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GLOBALISATION: THE CHALLENGE FOR NATIONAL ECONOMIC REGIMES

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Globalisation:
The Challenge for National Economic Regimes

1 Introduction

At the outset of my presentation, I would like to say how honoured I am to be presenting the Geary Lecture for 1993. I am honoured, first, to be following in the footsteps of such a distinguished panel of speakers; second to be associated with Ireland's most prestigious research institute; the third, to further commemorate the memory and splendid achievements of the founder director of The Economic and Social Research Institute - Dr Robert Geary.

The role of government, as an organising force in a market economy, is coming under increasing scrutiny. Yet, in spite of an almost universal eagerness to contain or reduce the extent of governmental intervention in the management of domestic resource allocation, it remains a fact that the countries which have recorded the most impressive economic performances over the past two decades are those whose governments have exerted a strong and positive influences over all aspects of commercial affairs[1].

My lecture today addresses just one, but an increasingly important, aspect of this enigma, viz the implications of the globalisation of business activity for the economic sovereignty of individual nation states. In particular, I propose to consider the implications of the globalisation of business activity for the organisation and management of location bound human and physical assets. I shall argue that the pace and direction of

1 The concept of strong and positive government does not necessarily imply there should be substantial government intervention in economic affairs. Indeed, a recent IMF study (Ostry, 1993) of East Asia's experience suggests there is little evidence to suggest that even "selective" interventionism is correlated with superior growth performance. Instead, high domestic savings and investment rates, an emphasis on the upgrading of human capital, flexible labour markets and an unrestricted access to foreign resources, capabilities and markets are among the shared factors in the success of the Asian economies. However, it is our contention that, by their macro-economic and organisational strategies, governments may play a critical role in influencing the value of these, and other, competitive enhancing variables.

technological, political and institutional change, especially as it has affected the extent and character of international transactions, is demanding a systematic recasting of the traditional role of national governments as custodians of the economic welfare of the citizens within their jurisdiction.

Central to my thesis is the premise that, as a result of the dramatic growth in the cross-border linkages forged by multinational enterprises (MNEs) or transnational corporations (TNCs),[2] the latitude for autonomous and purely domestic oriented actions on the part of the governments of nation states - by which I mean actions which only affect the constituents of those states and not those of others - is being severely curtailed. Increasingly, too, national authorities - particularly those of the advanced industrial countries - are competing with each other for a share of the world's supply of technological and organisational capacity, and for the global economic rents of international production. Given this scenario, both the economic sovereignty of governments and the efficacy of their policy instruments for affecting domestic wealth creating activities are being called into question.[3]

My presentation will be divided into three parts. First, I shall briefly outline the main features of the global economy now emerging, and the reasons why globalisation is likely to continue for the foreseeable future. Second, I shall discuss the implications of globalisation - and, in particular, the cross-border activities of MNEs - for governments, and for the organisation of economic activity for which they are responsible. The third part of my presentation is more normative in that it speculates a little about what some of the responses of national governments *should* be to globalisation. Although, clearly, these responses will vary between

[2] I use these terms interchangeably with each other.

[3] Teece (1992) has pleaded for a re-evaluation of the role of the *corporation* in the light of the global economy; my analysis argues for a similar reconceptualisation of the role of government.

countries according, for example, to their size, industrial structures, institutional regimes, cultures and stages of development, I believe there are some general implications for the behaviour of all governments; and it is to these, rather than the more country specific consequences of globalisation, to which I wish to address my thoughts today.

2 *The Main Features of Economic Globalisation*

While scholars and business practitioners continue to debate the meaning of the terms "global business" and the "global economy", there is less disagreement about *globalisation as a process* towards the widening of the extent and form of cross-border transactions; and of the deepening of the economic interdependence between the actions of globalising entities - be they private or public institutions or governments - located in one country and those of related or independent entities located in other countries.

The *shallowest* form of globalisation - if that is not a misnomer for the term - is where an economic entity in one country engages in arm's length trade in a single product with another economic entity in one other country. The *deepest* form of globalisation - and it is here we can most easily distinguish globalisation from other forms of internationalisation - is where an economic entity transacts with a large number of other economic entities throughout the world; where it does so across a network of value added chains;[4] where these exchanges are highly co-ordinated to serve the worldwide interests of the globalising entity; and where they consist of a myriad of different kinds or forms of transactions.

In practice, few firms - for that matter - or countries engage in either the *shallowest* or *deepest* forms of globalisation. However, each of us, I am sure, could quite readily identify a number of firms or countries which are *towards* the bottom or top of the

[4] There are various other expressions which, like globalisation, are difficult to define precisely. Interdependence and integration are two of these.

globalisation spectrum. More to the point of my present interest, however, is the almost universal trend towards the deeper internationalisation of economy activity. The structure of the world economy is, indeed, very difficult today than it was even a generation ago.[5] I would, in particular, emphasise three features. First, the significance (and scope) of all kinds of cross-border transactions has greatly increased. For example, as a proportion of world gross national product (GNP), such transactions have more than doubled since 1970.[6] Second, the value of the foreign production of firms, i.e., production financed by foreign direct investment (FDI), and that arising from cross-border strategic alliances - both of which are deeper forms of internationalisation than that of arm's length trade - now considerably exceeds that of trade.[7] And third, there are a variety of signs that the organisation of international transactions, particularly among the largest MNEs, has become both more systemic and geographically integrated (UNCTAD, 1993).

It is, of course, true that the pace and pattern of globalisation has been very uneven among firms, sectors and countries. Indeed, since many of the features of globalisation just described are principally applicable to members of the Triad nations, some scholars (Morrison, Ricks and Roth, 1991) have argued that the term regionalisation better describes the current stage of development. This may well be the case; certainly, intra-regional transactions of all kinds in Europe, America and Asia have risen faster than inter-regional transactions. It is also true that certain parts of the world, notably sub-Saharan Africa, have been relatively unaffected by globalisation.

5 Some writers, indeed, Drucker (1989), trace the evolution of the globalisation of economic activity back to the 13th century.

6 In the US, for example, the percentage of GNP accounted for by trade rose from 7 per cent to 26 per cent between 1970 and 1990, while that accounted for by the stock of inward and outward direct investment increased from 89 per cent to 156 per cent.

7 Latest figures published by UNCTAD (1993) suggest that in 1993 the sales of the foreign affiliates of MNEs amounted to $5.5 trillion compared with that of trade of goods and services of $4.0 trillion.

