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International Handbook on the Economics of Integration, Volume III

Factor Mobility, Agriculture, Environment and Quantitative Studies

Edited by Miroslav N. Jovanović

INTERNATIONAL HANDBOOK ON THE ECONOMICS OF INTEGRATION, VOLUME III

ALSO FROM EDWARD ELGAR

International Handbook on the Economics of Integration Volume I
General Issues and Regional Groups
Edited by ***Miroslav N. Jovanović****, Economic Affairs Officer, United Nations Economic Commission for Europe, Geneva, Switzerland and Lecturer, European Institute of the University of Geneva, Switzerland*

International Handbook on the Economics of Integration Volume I covers two broad themes: general integration issues and regional integration groups. The first part discusses topics that range from an overview of the regional integration deals registered with the World Trade Organization, to multilateralism and regionalism, hub-and-spoke integration networks, limits to integration, rules of origin, and globalization. The second part is devoted to an outline of the principal integration arrangements in Europe, the Mediterranean, North and Latin America, East Asia and sub-Saharan Africa, as well as economic integration efforts throughout the Arab world.

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International Handbook on the Economics of Integration Volume II
Competition, Spatial Location of Economic Activity and Financial Issues
Edited by ***Miroslav N. Jovanović****, Economic Affairs Officer, United Nations Economic Commission for Europe, Geneva, Switzerland and Lecturer, European Institute of the University of Geneva, Switzerland*

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Let each of you look out not only for his own interests,
but also for the interests of others.
Philippians 2:4

Својим синовима Јовану и Николи

Στους υιούς μου, Γιάννη και Νικόλαο

Ai miei figli, Jovan e Nikola

To my sons, Jovan and Nikola

Contents

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Foreword

Economic integration at the international level used to be a European specificity; this explains why a European Institute has a major interest in supporting a handbook on international economic integration. Alongside the development of theories about international economic integration initiated in the 1950s, the European Economic Community, launched in 1957 among six (Western) European states, very soon appeared as the practical exercise designed for implementing such theoretical concepts. Thus economic integration is a strong element at the heart of European studies.

The Geneva University European Institute aims at understanding the great transformation of Europe, and not only the development of the European Community (EC) or the European Union (EU), while acknowledging the pre-eminence of the integration process driven by the EU in this evolution. European integration, even though initially based on the promotion of economic integration, also covers a much wider scope of human activities, spilling over into legal, political and even societal issues. This is why, since 1963, European studies at the University of Geneva have been pooled in an interdisciplinary institute; economic integration – even though a fundamental and necessary parameter of wider integration – is thus, and remains, closely interlinked with other societal factors. Interdisciplinary studies, however, in no way prevent comprehensive disciplinary efforts, such as the present Handbook.

International economic integration, for its part, changed gear in the late twentieth century, after the failure of the socialist model. In Europe naturally, where socialist countries of the Central and Eastern part of the Continent have been called to join the European integration process (EU), but also beyond Europe. This geographical spreading of international economic integration actually took two forms, both consequences of the undisputed dominance of the liberal model. The first one is globalisation, a phenomenon – whose anatomy is studied below by the editor of the Handbook – largely accelerated by both the development of new technologies and the conclusion of the Marrakesh Agreements of 1994, which closed the Uruguay Round and created the World Trade Organization (WTO). The second form consists in the realisation of numerous cases of regional economic integration, the latest example being the coming into force on 1 January 2010 of the free trade area between China and ASEAN; it follows the realisations of MERCOSUR, NAFTA, ECOWAS and other regional regimes. Both processes involve international economic integration, even though sometimes in contradictory terms – as is shown by the tensions existing between Articles I and XXIV (5) of the GATT Agreement (see the contribution by Lipsey and Smith on that issue, Vol. I, ch. 3). Thus the issue of international economic integration has to be conceptualised anew and analysed with regard to all these recent developments.

Since 2008, the European Institute of the University of Geneva has had the privilege of counting among its lecturers Dr Miroslav Jovanović, editor of this three-volume Handbook. His enthusiasm for teaching and the wide network of contacts he entertains throughout Europe and the world allowed this ambitious project to turn into the book you are holding. Not only a learned scholar, Dr Jovanović also holds a position at the

UN Economic Commission for Europe (UNECE), a UN subsidiary body dealing with economic issues within Europe as a whole. Thus my colleague has both an extraordinary observation position – at the heart of the most advanced regional economic integration process going on in Europe – and the proper distance for academic observation, since UNECE is not directly part of the mainstream process of the economic integration taking place within the EU, and Switzerland is not a member state of the EU.

