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Article — Digitized Version

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Intereconomics

Suggested Citation: Nicolaides, Phedon (1992) : Industrial policy in an interdependent world: Promoting national markets or global firms?, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 27, Iss. 6, pp. 269-273,
<https://doi.org/10.1007/BF02928059>

This Version is available at:

<https://hdl.handle.net/10419/140373>

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Phedon Nicolaides*

Industrial Policy in an Interdependent World

Promoting National Markets or Global Firms?

In Europe and North America there are increasing calls for an industrial policy that would foster innovation and technological development. The advocates of industrial policy warn that without active government support national firms will succumb to unfair foreign competition and that there will be an irreversible weakening of their technological capacity. OECD countries already spend 2-3% of their GDP on direct subsidies to industrial production, investment and R&D.

Is more public spending justified especially now that capital is needed for the reconstruction of Eastern Europe?

For the purpose of industrial policy the distinction between national and foreign firms is both crude and irrelevant. It is crude because it does not take into account the blurring of national origin brought about by increasing foreign direct investment and cross-border corporate alliances. It is also largely irrelevant because the strengthening of a country's technological base and capacity to carry out fundamental research is not necessarily achieved by assistance only to national firms. In fact the optimum policy for that purpose is more likely to support immobile factors such as skilled labour rather than mobile factors such as capital. Although such a policy would not normally discriminate between firms on the basis of their nationality, it would also aim to remove foreign barriers to investment because competitiveness also depends on access to new technologies emerging in different countries. In the longer term, an end to subsidy races would require both multilateral controls on subsidies and the removal of barriers to investment and other distortions to competition.

Like the business cycle, policy issues also appear to follow a cyclical pattern. Talk of industrial policy is again becoming fashionable. During the 1970s most industrial countries attempted to stop the decline of their steel, shipbuilding, coal-mining, textiles and car industries through measures of direct support and market management. By the end of the decade it was grudgingly recognized that adjustment and shrinkage were inevitable. With that recognition came a lull in industrial policy, coupled with the ideological shift away from

interventionism that characterised economic policies in most industrial countries during the 1980s.

We have now entered a new phase of the policy cycle. The need for and the means of industrial policy are again actively debated.¹ As in the 1970s, the re-emergence of industrial policy has been prompted by a rise in the intensity of international competition. However, there are important differences in the industries which demand public support, the nature of perceived competition and the policy instruments which are being considered.

This time it is high-tech sectors such as electronics and telecommunications rather than the old smoke-stack industries that are under competitive pressure from their foreign rivals. Public support for these industries is advocated because of their strategic nature, the contribution to their countries' technological strength and because international competition is thought not always to be fair. Consequently, proposed policies aim as much to remove unfair foreign measures as to support the activities of recipient firms. High-tech firms argue that if they are to survive global competition they need to be able to enter unhindered the national markets of their competitors.

Why should we be concerned about industrial policy, especially now that the West is supposed to teach the East the virtues of free markets? The simplest reason is that, according to recent OECD estimates, the richest countries, despite all the free market rhetoric, still spend about \$50-60 billion per year in direct subsidies to their industries. Not only could that money be spent on other

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¹ Cf. OECD: Industrial Policy in OECD Countries: Annual Review, Paris 1991.

things (e.g. investment in Eastern Europe) but there are also increasing demands for shares of that pie. One of the consequences of the end of the cold war is that defence industries are seeking public support to convert their production lines to civilian uses. Perhaps more importantly, if current policies do not take into account structural changes in the world economy they will continue subsidising the wrong firms and for the wrong reasons.

An effective industrial policy presupposes that national firms can be meaningfully identified. Globalisation of production, growing foreign direct investment (FDI) and the expanding web of corporate alliances are increasingly blurring the national origin of both products and firms. As FDI multiplies the linkages between economies, two potential policy problems emerge.² First, any assistance to what is thought to be a national firm may leak and benefit other firms in other economies. Second, both the targets and instruments of public policy may have to be changed as a result.

This essay argues, somehow paradoxically, that the best industrial policy is a non-industrial policy. In general, the answer to fair or unfair foreign competition is not to prop up national firms. In a world increasingly integrated through FDI, industrial competitiveness and technological strength are more effectively promoted by measures which do not lend direct support to individual firms. Moreover, it would be in the long-term interests of

industrial countries to establish international rules to control public support; a kind of subsidy disarmament like the one recently agreed between the United States and the European Community concerning their aircraft industries. An end to subsidy races is even more imperative now that we are supposed to be facing a global capital shortage.

The Growth of FDI

Trade has traditionally been considered to be an "engine of growth", a source of competitive pressure on domestic industries and a force of integration bringing national economies closer together. FDI is increasingly assuming the same roles and is becoming a major factor of structural change. During the 1980s trade grew at about 8% per annum. During the same period, FDI achieved growth rates that for some countries reached almost 40% per annum.³ The average growth rate for the G-5 countries was 27%.