Finally, since globalisation has been largely driven by events in the industrialised nations, it is understandable that - up to now, at any rate - its greatest impact should have been felt in these countries. But, like ripples in a pond, regionalisation may spread outwards, initially to the immediate hinterland of the developed countries, but then further as this hinterland generates its own momentum of growth. Neither should one overlook the surge of autonomous development within certain parts of the developing world - particularly in East Asia and parts of Latin America. Indeed, with growth rates in the advanced countries slipping, international transactions involving developing countries have risen faster in the last three years than those internal to the Triad countries. The critical issue - to which we shall return later in this presentation - is whether regionalisation will develop into a form of *regionalism* (a kind of extended nationalism, with all that this implies) or is a step - a phase - in the globalisation process.

3 Explaining Globalisation

The movement towards globalisation is essentially technology driven.[8] Admittedly, the tremendous growth in all forms of international transactions over the last two or more decades could not have taken place without the introduction of new organisational structures within and between firms; or the widespread restitution of the market system by many national economies;[9] or, indeed, without the removal of many obstacles to intra-regional or international trade. But, these events, together with the dramatic reduction in the time and costs of traversing

[8] We use the world technology to embrace all forms of assets which make for the more efficient development of resources and capabilities.

[9] McKenzie and Lee (1991), for example, argue that the fall of Communism in Central and Eastern Europe was triggered by economic, rather than political, forces and, in particular, by the former's impact on increasing inter-firm competition and reducing cross-border psychic distance between the countries of the world.

space, have, themselves, been accelerated by techno-electronic innovations, and their impact on the competitive pressures on corporations to seek out new markets and conclude cross-border cost reducing coalitions with other firms.

However, perhaps the most critical distinction between the globalising economy of the 1990s and the international economy of the 1980s rests in the nature of income generating assets. A century ago the international division of labour was primarily based on the spatial distribution of *natural* resources, such as the fruits of the earth and untrained or semi-trained human capital. Today, the capabilities of a country to produce wealth rests increasingly on the extent to which it can create new resources or assets - such as information, technological capacity, management techniques and organisational competence. Particularly, in the western world, where there is little population growth, it is the upgrading of the quality of human and physical assets and the more efficient use of existing assets - both natural and created - which is the critical determinant of economic progress.

It is, perhaps, worth spending a moment or two considering some of the implications of the growing importance of *created*, relative to natural, assets in the wealth producing process. First, by definition, created assets have to be produced. Unlike natural resources, they are not God-given; they are man made and, in the case of many created assets (e.g., a university, an airport and the knowledge embodied in a new drug), they are very costly - both in terms of human and physical capital - to produce.

Second, because of their intangibility, many created assets are locationally mobile - although the degree of their mobility may rest on the quality and cost of other, or complementary, assets, e.g., transport and communication facilities. Most kinds of knowledge, information, professional skills, entrepreneurial talents and organisational principles acknowledge no national borders, even though there may be considerable costs incurred in transferring or diffusing these assets between different cultures (Kogut and Parkinson, 1993). The "quicksilver" character of both financial and real assets is in marked contrast to the spatial fixity of many natural assets - a fact which helped shape the Ricardian and neo-classical theories of trade.

Third, created assets tend to be firm specific, i.e., proprietary to the firms producing them. In consequence, the market for created assets is likely to be much more imperfect than that for natural assets. Often created assets are the result of successful innovations; but, for every successful innovation, there are many more which are unsuccessful. To encourage firms to bear the risks and uncertainties inherent in innovatory activities, and to prevent the free-riding by competitors of successful innovations which cost little to reproduce, society - or, more specifically, government on behalf of society - has introduced various devices, e.g., the patent system, either to counteract such market failures or to reduce their net social costs.

Fourth, the markets for created assets tend to become more imperfect as and when they cross national boundaries. This is because the territorial expansion of firms into different political, institutional and cultural regimes is likely to raise the transaction costs of using such markets. Examples include the monitoring of quality control, the protection of proprietary rights, and the reduction of information asymmetries. Indeed, the desire to lower cross-border transaction costs and to exploit the cross-border economies of internal governance is one of the main reasons for the recent rapid growth of MNE activity which has, itself, helped sustain, or advance, globalisation.

Fifth, the conditions under which created assets are produced and marketed are often strongly influenced by national governments - and much more so than in the case of natural assets. Sometimes, this is because governments - be they federal or state, central or local -are the main producers of the assets; primary and secondary educational services, roads and airports are examples.

Sometimes it reflects the quality of the legal and commercial infrastructure they help provide; sometimes it is a direct result of the economic strategies and policies they pursue; and sometimes it is because of the general business climate and entrepreneurial ethos they foster. Several writers, notably Wallis and North (1986) and North (1993), have shown that, over the present century, these government influenced production and transaction costs and benefits have become a more important component of the total costs of economic activity; and particularly so in those of technology and information intensive manufacturing and service sectors, which are the fastest growth points in the contemporary global economy.

The net result of all these characteristics of created assets - which, I repeat, though primarily a consequence of technological change, is also affected by the way in which economic agents respond to them - is that the determinants of the international division of labour and of the optimum distribution of a nation's resources and assets are more affected by the behaviour of hierarchies - and especially multinational hierarchies - and that of national governments, than by that of pure or unadulterated (and I use this word deliberately) market forces.

The globalising economy, then, is, first and foremost, an expression of a new international division of labour. This new division of labour is based increasingly on the way in which countries and firms are able to engineer the production of new income generating assets, and to combine these with location bound natural resources - the quantity and quality of which, itself, is influenced by the policies and strategies of governments. It also comprises a network of imperfect intermediate product markets which are frequently under the common governance of multi-activity enterprises. The key wealth creating actor in this scenario is the MNE, which is also the main determining institution of the spatial distribution of created assets. By internalising the market for the intermediate products it wishes to acquire or use, and co-ordinating its markets throughout the world, it brings about a different pattern of resource allocation than that which would have been dictated by purely market forces.