Thus, Geneva is a highly interesting place for undertaking the work of editing such a handbook. Not only because it is the seat of the WTO, a focus point for trade liberalisation regimes, but also because it is the seat of numerous other international organisations (ILO, WHO, WMO and ITU among others), all closely linked to the ongoing global economic integration, which reaches far beyond international trade. Thus an 'economic-plus' integration process may, perhaps, be at work – in a form yet to be determined – at the world level, perhaps based on lessons learned from the most successful regional economic integration processes. Too soon to tell, of course; but if it has to be observed, it could well be in Geneva, by Dr Jovanović and the 'dream team' of economists he has gathered together to contribute to this Handbook. The European Institute at the University of Geneva is therefore proud and happy to be associated with this project. All my thanks to my colleague Jovanović for the contribution he thus brings, both to the understanding of the international economic integration process and to the academic renown of the European Institute of the University of Geneva.

Nicolas Levrat
Director of the European Institute
of the University of Geneva

Introductory note

Regional economic integration has the potential to complement national development strategies and to address some of the longstanding structural weakness of many developing and least-developed countries. UNCTAD research shows that integration – when implemented within a broader development strategy that promotes economic and trade diversification, structural changes and technological development – may enhance productive capacities, realise economies of scale, help to promote technology transfer, create new markets and improve competitiveness. Through the development of regional trade integration, firms can boost their competitiveness and diversity export markets. Regional economic integration can, therefore, be a launch pad for the effective participation of developing countries in the global economy.[1]

These days, regionalism has forcefully returned to the forefront of attention. One reason for this has been the slow progress in the Doha Round of multilateral trade negotiations that has led countries to increasingly pursue regional agendas. However, the benefits of regional integration cut deeper than this – as is clear by the evidence linking regional integration with economic growth and poverty reduction. One thinks in particular of the experience of economic and political integration in Europe; and of the differences in economic performances of the Asian region, where regional trade accounts for a very high proportion of total trade and economic growth has been rapid, compared to some countries in Africa, where regional trade accounts for less than 10 per cent and growth has been slow or even stagnant.

Trade is essential for regional integration and cooperation to support the development policy agenda, and it has to extend beyond trade liberalisation. It needs to include policy areas that strengthen the potential for growth and structural change in developing countries. These include macroeconomic and financial management, as well as trade support and industrial policies.

There is a considerable body of economics literature, mostly in the branch of international trade theory, which views regionalisation with alarm and sees it as the result of trade-diverting agreements which threaten to undermine the global trading system. Such agreements may have played some role in boosting regional trade at the expense of multilateral transactions, but it is far from clear that this is inevitably the case; indeed, there are a number of more fundamental forces at play that tend to be ignored by mainstream trade theory. Regional trade in Europe, North America and, increasingly, in East Asia is largely dominated by intra-industry exchanges of intermediate manufactures and capital goods, and these reflect a very high degree of specialisation in the various stages of the manufacturing production process. Intra-industry trade has the propensity to be most intense among industrialised (or industrialising) countries at similar levels of

[1] UNCTAD (2009), *Economic Development in Africa Report*, United Nations, New York and Geneva, UNCTAD (2007), *Trade and Development Report 2007: Regional Cooperation for Development*, United Nations, New York and Geneva.

development and is driven by dynamic economies of scale and specialisation and by the search for long production runs. These processes tend to generate economies of agglomeration and to trigger cumulative patterns that reinforce the degree of concentration over time.

Once such processes are under way there will be pressure from producers within the region to lower or remove the various barriers to intra-regional trade, including bureaucratic red tape, conflicting legal restrictions and administrative procedures and so on, as well as demands for better transport and communications infrastructure. These various demands are likely to be accompanied by the creation of institutions for closer regional cooperation, as has happened, for example, in Western Europe. At first, such cooperation will tend to focus on technical issues (trade barriers, standards and the like) but as regional production systems become ever more integrated, so the regional policy framework is likely to expand.