The world stock of FDI doubled during the 1980s, reaching over a trillion US dollars by 1990.⁴ Annual flows of both inward and outward FDI also doubled during the same period. By the end of the decade annual flows were in excess of \$100 billion.⁵ Given that annual flows are distorted by inflation, exchange rate movements and the business cycle, a measure of real flows is the ratio of FDI to GNP. By adding the ratios for the United States, Britain, France, Germany and Japan, Thomsen⁶ found that since the early 1960s outward investment has more than doubled.

According to one estimate,⁷ a very large proportion (87%) of the world stock of FDI (inward) is located in just seven industrial countries (USA, UK, Japan, Germany, the Netherlands, France and Canada). The four European countries alone are found to be host to 40% of the world stock of FDI. Other estimates, however, arrive at lower shares. At the lower end of these estimates is a recent report by UNCTC⁸ which put the cumulative share of the USA, the EC and Japan at 55% of total inward stock in 1987. The EC's share of the world inward stock of FDI was found to be only 26% (1987). A study by the US Department of

² These problems are in addition to the problems of ensuring that policies are cost-effective and that they are not neutralized by foreign government counteraction.

³ D. Julius: Foreign Direct Investment: The Neglected Twin of Trade, Occasional Paper 33, Group of Thirty, London 1991.

⁴ UNCTC: Foreign Direct Investment in the Triad, New York 1991; I. Akimune: Japan's Direct Investment in the EC, in: M. Yoshitomi: Japanese Direct Investment in Europe, London 1991.

⁵ UNCTC, op. cit.; P. Turner: Capital Flows in the 1980s, BIS Economic Papers 30, Basle 1991.

⁶ S. Thomsen: Integration through Globalisation, in: National Westminster Bank Quarterly Review, February 1992, pp. 73-83.

⁷ Cf. I. Akimune, op. cit.

⁸ Cf. UNCTC, op. cit.

PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

KONJUNKTUR VON MORGEN

Annual subscription rate
DM 135,-
ISSN 0023-3439

The short report on domestic and world business trends and raw material markets published every fortnight by HWWA-Institut für Wirtschaftsforschung-Hamburg

VERLAG WELTARCHIV GMBH – HAMBURG

Commerce (1991) arrived at higher figures. The share of the seven countries was 61.3%, that of the United States, EC and Japan was 63.8% (28.6%, 34.5% and 0.7%, respectively), while that of the four European countries alone was 24.7% (1989). In fact the American study reported the world stock of FDI as having tripled during the 1980s, from \$505 billion in 1980 to \$1403 billion in 1989.

Despite the impressive growth in FDI, these statistics understate the true extent of foreign involvement in national economies. A phenomenon of equally unprecedented magnitude is the expanding web of global corporate alliances. In Western Europe and North America there is hardly a car manufacturer, electronics company or a telecommunications firm without some kind of joint venture (e.g. collaborative research, subcontracting and OME agreement or joint distribution) with one or more foreign firms. The more popular business literature is replete with accounts of yet more corporate alliances. Hagendoorn⁹ attempted to count and classify inter-firm agreements in technological cooperation. He found that the total number of such agreements grew from 153 in 1973-76 to 1936 in 1985-88. Hagendoorn and Schakenraad¹⁰ also found that inter-firm agreements for exchange of technology are more prevalent between firms of different nationalities than between firms of the same nationality.

These cross-border corporate alliances suggest that foreign involvement in national economies is more subtle but no less potent. Foreign firms have an impact on national economies without necessarily exercising explicit control over national firms. Such alliances are, of course, reciprocal relationships. Host countries also have an impact on home countries without having to undertake any explicit cross-border investment. These alliances strengthen the linkages and precipitate the leakages between national economies.

The Effect of FDI on Industrial Policies

To understand how FDI may have a bearing on the effectiveness of industrial policy it is necessary to ask, first, whether public assistance is dissipated or absorbed by recipients other than the intended ones and, second, whether policies have any perverse results which be may the opposite of the intended ones. To make the task of this essay manageable, it is assumed that industrial policy instruments are only those that provide direct support to someone (factor or firm) or something (activity or operation).

⁹ J. Hagendoorn: Organisational Modes of Inter-firm Cooperation and Technology Transfer, in: *Technovation*, Vol. 10, 1990, pp. 17-30.

¹⁰ J. Hagendoorn and J. Schakenraad: *New Explorations in the Economics of Technical Change*, London 1990.

We can now turn to the first question. It is clear that the more general and the more open the domestic support policies, the greater the benefit that foreign firms would be able to derive from them. For example, general subsidies to training, favourable tax treatment of non-traded services, general tax concessions on certain investment activities would benefit all firms operating in a market irrespective of national origin. Furthermore, foreign firms would derive a greater benefit, the more closely involved they are with domestic firms.