4 Multinationals and National Governments

The relationship between international companies and national governments has always been an uneasy, if not a schizophrenic, one. This is primarily because, while MNEs normally aim to maximise the economic rent on their *global* activities, governments are more concerned with maximising the value added *created* by MNEs and particularly that part of which is *retained within their national boundaries*. Moreover, because of their wider locational options, MNEs are frequently perceived to possess more bargaining power than national governments. Frequently, in the past, MNEs have been targeted for criticism by host countries for attempting to extract an unacceptably large share of the value added they - the MNEs - have helped create; or for not engaging in the kind of economic activity which is perceived to be in the best long-term interests of the country. Similarly, home countries have been anxious lest MNEs should export jobs, worsen the balance of payments or, by transferring technology to foreign competitors, inhibit the upgrading of their own resources and capabilities.

At the same time, both host and home governments well recognise the benefits which MNE activity may confer. To host countries, MNEs being new technologies, management skills, access to markets and organisational capabilities. They may inject new entrepreneurial cultures, competitive stimuli and working procedures. By their procurement practices and marketing and distribution techniques, they may help elevate the capabilities of their suppliers and raise the productivity of their industrial customers. To home countries, MNEs may not only earn valuable investment income and open up new markets, but they are the principal means of tapping into and monitoring the competitive advantages of foreign firms and countries.[10]

The last 100 years is a story of the ambivalent and shifting attitudes of governments (particularly host governments) towards the perceived costs and benefits of MNE activity. In retrospect, a kind of Kondratieff long-wave cycle seems to have been at work. Inbound investment has been particularly welcomed at times of strong market oriented economic growth, and when the need for the innovating and competitiveness enhancing qualities of FDI has been especially marked. Such was the case in the late 19th and early 20th century, the 1960s and the late 1980s.

By contrast, it has been less enthusiastically acclaimed when the perceived need for its unique qualities has been less pressing, and where host governments have been pursuing market distorting or self-reliant economic policies; or where there has been a particular sensitivity to the strategic or cultural impact of MNE activity. The inter-war years and the 1970s saw one or other of these attitudes holding strong and, to a certain extent, they are currently reflected in the less than cordial response by some US interest groups to Japanese inbound investment.[11] Similarly, but I shall not do more than mention these, there have been periods, dating back at least to the first part of the 19th century, when the attitude of governments towards *outbound* MNE activity has been very restrictive.[12]

For the most part, however, the reactions of governments in the 1990s to MNE activity fall into the first category. According to a study published by the UNCTC in 1991 (UNCTC, 1991), more than

[10] The role of MNEs in upgrading the competitive advantages of both home and host countries is described by several writers in a special edition of *Management International Review,* edited by Alan Rugman and published in Spring 1993.

[11] Going even further back in history, anxieties were expressed by American businessmen and statesmen in the last quarter of the 19th century about the possible takeover of large segments of US industry and agriculture - particularly in California and Colorado - by British interests (Wilkins, 1989).

[12] These are more fully described in Dunning (1993a).

80 countries have liberalised their policies towards inward direct investment since the mid-1970s. At two conferences at which I presented papers earlier in 1993 - the one attended by Central and East European parliamentarians in Warsaw and the other by Chinese officials in Beijing, not a single voice (apart from mine) was raised about the costs of FDI. The only concern of the participants was how to best attract as much inbound MNE activity as possible. In parenthesis, I would observe that China, in its gradualist adoption of a market economy,[13] has been considerably more successful in gaining new FDI than the erstwhile Soviet Union and its satellites, in their whirlwind embracement of capitalism! By the end of 1992, China was not only attracting more inbound MNE activity than any other developing country; but the stock of inward FDI (at $40 billion) was 2-3 times that in the whole of Central and Eastern Europe (UNCTAD, 1993).

Of the several reasons for the change in governmental attitudes toward MNE activity since the 1970s, two deserve special mention. The first is the deceleration of economic growth and increasing unemployment in most countries of the world, which, coupled with the implementation of new labour and materials saving technologies and the increased mobility of intangible assets made possible by telecommunication advances, has added to the pressure on countries to seek the ingredients of competitiveness and growth from wherever they can. The second factor is the opening up and development of new territories - especialy in East Asia - which has meant that the locational options open to MNEs have widened. These options have occurred at a time when global competitive pressures have impelled firms - especially MNEs - to be more adventurous in seeking out the most cost efficient locations for their value added activities, and to form an increasing number and variety of cross-border alliances.

[13] What it chooses to call a "socialist" market economy.

At the same time, there has been some reprioritisation of the objectives of governments. From an emphasis on political and domestic oriented objectives in the 1960s and 1970s, the lens of governments have been refocused towards identifying and deploying every means by which competitiveness of their firms and their location bound resources may be enhanced; although the renewed quest for cultural autonomy and the growing resurgence of ethnic fruitions and tribalistic sentiments within nation states (possibly a reaction to the trend towards the harmonisation of economic values) may well demand much more attention by governments in the next two decades or more.[14] In so doing and in recognising the innate mobility of many created assets, national authorities have begun to accept that, to best achieve their social objectives, they have to offer at least as attractive opportunities for the production and marketing of goods and services as do their main competitors; and to ensure that their domestic macro-economic and organisational policies are such that both their own and foreign firms - in following the dictates of a demanding and dynamic global market economy - are induced to invest in upgrading the kind of value activities best suited to the dynamic comparative advantages of their resources and capabilities.

Most certainly, one of the mistakes many governments made in the 1970s and early 1980s was to try to force MNEs and their affiliates to accept the mould of established economic policies, and to extract penalties on those who did not. Often, the imposition of further market distorting programmes not only did more harm than good, but soured the relations between MNEs and governments. Today it is recognised that in a world which is technologically *force majeure,* becoming economically interdependent and, for the most part, driven by international capitalism, the pursuance of domestic policies which are out of line

14 For example, John Naisbitt, the author of *Megatrends 2000,* has argued in his new book *Global Paradox* (to be published in 1994) that, in the next 20 years or so, the number of sovereign states will dramatically increase from its present (1993) number of just under 200 to upwards of 500.

with those of one's major competitors, is an unaffordable luxury. But - and here is the point I want to stress - although, in the 1980s, the inappropriateness of some government strategies was becoming sharply exposed by the activities of MNEs, such activities were not the primary cause. MNEs do, indeed, respond to the imperatives of the globalising marketplace. But, although they are the main *agents* of change, they do not, alone, determine the consequences and shape of that change. This responsibility is shared by the macroeconomic and organisational systems devised and implemented by governments, and by international economic regimes, e.g., GATT and the IMF. In considering, then, the shift currently taking place in national government policies towards MNEs, it is necessary to look beyond the determinants and outcome of the latter's activities - and toward the implications of the globalising economy *per se.*

5 The Changing Role of National Governments

I have suggested that globalisation - and its main enabling vehicle - the telematics revolution - is dramatically encapsulating space, and by so doing, is linking national economies in a way undreamed of by our forefathers. In addition, since economic growth is increasingly dependent on the enhancement and disposition of mobile created, rather than location bound, natural assets, it follows that there is much more inter-country competition for the former and their products than for the latter and their products.