With these underlying processes in mind, it seems clear that regional economic integration can contribute to generating development prospects in a wide range of areas. It can improve development prospects in terms of physical infrastructure, which is often missing or of poor quality in developing countries. Road, rail or air transport are areas where cooperation on major investment projects can help reduce bottlenecks in public infrastructure. Energy and water supply are other cases in point. The first Union of South American Nations (UNASUR) Summit on Energy held in 2007 was a successful experience promoting energy integration in the region.

In the context of regulatory and institutional cooperation, regionalism can also help address those areas which present today's central development challenges. Cooperation in the regulation of infrastructure services sectors can facilitate the supply of energy or water to the poor and marginalised by creating economies of scale that contribute to extending the coverage of services at lower costs.

Cooperative regional arrangements on monetary and financial aspects, such as the Chiang Mai initiative, provide valuable tools for the stabilisation of intra-regional exchange rates, and thereby reduce their potential to serve as a source of instability or as a transmission mechanism for global shocks. The Bank of the South (Banco del Sur), recently established by seven South American countries to finance projects in agriculture, energy and health care for member nations and to enhance trade, is yet another example. Cooperation in areas related to migration and the movement of people, the protection of the environment or the management of river basins provide further evidence. Other areas in which regional integration may also bring substantial improvements are education, research and development, and transfer of technology.

South–South cooperation has also been deepened on agriculture, rural development and food security, for instance: the Comprehensive Africa Agriculture Development Programme (CAADP);[2] the New Partnership for Africa's Development (NEPAD), the Council of Agriculture of South America (CAS); and the ASEAN Integrated Food Security (AIFS) Framework and the Strategic Plan of Action on ASEAN Food Security (SPA-FS) adopted by the 14th ASEAN Summit in 2009.

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[2] UNCTAD, 'The role of South–South and triangular cooperation for sustainable agriculture development and food security in developing countries', TD/B/C.II/MEM.2/5, 2009.

In UNCTAD we have a particular interest in regional integration on trade, an area which has been highly dynamic over the last decades. Since the 1990s there has been a proliferation of regional and bilateral free trade agreements (FTAs) or preferential trade agreements (PTAs) between developed and developing countries. The number of currently operational regional trade agreeements (RTAs) notified to the World Trade Organization (WTO) has risen from fewer than 100 in 1995 to more than 225 in 2009. Consequently, more than half of world merchandise trade, and a significant portion of trade in services, fall under regional trading regimes.[3] The scope of RTAs has evolved significantly over time. The newer generation of RTAs – characteristic of the so-called 'new regionalism' – has wider coverage, going beyond just tariff measures to include deeper 'behind-the-border' regulatory policy measures, such as services, investment, competition policy, government procurement and labour mobility, as well as such non-trade policy commitments as current and capital account opening. The financial and economic crisis has accentuated the vulnerability of countries that have made broad and deep commitments through RTAs.[4]

There are numerous reasons for developing countries to negotiate RTAs: to secure market access, to obtain preferential concessions or to overcome stalemate in the Doha Work Programme. Nevertheless, RTAs, particularly when undertaken on a North–South basis, also present multiple – sometimes difficult – choices for developing countries. RTAs may require sharp tariff reductions (which can expose domestic manufacturers to overwhelming competition), include the WTO 'plus issues' (for example, competition, investment or government procurement), replace special and differential treatment with full reciprocity or even lead to preference erosion.[5]

Hence, in assessing the possible economic and social benefits and costs of entering into North–South bilateral or regional FTAs, developing countries should not only look at the potential changes in exports and imports arising from new or more secure market opening but also consider the impact of such agreements on their policy options and instruments for longer-term development.

In the years from 1995 to 2007, trade growth in developing countries doubled its ratio to GDP, reaching more than 50 per cent of developing-country domestic output – illustrating the importance of trade as a channel of finance for development. In particular, South–South trade between developing countries increased by more than three times its 1995 level, reaching almost 46 per cent of their total trade in 2007. These trends helped developing countries to diversify production and create new trade and investment flows.

Linking South–South trade to structural transformation will pose different policy challenges for different groups of countries. For African economies, South–South trade offers opportunities for diversification away from commodity dependence, and perhaps

3 Roberto Fiorentino's chapter in this Handbook (Volume I, ch. 1) entitled 'The never-ending story of regional trade agreements', examines recent developments in RTA proliferation.

