms of local services like cinema, restaurants, etc... as well as more direct possibilities of interaction. 2. The second type of relation is between the firms themselves, given small firm size, links reflect the fact that considerable number of tasks must be performed externally. Many more horizontal, research and knowledge transfer oriented links also exist between firms in the region. Many firms' links also arise because of corporate spin-out activity. . The third type of link operates through the functioning of the local labor market. Apart from providing access to a vast range of technical skills, the frequent movement of employees between firms, and from the university to firms has served to facilitate knowledge flows. Taking these factors together, Cambridge, as a region, has a significant capability for taking new ideas to market, especially via the process of new start-ups centred on a research-based idea or innovation. Both organizational structure of Cambridge University and local firms act to encourage spin-off activity. The small size of the region's firms means that many employees are very close to management decision making, providing the innovation and know-how for these employees to start up new firms. Extensive networks exist which facilitate the working of firms often with few material resources. With these firms, the distinction between products and the firms themselves is in practice quite fine (in competence terms the firm itself is thin).

However, this “ failure” of individual firms to develop thick competences does not have to be seen as a “ regional bad” in any sense. Small specialized firms always capable of producing far more than it does, and this explain why many firms fail or taken over by other firms. To focus upon the success or failure of particular firms ignores the features of the wider context in which the conditions for significant technology creation and transfer are reproduced. The firm-based competence perspective correctly identifies factors other than events and states of affairs (products, market positions, etc...) in explaining economic phenomena. The distinction between firms that are thin or deep in terms of competences is clearly relevant in accounting for the experience of Cambridge firms. But what is missing in firm based competence perspective, in this case, is the regional set of competences within which firm’s activities need to be understood and assessed.

Conclusion: The main argument of this chapter that competences of productive systems can be understood to exist at “ deeper” level of analysis and best conceived of as emerge