At the time of David Ricardo, i.e., the early years of the 19th century, it was possible to draw a clear dividing line between the foreign and domestic economic policies of national governments. As regards the former, the debate largely centred about the merits of protectionism in those cases where foreign competition was perceived to be damaging - or potentially damaging.

Not surprisingly, the stance taken by countries rested on their relative pecking orders in the development stakes; and also the lobbying power of firms from those sectors most likely to be adversely affected by trade liberalisation. But, in general, the "near" free traders - like the UK - recommend little government intervention, as long as countries produced and argued strongly - and produced efficiently - that all countries should produce those goods and services which required resources in which they possessed a comparative advantage, and exchanged those for others requiring resources in which they were comparatively disadvantaged. The preferred organisational route for achieving this goal was the unfettered market, with national governments only intervening when the market was thought to operate inefficiently or unfairly, or where the barriers to entry into socially beneficial economic activities were too high for private investors to bear.

However, with one major exception, resources and capabilities were assumed to be location bound within national borders. Since, too, domestic firms could not "escape" from unwelcome fiscal, competition, environmental, transport or energy related policies of governments - nor foreign firms be tempted to take advantage of more favourable policies - the only constraint on the behaviour of governments was that of the demands of foreign countries and the supply capabilities of foreign producers via trade; and even here the connection was an indirect one. The one exception was the price of finance capital - the one created asset that was able to flow freely across national boundaries. Hence, the argument later put forward by economists such as Robert Mundell (1957) that trade in capital and goods were largely substitutable for each other. In such a scenario, national governments could pursue domestic economic and social policies largely independent of each other without fear or favour that these policies would provoke undesirable reactions by other governments. And, in point of fact, for much of recent economic history, such policies have differed greatly both between countries, and in the same country at different periods of time.

In the globalising world of the 1990s, the options open to national administrations are much more constrained. Primarily because of the easy movement of the critical wealth creating assets, and the fact that there is more intensive competition among nation states to produce similar goods and services than once there was, the domestic economic strategies of national governments are more closely intertwined than once they were. This is because of the widening choice of the owners of the mobile assets as to the location of their production and usage. Thus, in pursuance of legitimate domestic objectives, if the government of one country imposes too high a corporation tax, firms - be they domestic or foreign - may decide to relocate their value added activities in another country where taxes are lower; or, in considering where to site their new plants, firms may choose that country with the least burdensome environmental constraints, or whose government pursues the most favourable industrial policy, or which offers the most advanced telecommunication facilities or the most attractive tax breaks for R&D activities. Indeed, as several economists, notably Guisinger and associates (1985), have shown, anything and everything a government does which affects the competitiveness of those firms which have some latitude in their cross-border locational choices must come under scrutiny. *In such cases, the boundaries of domestic economic jurisdiction becomes blurred. And, because of this, one of the critical assumptions underlying the behaviour of any government - viz its autonomy in the framing and implementation of its economic strategy - is no longer valid. The mould is broken; it needs to be recast.*

The last 20 or more years have seen a growing recognition by the leading industrial nations of the need for some co-ordination in their macro-economic policies to avoid counter-productive domestic monetary and fiscal policies, and to cushion the adverse effect of shocks to an increasingly volatile international financial system. Though the *Group of Seven* has had some success in this area - and, indeed, it may be argued that the decisions of this informal group of leaders has exerted more influence on the domestic macro-economic policies of the Triad nations than the actions of more formal supra-national regimes, e.g., EC, World Bank, etc. - the recent fragility of European currencies vividly demonstrates some of the difficulties of maintaining a unified exchange mechanism, where the member countries vary in economic well-being or are faced with different economic and social needs. When the crunch comes, national interests always seem to triumph over regional or international interests.

More recently, the attempt to widen the terms of reference of GATT, notably to embrace issues relating to FDI and competition policy, is, perhaps, the most explicit acknowledgement that the domestic economic programmes of national governments can and do affect the playing field of international transactions; and that market distorting industrial and other policies (known as TRIMS)[15] may be as damaging to the level and direction of world trade as any tariff or non-tariff barriers. Once again, as in many other issues - notably the initiation of EC 1992 - MNEs, through such institutions as the European Round Table and UNICE (Union of Industrial and Employers Confederation) have played a critical role (Cowles, 1983). More than most other economic agents, they - the MNEs - understand the implications of the gamut of legislation and policies - designed by governments to advance their own political and economic goals - not just on their own competitive position in international markets, but on how, in turn, these measures may induce a reaction from other governments.

The idea that governments, like firms - and on behalf of their constituents - compete with each other for resources and markets, and that, like firms, they may behave as oligopolists in their rent seeking activities, is one which has, so far, gained only limited intellectual support. This is particularly so among neo-classical economists who believe that firms are the sole wealth

[15] Trade Related Investment Measures

creators in society; and that the role of government is simply (sic) to provide the legal and commercial backdrop to the market allocative mechanism, which alone and unaided, should provide the signals as to *what* should be produced, *how* it should be produced, *who* should produce it and *where* it should be produced. The idea of a UK, US or Ireland Ltd smacks too much of corporatism, and of the kind of economic interventionism which, in the past, has proved to be less effective than the imperfect markets which it sought to replace. In particular - so it is argued - the experiences of Central and Eastern Europe, over the past 40 or more years, have shown that there is an unacceptable face of government just as there is an unacceptable face of the market place.