4 UNCTAD, 'South–South cooperation and regional integration: where we stand and future directions', TD/B/C.II/MEM.2/2, 2008.

5 See the chapter by Richard G. Lipsey and Murray Smith in this handbook (Volume I, ch. 3), entitled 'Multilateral versus regional trading arrangements: substitutes or complements?', for an examination of the political economy dynamics of RTAs.

more so than their trade with the North, although this is likely to vary across product groups. It also offers some middle-income economies in Asia and Latin America an opportunity to avoid producing only relatively unsophisticated manufactured goods. Moreover, new opportunities might be emerging for those developing countries, which export higher value-added, technology-intensive products.[6]

The recent financial and economic crisis has forced Northern economies to undertake large-scale adjustments (at the household, government and national levels) and to correct the massive financial imbalances that have built up over the last few years. This has slowed down consumption and growth in these economies, and it has also exposed the dangers of relying too heavily on Northern economies as main trading partners. These developments suggest that Southern trade, as both a vent for surplus and a source of diversification and upgrading, might take on an even greater importance over the coming years.

Expanding these opportunities will not come automatically, it will depend on renewed cooperation among countries of the South. In this respect, South–South trade should not be approached as a stand-alone engine of growth, but as part of a broader set of interdependent challenges involving investment, structural changes and technological upgrading.

The area of international investment has also seen important developments at the regional level. In the case of East Asia, a close association between the pattern of industrialisation and its regional location had been linked with the upgrading of economic activity from resource-based and labour-intensive industries to more and more sophisticated manufactures by the lead economies, which in turn has opened up opportunities for the less-developed neighbouring countries to enter the regional division of labour by engaging in less-demanding activities.

To stay ahead, the countries in the first tier of development have been forced to move up the trade hierarchy and export more sophisticated products where they now have a comparative advantage, with foreign direct investment (FDI) providing one possible route for recycling comparative advantage. This idea of a regional division of labour, combining an industrial and locational hierarchy, has been described as the 'flying-geese' development paradigm. Within this paradigm, government policy has been central to the regional impact of FDI, and when drawing wider lessons from this experience, it should not be forgotten that much of the international spillovers within East Asia have been ultimately generated because of the success of the industrial policy of the first-tier newly industrialised economies, rather than through a purely market-generated process.[7]

UNCTAD, which is the focal point within the United Nations Secretariat for matters related to FDI, is collecting – and disseminating – data on investment rule-making at the regional level. The number of BITs – bilateral investment treaties – has risen rapidly across the world. From 388 in 1990, the number at the end of 2008 reached a total of 2,676. Among developing countries, Asia led the conclusion of BITs, with 31 new BITs in

[6] UNCTAD, 'Making South–South trade an engine for inclusive growth', Policy Brief 8, November 2009.

[7] UNCTAD has provided an extensive discussion of the East Asian model of development in its Trade and Development Reports, in particular those in 1994, 1996 and 2003.

that year alone. However, just how successful BITs are in attracting FDI remains an open question, and further research is needed on this issue, including on whether such treaties involving developing countries carry clear advantages. Besides BITs, international investment rules are progressively being adopted as part of regional, inter-regional and plurilateral trade agreements. These agreements have been multiplying steadily (287 by the end of 2009). Again, a large majority of agreements – about 87 per cent – have been concluded since the 1990s. Until the late 1980s, investment facilitation through these agreements remained confined mainly to intra-regional processes involving countries at similar levels of development, albeit with a few exceptions (such as the agreements between the European Community and developing countries). Since 1990, however, countries and groups located it different regions have concluded trade and investment agreements with one another, involving both developed and developing countries.

The spreading of these types of agreement has been one of the key developments in international economic relations in recent years. These 'other IIAs' are particularly relevant as they manifest a trend towards a more integrated approach when dealing with interrelated issues in international investment rule-making. Their greater variation presents an opportunity for experimenting with different approaches and accounting for the special circumstances of countries in different regions and at different levels of economic development. At the same time, their complexity increases and so does the likelihood of overlaps and inconsistencies between provisions. Over time, the negotiation of these agreements has created a multifaceted and multilayered system of overlapping – and sometimes also contradictory – rules.