It follows that general and non-discretionary measures of support would benefit foreign investors as much as they would benefit domestic firms. It also follows that when such measures are specific and discretionary, foreign firms can benefit only to the extent that they can become involved in the activities of the favoured firms.

If, therefore, industrial policy in the form of general support measures is intended to enhance the international competitiveness of national firms, its effectiveness will decline as FDI increases. Indeed, to some extent they are "self-destructive" because they attract FDI. If such measures are to remain effective they would need to be targeted more selectively. There immediately emerges the policy dilemma of choosing between general and selective policies. This dilemma is caused by the fact that selective policies which may stop leakages may also give backing to the wrong firms in terms of efficiency and potential for innovation.

Of course, industrial policy is not only used as a means of improving corporate competitiveness. It can also aim to correct market failure. In general, market failure is not exclusively linked to particular firms or particular products. It is more likely to be linked to (a) the size of the market in relation to available technology and (b) the performance of certain activities such as services and research whose costs and benefits may not be completely internalisable (externalities) or which may be prone to problems of asymmetric information. Again, foreign firms established in the domestic market would normally be able to take advantage of general programmes whose aim is to correct market imperfections. They would also be penalised as much as domestic firms by general restrictions and prohibitions (e. g. regulation of transport services).

This brings us to the second question of whether industrial policy can have perverse results (opposite of the intended ones). The answer is yes because public assistance may also constrain the actions of recipient firms. The most obvious, and perhaps most rigid, constraint is state ownership. States own "important national assets" in order to safeguard them and promote their development. Public ownership, however, with its

controls on capital borrowing and corporate strategy may prove to be no panacea when rival firms are free to form cross-border alliances and raise capital in international financial markets.

Similar effects may be caused by other forms of intervention. Even "soft" forms of industrial policy such as guidance and coordination of investment objectives may still lock the firms involved in outdated schemes or with the wrong partners, especially if partnerships are conceived as a means of cross-subsidising weak firms (such as the recent French plan to create an electronics-to-nuclear-energy conglomerate). In general, the constraints which may accompany government involvement may prevent assisted firms from gaining access to foreign technology through international partnerships. In an age where national boundaries have to be transcended, if a firm is to remain competitive, forcing a firm to retain its national character may also have a negative impact on its competitiveness.

To summarise so far, the presence of foreign firms which produce in the local market and collaborate with local firms may generate the following policy dilemmas. First, they would benefit from general measures of assistance, thereby neutralising any advantages domestic firms might have enjoyed before direct investment occurred. Second, a shift from 'general to selective measures raises the problem of choosing the firms with the highest potential. Third, selective measures become less justifiable as more foreign firms expand their operations in the domestic market. Fourth, selective measures accompanied by controls on the recipients' national character may reduce their ability to gain access to foreign markets and technology and to collaborate with the most suitable partners, which may happen to be foreign.

Objectives of Industrial Policy

The crux of the policy problems outlined above is that multinational firms are mobile. In essence, what the government would need to consider is not whether to assist national firms or not, but whether to support the immobile factors of production instead of the mobile ones. In other words, the choice is between supporting the location of production rather than firms. And, if it is the location which is supported, it also has to be decided whether particular activities within an area are favoured more than others. These options (national vs. foreign, firms vs. location – i. e. mobile vs. immobile –, location vs. activities) are not necessarily mutually exclusive. Nevertheless putting these choices in such a stark relief helps bring out issues of relevance to the conduct of industrial policy in the presence of foreign firms.

Discrimination in favour of national firms is often advocated because they are thought to do more "real" manufacturing than foreign firms by generating more value-added. But to rationalise assistance to national firms on these grounds would result in a very crude policy. Such a policy would ignore that not all activities of domestic firms are worth, or need, supporting and that some foreign firms may also be eligible for assistance. Even firms which are closely identified with particular countries (e. g. Philips, Olivetti, Ford) do not manufacture all their products in their home markets. In fact some of the products bearing their brand names are manufactured abroad by their main competitors. It may be concluded, therefore, that all similar firms which do similar things should be eligible for the same kind of public support irrespective of their national origin.

A policy which does not discriminate between the national origin of firms in a given location has several advantages over a discriminatory policy. First, it runs a lower risk of backing the wrong firms. Second, it does not distort competition among firms in that location. Third, it may attract firms from other locations. Nonetheless, even such a policy would still beg the question why the government should intervene at all? If industrial policy is conceived as a remedy to market failure then, with one exception examined later on, it would not normally discriminate between firms of different nationality.