Yet, there can be no escaping the fact that in our complex and interdependent global village, markets do not always operate costlessly efficiently,[16] neither can one deny that in social democracies, the government of the day *is* accountable to the electorate for its conduct of the economy, just as it is responsible for defence, law and order, the environment and public administration, and for the protection of the less able and less fortunate members of society. Indeed, there is a parallel between the task of the elected authority to protect its citizens against military conquest or unacceptable political intervention and that of the sustenance of its economic security.[17] In conditions of economic isolation, this latter task is a minimal one. In the text book world of a simple division of labour, perfect markets, immobile resources and complementary trade and production, there is little need for governments to intervene with the decisions of producers and consumers. But, this is not the global economic scenario of the 1990s. Countries and firms *are* intricately linked with each other. Resources *are* mobile. Governments *do* compete

[16] This was recognised by Emile Durkheim in 1893, when he stated that increasing internationalisation and division of labour in a society - the hallmarks of economic progress - leads to the "accumulation of government tasks" (Durkheim, 1964, pp. 219-226).

[17] Indeed, in the past, many wars have been fought to preserve or advance such security.

with each other. The division of labour is making for more, rather than less, interdependence of economic activities and more, rather than less, asset specificity. And, markets *do not* always perform in the way that neo-classical economists like to think they should.

The literature on the rationale of government intervention to overcome or mitigate the inability of markets to fully optimise economic welfare is substantial and growing. It is also quite recent, although many of the justifications for government intervention date back to the time of A.C. Pigou and beyond. Economists today argue that there are three main reasons why governments may wish to intervene in markets.[18] The first - and one which I will not address in any detail in this presentation - is to achieve goals other than the efficient use of resources - notably to advance social, political or cultural mores - which the market system, is not (and never was), set up to achieve. This form of intervention by government is only relevant in the present context in so far as the money spent on the attainment of social goals may (I repeat, *may*, not necessarily will) be at the cost of maintaining or upgrading a country's competitiveness in international markets, and, hence, the resources available to support social objectives in a future period of time. In other words, the competitiveness of US, British, German or Irish firms relative to their foreign competitors in period 1 will - in part at least - determine how much the US, British, German or Irish governments can afford to spend on social welfare in period 2.

The right, or optimum, balance of allocating a country's resources and capabilities between wealth creating and other welfare enhancing activities cannot be decided on economic grounds alone; moreover it is likely to be highly country specific.

[18] The literature on this subject is extensive. For some recent contributions to the debate, see Aaron and Schultze (1992) Audretsch (1989), Colclough and Manor (1991), Krueger (1990), McKenzie and Lee (1991), Ostry (1990), Stopford and Strange (1991) and Wolf (1988). For an analysis of the changing balance between the role of governments, hierarchies and markets as economic development proceeds, see Dunning (1993b), and Hämäläinen (1994) and National Academy of Engineering (1993).

However, in comparing the economic performances of nations over the last 20 to 30 years, writers (such as Scott and Lodge, 1985, and Lodge and Vogel, 1987) have pointed to the very different emphasis to the creation and the distribution of wealth by the US and UK governments, compared with that given by the Japanese and German governments. I will say no more on this issue, save to observe that the growing imperative of countries to be competitive in world markets - to maintain, let alone advance the living standards of their constituents - is requiring an increasing proportion of their resources to be directed to competitive enhancing activities; and it is this realisation which is compelling some administrations to reappraise some of their spending programmes and the means of financing them.

The second, and least controversial, reason why governments intervene in markets is because they perceive that the terms and conditions of exchange are being distorted by the conduct of one or more of the participants in the market - or of foreign governments. Such *structural* market impurities essentially result from the monopolistic, or monopsonistic behaviour, on the part of producers or consumers, although sometimes the desire to eradicate these distortions gets confused with the debate of whether some markets, e.g., those for education, housing, rail transport and health should preform a social as well as an economic function. *Inter alia,* this ambivalence of objectives explains why state run sectors are often uncompetitive. Here the concept of the social market economy becomes relevant, although in recent years, this concept has been widened to embrace other kinds of market failure.

National governments possess a plethora of instruments to deal with structural market failures - most of which are directed to making markets more contestable, and to inhibiting one group of participants from exploiting such economic power as they may have at the expense of other groups. Anti-trust policies represent the kernel of such instruments. In so far as the globalisation of economic activity intensifies competition between firms, the intervention of governments may be less necessary. But, more relevant is the fact that technological and organisational advances that such globalisation is shifting the main locus of inter-firm rivalry from being intra-national to being international.

At the same time, market structures are becoming more complex as firms both compete and collaborate with each other. The growth of cross-border strategic business alliances has been one of the most dramatic phenomenon of the last decade. Such alliances as the design and production of a supersonic aircraft, or a new generation of computers, are usually intended to accomplish a very specific purpose and, while some observers are concerned lest they are an excuse for monopolistic behaviour, the general consensus is that many help protect or advance the global competitive positions of the participating firms.

The British government is, in fact, currently encouraging transatlantic alliances between small to medium size firms. However, the point I want to particularly underline is that one government's attitude - *vis-a-vis* that of another government competing for the same resources - towards the increased oligopolistic structure of transnational production and the conclusion of cross-border mergers and alliances, may decisively affect both the incentive and capabilities of its domestically based firms to service foreign markets, and the locational options open to foreign based MNEs (or increase their investments) in that country. *The mould of competition policy which is suitable to a closed economy may need to be recast in a global economy.* At the same time, to discourage governments from using their competition policies to achieve goals other than those addressed by an efficient market system, some kind of supra-national surveillance may be necessary where other governments are promoting economic strategies which are structurally distorting. I shall return to this point a little later.

Let me now turn to the third justification for governments to intervene in the way markets allocate resources; and one which I believe globalisation is forcing a major reassessment of the whole ethos of their macro-organisational strategies. This is to overcome, or to counteract, what I have referred to elsewhere (Dunning, 1993a and 1993b) as *endemic or pervasive market failure;* the word endemic meaning that the very nature of market conditions in which goods and services are bought and sold, rather than the behaviour of the participants, does not permit it to optimally fulfil its functions. Two reasons are commonly adduced. The first reflects the costs required to create and sustain an efficient market. Economists refer to these costs as *transaction* costs; but, *de facto,* they include all expenditures which have to be incurred to ensure that the buyers and sellers in the market have the knowledge and incentive to behave as they would in a situation of perfect competition.

The second reason is that, in contrast to the assumptions of neo-classical economic theory, individual markets - be they product, labour or financial markets - are not always self-contained, independent entities, but are complementary to, and interdependent of, each other. The main implication of this interdependence is that a particular transaction may affect, for good or bad, the welfare of individuals or institutions other than those involved in that transaction. These are the so called externalities of markets. Sometimes in their evaluation of the efficiency of markets, analysts distinguish between *private costs and benefits* (i.e., those incurred or enjoyed by the transacting parties to an exchange) and *social* costs and benefits, viz those enjoyed by the wider community. To give just one example; it has been calculated (by some economists[19]) that the average social returns to R&D exceed those appropriated by the investing firms by 50 per cent - 100 per cent.