All these and many more, are good reasons for the development community to take a careful look at the state and prospects of regional cooperation and economic integration today. In UNCTAD, we attach great importance to the close collaboration with academia, creating useful linkages between policy making and theory. Studies like this International Handbook are, therefore, a major achievement and I would like to thank all the participants for the hard work and congratulate everybody for the impressive contributions they are making to this welcome endeavour.

Petko Draganov
Deputy Secretary-General
UNCTAD

Preface

The importance of international economic integration is well recognised. It has touched most of the countries in the world and has become an unavoidable element in most national economic policy decisions. In fact, most countries have attempted to integrate with others, creating a global 'spaghetti bowl' of trade regimes and agreements. The biggest and deepest achievements in integration have been among the developed countries, in particular in Europe. Countries in other regions of the world have tried to copy, both formally and informally, certain integration accomplishments that took place in Europe, but with varying degrees of success.

Policy makers usually had a favourable view regarding integration. They attempted to use economic integration as a means for securing access to a wider market, to locate certain production (and employment) within the confines of their influence and to reinforce growth in order to achieve a higher level of national welfare. The global credit crunch (2007–08) and the related global economic recession were followed by a wave of 'economic nationalism' in the form of 'buy domestic' campaigns, in which many countries throughout the world introduced direct and indirect protectionist measures. This was compounded by a continuing stalemate in the Doha Round of multilateral trade negotiations under the auspices of the World Trade Organization. International economic integration and the multilateral trading system suffered a temporary setback. None the less, international economic integration remained an attractive longer-term economic strategy for most countries. In fact, in the longer term there may be several bigger integration groups in the world that will deal with one another.

The process of international economic integration has been characterised by several factors since the mid-1990s:

- A rapid increase in the number of integration deals among countries. This is compounded by continuous problems and a lack of progress in the Doha Round of multilateral trade liberalisation negotiations.
- A deepening and widening integration in the European Union (EU) and, to an extent, in North America and south-east Asia.
- Various forms of economic integration between developed countries in Europe with less-developed ones in Central and Eastern Europe; as well as between the United States and Canada with Mexico, a country that is still in the process of economic development; and similar North–South integration efforts in South-East Asia.
- A change in economic policies in the developing countries towards more outward-looking models.
- Progress in technology and changes in demand which create new opportunities and challenges for theorists, policy makers and business executives. As a number of economic activities became fragmented, 'footloose', highly mobile in space and internationally connected, one of the most demanding and intricate questions in such a situation is where would firms and industries locate, relocate or stay? Where does international economic integration take place in these circumstances?

- A transformation of contemporary economies from commodity manufacturing to knowledge-based economies.
- Last but not least, is a massive international relocation of manufacturing towards China, in spite of integration efforts elsewhere.

The objective of this three-volume Handbook is to offer an insight and introduction into the principal contemporary economic issues linked with international economic integration. The literature on the various strands of the issue started in the 1950s in the works of Jacob Viner, Jan Tinbergen, James Meade, Helen Makover, George Morton, Tibor Scitovsky, Franz Gehrels, Richard G. Lipsey and Harry G. Johnson. It continued its evolution during the 1960s. Integration seemed to be an almost dead research issue during the 1970s and until the mid-1980s. Then, the EU's Single European Market Programme (1985–92) for the opening of the internal market in the Union prompted a flow of studies on various aspects of economic integration, mainly in Europe, but also elsewhere, which has evolved enormously. In addition, the European Monetary Union started in 1999. This system is not based on gold, but on a strong (so far) political promise on paper. Apart from wars and the collapse of the centrally planned economic system, this was the most important economic and political event in Europe since the Bolshevik Revolution (1917). A growing number of countries have already entered or intend to join the eurozone.

Contributors to this three-volume Handbook not only survey the literature (look backwards), but also present their own arguments and do not shy away from new ideas and concepts in order to offer a perspective (look forward), as well as explain the issues they think essential for the field. This permitted a constructive interplay between theory and future policy. Each chapter is followed by a summary, hence the reader has a concise overview of its subject matter. The reader cannot fail to notice the impression that a large number of the chapters are 'Eurocentric'. That should come as no surprise as international economic integration has so far the deepest meaning in Europe. However, other regions of the world have not been neglected. As such, it is expected that this Handbook will contribute to a better understanding of the role of international economic integration in economic research and practice.