An important advantage of supporting particular activities (instead of firms or locations) is that such an approach would get closer to the sources of market failure because it is the nature of certain activities that causes market failure and because such activities normally transcend individual firms. In addition, it would not have to determine whether foreign firms do "enough" manufacturing to be considered eligible because eligible recipients of assistance would have to be involved in the activity targeted by the policy (e. g. training, R & D). Moreover, any leaks to other countries would probably be less serious because foreign firms would "pay" for received benefits by undertaking the targeted activity.

Given that support of activities inadequately provided by the market is the least interventionist and least discriminatory of the three pairs of options outlined above, it would also miss opportunities of exploiting particular national strengths to extract rents from international markets (e. g. helping firms with new technologies to dominate world markets). As with other strategic policies, an industrial policy of actively promoting national champions should not be assessed on the basis of the few conspicuous missed opportunities but on the basis of the many other less obvious ways that policy can support the

wrong firms with the wrong instruments and for the wrong purposes. Given that the more selective the policy, the more closely it is determined in conjunction with the favoured firms, the more likely that it is shaped according to the narrow interests of those firms.¹¹

In principle, however, a policy of non-discrimination may even in the long term be suboptimal when distortions originate in foreign markets. So far it was assumed that the aim of industrial policy was to correct distortions originating in the domestic market. But industrial policy is often advocated as a shield against predatory, unfair or otherwise discriminatory investment practices and policies in other countries. How should industrial policy respond to unfair or interventionist policies in other countries?

Responding to Foreign Barriers

Much of the panoply of GATT-permissible instruments that most countries have in dealing with unfair practices and policies apply to the cross-border trade of goods. If the Uruguay Round is successfully concluded additional disciplines will cover the trade of services. The currently negotiated rules on trade-related investment measures (TRIMs) are largely confined to performance requirements (e. g. minimum local content). Hence, there are currently no multilateral rules and processes either for removing barriers to direct investment or for defining and preventing unfair investment (an exception is the OECD voluntary code on the treatment of foreign companies).

Industrial (and trade) policies do take into account foreign obstacles to imports. Should they also take into account foreign obstacles to inward investment? It is true that if foreign firms operate from within closed markets they may have an unfair competitive advantage over domestic firms. For example, a foreign monopolist, operating from a protected market, could afford to export its products at a lower price or buy a company at a higher price by cross-subsidising its costs with excess profits from its home market. But barriers to investment do not necessarily translate into excess profits when foreign firms compete vigorously against each other. They may, nevertheless, translate into a one-way flow of capital and technology which in the long term may have the following negative impact on the industrial capacity of more open countries.

If, as a result of foreign barriers to FDI, foreign firms have exclusive access to new technologies and if domestic firms do not succeed in being innovative enough, the foreign firms may edge out of the market their domestic rivals by selling cheaper and/or better products. This may force domestic firms into bankruptcy. Once local corporate

R&D operations are disrupted there may be a knock-on effect on the country's scientific and technological capability and a vicious circle may set in whereby foreign firms invest only in low-skill operations.¹² A similar effect may take place when the high-tech exports of a country encounter foreign trade barriers. Foreign trade barriers may ultimately weaken the exporter's ability to keep up with the international technology race.¹³

What should be the policy response in this case? The appropriate policy is unlikely to be in the form of retaliatory restrictions on FDI because they would impose considerable costs on the domestic economy. The first-best response would be to seek the removal of the foreign restrictions. If their removal cannot be achieved through negotiations the next best option would be to support the development of technology which is not easily accessible by domestic firms and which cannot be effectively developed privately (because of uncaptured externalities). Such a policy would support particular research projects rather than firms. Participation by foreign firms would not necessarily be obstructed, provided that they contribute as much as other firms. In effect, there may be legitimate reasons for an active trade policy seeking to remove barriers to FDI and to level the playing field. Nonetheless, foreign direct investment in itself is unlikely to weaken the host country's industrial capacity.

Conclusions

The discussion above leads to four conclusions. First, general measures of industrial support are likely to be dissipated as both inward and outward FDI expand. Indeed, such measures would tend to function as investment incentives. Second, non-discriminatory measures which target activities rather than firms are probably more effective and less wasteful because they are more likely to address directly market failure. Third, when foreign barriers to inward investment distort competition and threaten a country's technological base, the appropriate policy is to support the development of comparable home technology rather than to restrict FDI. Finally, the best long-term option is the establishment of multilateral controls on subsidies coupled with the removal of barriers to FDI and other distortions to competition.

¹¹ For a review of the arguments cf. D. Richardson: *The Political Economy of Strategic Trade Policy*, in: *International Organisation*, Vol. 44, 1990, pp. 107-23.

¹² J. Cantwell and J. Dunning: *MNEs, Technology and the Competitiveness of European Industries*, in: *Außenwirtschaft*, Vol. 46, 1991, pp. 45-65.

¹³ D'Andrea L. Tyson: *Managed Trade*, in: R. Lawrence and C. Schultze: *An American Trade Strategy*, Washington, DC 1990.