The literature provides countless examples of situations in

[19] See especially Aaron and Schultze (1992).

which endemic market failure is likely to flourish. Broadly speaking, these fall into two main groups. The first relate to characteristics of the goods or services being transacted; and the second to the conditions under which they are exchanged. Of the former, products whose production requires assets with a high level of specificity (or start-up) to variable costs of production (i.e., capital or technology intensive products); products the demand for which or supply of which is inelastic, uncertain or unstable; products, the supply of which is subject to substantial economies of scale or whose value rests on strict quality control; products which are more valuable if they are used jointly with other products; and products the output or use of which generates substantial external economies or costs (e.g., environmentally sensitive products).

As to market specific transaction costs, these are frequently the outcome of imperfections in interpersonal relationships, information asymmetries and inappropriate macro-organisational policies. They include country related political and economic uncertainties; the inadequacy of the legal or regulatory system with respect, e.g., to contract enforcement and protection of property rights; exchange risks; unacceptable or misunderstood business practices; undemanding consumer attitudes towards product improvement and quality; abrasive work and worker-management relationships; and the failure of government to adequately acknowledge or cope with endemic market failure.

It may not have escaped your notice that the products which possess the characteristics just identified - or, to put it another way, when produced and sold through the market, incur substantial relational and transaction costs - are the output of created assets. They are also products which are currently predominantly supplied by large firms - though, because of telecommunication advances and the opportunities offered by strategic alliances, are likely to be increasingly provided by small to medium size corporations; and the conditions of their production are markedly influenced by the actions of national governments.

They are products the supply of which tends to increase proportionately as a country moves along its development path. They are also trade and FDI intensive; while the markets for them vary in their degree of imperfection according to the location of the participants involved. Finally, they are the products at the forefront of globalisation, which, to be produced efficiently, often require the use of complementary assets.

Economic theory suggests that there are three main responses to market failure. The first is for firms to internalise intermediate product markets by the vertical integration of value chains or the horizontal diversification of products or processes. Such action may either lower or increase economic welfare, depending on whether it is prompted by the desire of the internalising firms to raise economic efficiency or to advance monopoly power (Teece, 1986, Dunning, 1988). An example of the former case is where a hierarchy internalises a market to lower its transaction costs or to exploit the economies of scale or scope. This is likely to be welfare raising, especially where the firm is faced with competition in the less idiosyncratic factor or intermediate goods markets, and in the final goods or services markets. On the other hand, a hostile takeover could be prompted by the desire of the acquiring firm to eliminate a competitor and engage in market distorting practices.

The second response to market failure is for the participants in the market - sometimes assisted by non-participants - to try to reduce that failure. For example, quality variation and an inability of subcontractors to adhere to delivery dates might be reduced by a closer and more productive working relationship between the buying firms and their suppliers; while, by reducing macro-economic uncertainties and removing market inhibiting governmental practices, e.g., discriminatory purchasing procedures, transaction costs might be lowered.

The third solution is for governments or some other extra-market institutions (e.g., groups of firms) to counteract the intrinsic deficiencies of the market by offering producers and consumers inducements to behave as if a perfect market existed. Examples include the provision of tax concessions and subsidies to increase the private benefits of R&D and training to the level of their social benefits; improving information about the export opportunities for small firms; setting up investment guarantee schemes to protect outbound MNEs against political risks; making certain that patent legislation and procedures properly reflect the needs of innovators; assisting the market in its provision of risk capital - especially for projects which are likely to generate social benefits and are long-term in their gestation; and ensuring directly or indirectly, that the transaction or "hassle" costs of doing business -e.g., industrial disputes, inadequate transport and communication facilities and time consuming bureaucratic controls are kept to the minimum.

Each of us can, undoubtedly, think of many other examples of endemic market shortcomings, but most, I suspect, would reduce to the presence of X inefficiency of one kind or another. But, there is another aspect of market failure which economists are apt to neglect, mainly because they tend to assume human beings behave in a consistent and rational manner and are only interested in the pursuance of wealth. But - one might question - is this a realistic interpretation of why individuals and institutions engage in market transactions? Organisational theorists question this, and talk about the bounded rationality and opportunistic behaviour of producers and consumers; and about the *homo psychologicus* of cognitive psychology as compared with the *homo economicus* of economics.[20]

I would like to extend this idea of psychological man to the mentality or culture of wealth creating activities by countries and corporations. Even the most cursory glance at the ways in which (say) the Arab countries, and the Germans conduct day to day business; or the attitudes of the Japanese and Nigerians to inter-firm relationships and contractual obligations; or the ethos of work

20 As, for example, explored by Williamson (1992).

and leisure of the Taiwanese and Greeks; or the perceived responsibilities and duties of workers, business managers and governments of the Koreans, Chileans and Russians - or the cross-border operational and organisational strategies of Nissan and Toyota or Motorola and Texas Instruments - reveals wide differences in the culture or ideology of wealth creating behaviour. The globalising economy is unearthing a new importance to concepts such as trust, forbearance and reciprocity; and of informal, rather than formal, organisational forms in affecting national competitiveness, and, hence, the disposition of resources and capabilities.

The extent to which the culture of wealth creating behaviour is an intrinsic characteristic of a country or corporation or can be shaped by exposure to other cultures, by decree or economic pressure, or by a reorientation of personal or business values, is debatable. But, surely there can be little doubt that the forces of globalisation are compelling firms and governments to review their respective roles in influencing mental attitudes towards wealth creating activities. Whether we like it or not, the trade-offs between these and other activities, such as leisure pursuits, are changing; and, whether we like it or not, to a large extent, they are being set by countries which value competitiveness the highest. The grasshopper's attitude to life is fine as long as the grasshoppers do not aspire to the living standards of the ant. The trouble is that most of us want to retain our lifestyles of work and leisure, but also enjoy all the material benefits of our economically more successful neighbours.