The salient feature of international economic integration covers such a wide array of topics that it is not possible to do justice to many of them. Those who have tried to edit a volume would soon have recognised that the choice of fields to be covered and contributors ought to mix idealism, pragmatism and time. Our intention, however, was to offer important insights into the most relevant issues for the understanding of the role and influence of international economic integration on the economy. Therefore, this Handbook of readings aims to provide no more than an introduction to the subject, to give a theoretical and analytical framework to the reader, to provoke research curiosity, and to present select analytical studies.

I believe and hope that the *International Handbook on the Economics of Integration* will prove useful to scholars, students, civil servants, business executives and others in widening their knowledge and increasing their awareness of the process of international economic integration in the economy of today and tomorrow, as well as stimulating further research.

Acknowledgements

My involvement in international economic integration began when I was studying European integration at the University of Amsterdam (1980–81). That was the period when integration seemed to be a dead academic and research issue in economics and I had serious doubts as to whether the choice of my specialisation was correct. None the less, subsequent developments, in particular following 1985 (the Single European Market Programme from 1993, the European Monetary Union from 1999 and enlargements of the European Union) proved the contrary. A new boost of my involvement in international economic integration came when I succeeded my distinguished teacher and colleague Professor Victoria Curzon Price as a lecturer at the European Institute of the University of Geneva, following her retirement in 2008. The Institute provided a simulating and fully supportive academic environment for teaching and research. This Handbook was written under the auspices and with the full backing of the Institute.

Over the years I have profited from discussions with and the help of many friends and colleagues worldwide. However, I owe a special debt of gratitude for inspiration, support, comments and criticism to my distinguished teachers Professor Victoria Curzon Price and Professor Richard G. Lipsey. I also express my warmest thanks to all contributors to the Handbook for their involvement, advice and constructive criticism.

The contributors to this three-volume Handbook come from a wide variety of countries and are both seniors and juniors, hence they represent both wide geographical space and various generations of scholars.

Special gratitude is due to the European Institute of the University of Geneva and its Director, Professor Nicolas Levrat and his team for their full support of the project, all the necessary encouragement and valuable input. Dušan Sidjanski, Professor Emeritus at the University of Geneva and Special Adviser to the President of the European Commission also provided useful comments and suggestions.

I would like to record my appreciation for the support given to the Handbook by the late Professor John H. Dunning. I had the privilege and joy of working closely with him during 1989–92 on the project in the United Nations Library on Transnational Corporations in New York. He kindly accepted the invitation to contribute to the Handbook, and subsequently produced a chapter with Dr Jeremy Clegg, which appears here in Volume III. We are all saddened by his loss.

I am also grateful to Edward Elgar for the invitation to edit this Handbook and to his helpful and enthusiastic team which included Nep Elverd, Alexandra O'Connell, Laura Seward and Nicolas Wilson. The volume was superbly edited by Margaret Pugh. *Un ringraziamento va a Marina Rossi che mi ha aiutato senza saperlo*.

I would also like to thank the United Nations Economic Commission for Europe for the authorisation to accept Edward Elgar's invitation to edit this Handbook.

I am grateful to all of them. The usual disclaimer, however, applies here: I am solely responsible for all shortcomings and mistakes. In addition, the views expressed are my own and do not necessarily reflect those of the organisation in which I work.

Miroslav N. Jovanović
Geneva, January 2011

Introduction

International economic integration is a process by which countries merge into larger entities in order to increase their national and/or group's welfare. The objective of the theory of international economic integration is to discover the economic rationale and determinants for the process, to explain and try to shape its evolution, as well as to provide tools for the measurement of its impact on welfare. However, theoretical consideration of economic integration is complex, because integration both promotes and restricts trade and factor mobility at the same time. Trade (and factor mobility in certain types of integration) is liberalised, at least in part, among the participating countries, while at the same time it is restricted and distorted between the integrated group and the rest of the world. Hence, international economic integration may be regarded in certain circumstances as a kind of inward-looking economic strategy for the participating countries (at least and hopefully only during the initial phases of integration).

The basic types of international economic integration are given in Table 0.1. What matters is that the process of integration does not necessarily need to be gradual from the 'lower' types of integration towards 'higher' ones. For instance, a group of countries may decide to create a common market and 'jump' over the 'lower' types of integration such as a free trade area and a customs union. Everything depends on the ambitions, intentions, goals and current and future potential of the group of countries and on their specific integration agreement. This table, however, does not cover the new economic integration models practiced in South-East Asia. Integration takes place in this region on a 'technical' trade-facilitation level. Governments and firms are interested in the removal of barriers that slow trade and impede the smooth operation of value-adding and distribution chains.