Here, again, I believe governments have a critical role to play, both as information providers to their constituents about the real costs of *not* being competitive in an open world economy; and in helping to create a culture or psychology of economic behaviour which encourages, rather than discourages, competitiveness. Much more contentious is the extent to which some culturally related work practices are perceived to be the "unacceptable face of competitiveness". Why should British, or American, or Dutch textile workers be expected to have their wages or working conditions reduced to the level nearer their counterparts in Bangladesh or Sri Lanka - *or* lose their jobs? Although the question of harmonising cross-country cultures of work and wealth creating activities is not yet on the political agenda of countries, it is not far below the surface, and is likely to become an increasing talking point as globalisation impels governments to reappraise their attitudes on this issue.

Of course, the culture of economic behaviour does not start or end with the work ethic. A no less - and perhaps, a more important consideration - and one which is in line with the principle of comparative dynamic advantage - is for a country threatened by low labour cost competitiveness to upgrade or restructure its resource usage and efficiency. Governments again can play a decisive part not just by providing the right kind of market enabling incentives and structural adjustment assistance (Ozawa, 1987), but by encouraging - and be seen to be encouraging - an ethos of entrepreneurship and innovation; a readiness by enterprises to anticipate and take advantage of technical and economic change; and an appreciation by workers of the need for job restructuring and retraining.

If what I have said is familiar in an audience of this kind, I do not think it is generally acknowledged. And, this, primarily, is because the average Westerner's perception of the appropriate tasks of government is 50 to 100 years out of date. Part of the reason is, most certainly, a cultural or ideological one - compare, for example, a Christian with an Islamic or Confucian viewpoint of such issues as personal initiative, authority and collective responsibility; but, part is because Western governments have not seen the need for, or have had the political will to, recast the mould of their economic responsibilities. Some recent contributions by scholars have urged governments to reappraise their philosophies[21] - but these are not helped by analysts who continue

21 See especially those identified in footnote 18, page 18 and Dunning (1992).

to preach a minimal role for governments, or encourage a "them" and "us" attitude between private firms and the public sector; with the former being perceived as the wealth creators and the latter as the profligate spenders of that created wealth.

The core task of government as an enabler or facilitator of wealth creation is not yet appealing to most people. The reality - as opposed to the idea - of a partnership between government, firms and individuals in enhancing competitiveness remains mainly confined to East Asian nations. The suggestion that the globalised economy demands a fundamental rethinking of the "how, "why" and "wherefore" of the organisation of government, as it does of firms, fails to gain little support. For the most part, political scientists and economists either assert that governments should not involve themselves at all in macro-organisational affairs, or that they should play a direct and activist interventionist role in shaping or manipulating markets to better meet perceived social and economic needs.

Yet, *de facto,* the rhetoric of government ministers is often far removed from the practice. To take one example; in her time at 10 Downing Street, Mrs Thatcher constantly applauded the virtues of the free market. Yet, a reading of her record suggests that she was one of the most interventionist of Prime Ministers - if one uses the word interventionist to include any and every action taken by a government which might affect the competitiveness of the resources under its jurisdiction. But somehow, either out of ignorance, lethargy, or for some reason best known to themselves, right wing politicians seem reluctant to acknowledge that such actions as tax hikes, environmental regulations, a new educational curricula, attitudes towards monopolies, investment in roads, energy policies, regional development, health care programmes, industrial relations legislation and the finance of universities - all affect competitiveness just as much as direct intervention (mainly via industrial policy) in the allocation and use of resources. And

0certainly, there seems little appreciation of how these policies interact with each other; hence, there is no holistic or systemic approach to them.

I do not want to press my critique of western governments too far. In several countries, there is a growing recognition that the globalising economy is compelling an up-scaling of industrial competitiveness on the political agenda, and a reappraisal of traditional macro-organisational strategies. Issues such as training, the funding of R&D, information and advice for small businesses, competition policy, attitudes towards inward investment, new road and rail links and so on are being increasingly viewed and evaluated in terms of their perceived impact on competitiveness. But, for the most part, most of the action so far taken by Western governments has been *ad hoc,* uncoordinated and fragmentary; and as an "add-on" to existing policies, rather than part of a systemic remoulding of the organisational structure of decision taking so that it may best embrace the challenges and opportunities of a globalising economy.

To some extent, the problem is educating the decision takers in government. Here, the fault partly lies with academics such as ourselves. We have just not got over the message that there is a fundamental difference between the kind of government action necessary to help overcome endemic market failure and to facilitate the upgrading of resources and capabilities, and that which seeks to replace or modify the behaviour of firms in the belief that central planning can do a better job in advancing economic and social welfare than can markets. We have not got over the message that, to optimise their efficiency and response to market signals, firms require the availability of created assets and a wealth creating ethos which only governments can provide. We have not got over the message that increasingly *what* governments do and *how* they do it, is much more important than *how much* government involvement should there be!

To some extent, too, the problem is one of re-forming opinions and attitudes towards the role of governments. I believe we need a new vocabulary to promote the image of government as a public good rather than as a necessary evil. We need a "perestroika" of government. We need to recognise that, just as "Fordism" is an out-dated method of organising work, so the kind of government interventionism appropriate to a "Fordist" environment is outdated. And, just like the emerging managerial structure of 21st century firms, we need governments to be lean, flexible and anticipatory of change. The new paradigm of government should eschew such negative or emotive sounding words such as "command", "intervention", "regulation", and replace them by words such as "empower", "steer", "co-operative", "co-ordination" and "systemic". Moreover, not only must governments recognise the need for a much more integrated and holistic system of organising their responsibilities, which demands a "spider's web" rather than a "hub and spoke" relationship between the various decision taking departments and the core of government, viz the cabinet of the Prime Minister or President (Dunning, 1992); but, for all those affected by governments, and particularly the ordinary tax payers, to take a more positive view of the benefits which only the former can produce.

It would be an entirely other lecture to suggest how the organisation of governments should change to accommodate the kind of remoulding I have articulated. But, this issue is now very much being considered in the literature. In a recent contribution with the intriguing title *Transforming the Dinosaurs,* Douglas Hague (Hague, 1993) has identified four ways in which institutions - be they public or private - can re-engineer themselves, viz by coercion, contagion, coaching and learning. While the latter three are usually more acceptable agents of change than the first; in practice, such change usually has to wait until some kind of crisis coerces action. While Hague's remarks are primarily addressed to the UK situation, they would strike a chord of sympathy with the business leaders of

Japan who, last April, made a powerful plea for a radical redesign of the central administrative structure of the Japanese government. Among other things, they argued for a greater degree of co-ordination between the different ministries and agencies of the executive; and for a flattening of the pyramidal system of decision taking. Unless this is done - and done efficiently - then, according to the Keidaren - Japan's economic future may be put at risk.

We do not wish to imply that actions taken by national governments to overcome or reduce market failure are costless, or that such actions are necessarily the most cost effective way of achieving that objective.[22] At the same time, it is possible to identify the kind of situations which favour government intervention of one kind or another. Exhibit 1, which is derived and adapted from Robert Wade's evaluation of the role played by national administrations in fostering the economic development of Japan, Taiwan and Korea (Wade, 1988) sets out some of these situations, and the ways in which they may help reduce the transaction costs of governance.

While the data in Exhibit 1 are fairly self-explanatory, and provide a set of guidelines for governmental intervention, they have not yet been subject to rigorous scrutiny by scholars.

22 Among the possible failures of direct government intervention to successfully overcome the deficiencies of the market, one might mention the rent seeking activities of powerful pressure groups; the magnification of market failures (e.g., with respect to the supply of environmental or social products) by the news media or other politically motivated interests; the inability of governments to attract the best talents (due *inter alia* to ineffective incentive systems); the lack of commercial expertise and bounded rationality of public decision takers; the pursuance of non-economic (especially ideological) goals by politicians; the inadequacy of market related performance indicators which may lead to the establishment of sub-optimal standards (e.g., with respect to budgets, investment and control of information flows); the high-time discount (or short-termism) of political decision takers; the lack of market pressures to minimise X inefficiency, especially in the case of public monopolies; uncertainties and ambiguities inherent in the provision of goods and services, which are in the domain of governments, e.g., defense equipment, educational and health services; and the lack of a co-ordinated system of governance (c.f. with that in case of private hierarchies); and the difficulty of adjusting policies and institutional structures to quickly meet the needs of technological and economic change. For a more detailed examination of these and other factors which might lead to excessive or inappropriate governmental intervention or the suboptimal provision of public goods and services, see for example Wolf (1988), Grestchmann (1991), Stiglitz (1989) and Hämäläinen (1994).

The globalising economy may well enhance the need for such a scrutiny, as it increases the costs of misinformed or inappropriate government action.

6 Multilateral Action

I cannot end my presentation without at least the briefest of mentions of the implications of globalisation for the existing supra-national regimes of governance. If my thesis that governments are increasingly competing with each other for resources and markets to maintain or increase their living standards is correct; and, if, *de facto,* such competition tends to be oligopolistic, then, there is a real danger that the strategic rent seeking measures taken by individual governments might lead to a situation not unlike the "beggar my neighbour" restrictive trade policies of the inter-war years. For the last 40 years, GATT has helped set the rules of the game for trade. But, today the playing field of international competition is structured very differently. As we have argued in this presentation, it embraces many policy instruments of governments, which as much affect the capabilities of nations trade and compete with each other, just as much as the conditions underlying trade *per se.*

And, it is in pursuance of industrial, technology, taxation and competition strategies to advance national interests where the level of the playing fields is currently the most uneven. Again, *inter alia,* because of their unique business cultures, different countries have different interpretations of the fairness or otherwise of government interventions; hence - to give just one example - the strategic initiative talks between Japan and the US have been designed to try to reconcile some of the differences between the two nations in their interpretations of the legitimacy of government enabling measures.

The next decade is likely to see much written about the remoulding of international institutions such as GATT, the World

Exhibit 1: *Some Examples of Situations in which Governments might Successfully Contain their own Organisational Costs*

Intervention or Form of Government Intervention

- The enhancement of national competitiveness by market facilitating measures; and publicly promoting this objective
- The containment of interventionist policies to activities severely hampered by market failures
- A holistic approach to the co-ordination of complementary policies and institutional mechanisms
- An ethos of consensus and co-operation between private and public policy makers, e.g., with respect to mutually beneficial goals and the means by which goals can best be achieved
- The recruitment of the most talented and well motivated individuals for public sector employment, e.g., by offering competitive working conditions and encouraging initiative and entrepreneurship
- The insulation of the policy making process from the strongest (and most undesirable) pressure groups
- The presence of a national ethos or mentality of the need to be competitive and create wealth. Partly, this embraces a "commutarian" culture and partly one which encourages personal initiative, entrepreneurship, scientific specialisation and competition
- The absence of strong sectoral interest groups, e.g., farmers and left-wing labour groups, which might press for interventionist measures by governments other than those which are market facilitating

Consequences for the Reduction of Government Related Transaction Costs

- Reduces effectiveness of rent seeking special interest groups
- Increases work effort of public agents
- Makes policy trade-offs easier to identify and solve
- Clarifies policy makers' task and reduces problem of bounded rationality
- Reduces likelihood of sub-optimisation
- Captures economies of scope in governance and increases intra-organisational information flows and learning
- Reduces transaction costs of interaction between representatives of private and public sector
- Increases knowledge of public decision takers
- Reduces chance of uninformed or biased media coverage in forcing governments into ill advised or hasty decisions
- Likely to inhibit the pursuance of sub-optimal goals and to reduce bounded rationality and opportunism and use of inefficient production technologies
- Reduces the effectiveness of rent seeking by special interest groups, and relieves the policy making process from the pressure of day to day politics
- Favours co-ordination of strategies and policies of public and private organisations and reduces the sub-optimisation problem in the public sector
- Reduces possibility of ideological conflicts and undue emphasis being placed on the redistribution of incomes as a (short term) social good

Sources: Wage (1988), Stiglitz (1989), Grestchmann (1991), Hämäläinen (1994).

Bank, IMF and the UN so that they can better cope with the problems of globalisation - including those occasioned by the dictates of MNEs - which cannot easily be tackled or solved at a national, or even a regional, level.[23] Again, the role of national governments in championing their own causes will be a critical one. But, just as we have argued today, the kinds of restructuring of the organisation of markets and firms demanded by globalisation is impelling national governments to redesign their world of governance; so, too, the functions and authority of international institutions may need to be reconsidered if globalisation is to offer the fullest possible benefits - which a free exchange of people, goods and services demands.

23 For an examination of some of the issues involved, see particularly Ostry (1990), Preston and Windsor (1992) and Bergsten and Graham (1992).

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