Table 0.1 Basic types of international economic integration

Policy action	Type				
	Free trade area	Customs union	Common market	Economic union	Total economic union
Removal of tariffs and quotas	Yes	Yes	Yes	Yes	Yes
Common external tariff	No	Yes	Yes	Yes	Yes
Factor mobility	No	No	Yes	Yes	Yes
Harmonisation of economic policies	No	No	No	Yes	Yes
Total unification of economic policies	No	No	No	No	Yes

The Handbook is organised in three volumes. Volume I presents general issues and regional groups; Volume II is devoted to competition, spatial location of economic activity and financial issues; while Volume III covers contentious issues of agriculture, the environment and quantitative studies.

VOLUME III

Part I examines factor mobility and is divided into two sections: transnational corporations (TNCs) and labour migration. Transnational corporations are covered in the first six chapters. Pitelis considers the issue of foreign direct investment and economic integration. Dunning and Clegg evaluate how the Eastern enlargement of the EU benefited through foreign direct investment in both the new and old EU countries. Ietto-Gillies devotes attention to the differentials in regulatory regimes on the strategic behaviour of TNCs. Rugman and Oh indicate that the world's largest 500 firms mostly operate within their home regions of the broad triad, rather than globally measured by their sales. Ando devotes special attention to the Japanese TNCs in Europe. Safarian discusses international mergers and acquisitions in Canada, the United States and the EU. Labour migration is covered in two chapters: Zimmermann and Constant deal with integration of immigrants, while Djajić offers a proposal for the reform of the international immigration system.

Part II on agriculture and environment opens with a discussion by van den Noort of the evolution of the Common Agricultural Policy (CAP) in the EU. Silvis and Jongeneel examine various reforms of the CAP and offer a vision of its future. Anderson and Valenzuela note barriers that come from various agricultural policies on global economic integration. Tosun and Knill shed light on the impact of economic integration on the environment policy.

Part III, on the quantification of effects of integration, begins with a survey chapter on quantitative studies by Grimwade, Mayes and Wang. Badinger and Breuss present an overview of quantitative effects of integration in Europe. Le, Minford and Nowell state that the EU put political integration before economic efficiency as it pursued protectionist policies in food, manufacturing and services, which may amount to 3 per cent of Britain's GDP and some 4 per cent for the rest of the EU. Hagen and Mohl examine the Cohesion Policy of the EU which corners a third of the EU budget; however, the results of this regional expenditure are mixed if not somewhat contradictory. Hufbauer and Adler analyse how tariff reductions and the conversion of tariffs to quotas by the United States and its major trading partners have been a bonus for trade for the United States. Rose reviews the recent literature that quantitatively assesses the effect on international trade of membership in the WTO and its predecessor, the GATT. Finally, Marchetti concludes the Handbook with a consideration of services and integration agreements.

PART I

FACTOR MOBILITY

Section 1

Transnational corporations

1 Foreign direct investment and economic integration

Christos N. Pitelis[1]

1 INTRODUCTION

This chapter explores the role of foreign direct investment (FDI) on the competitiveness of emerging economies and economic integration.

This chapter is structured as follows. Following this introduction, Section 2 assesses briefly and critically extant theories of FDI and the multinational enterprise (MNE). Section 3 critically assesses competitiveness and catching-up theory and policy and the role of FDI in this context. Section 4 sets off from limitations of extant scholarship identified in the previous section to develop a novel framework for competitiveness and catching-up and discuss the role of FDI, clusters and government policy in its context. Section 5 discusses ways through which emerging economies can effect economic integration through enhanced competitiveness and accelerated catching-up, by leveraging strategies informed from recent developments of scholarship in international business (IB) strategy. Section 6 summarises and concludes.

2 THEORY OF FOREIGN DIRECT INVESTMENT AND THE MULTINATIONAL ENTERPRISE

Extant Theory of FDI and the MNE

The theory of FDI and the MNE dates back to Stephen Hymer's PhD dissertation, completed in 1960, and published in 1976. Hymer is arguably the father-figure of the theory of the MNE because he is the first scholar who posed the question 'why FDI?' *vis-à-vis* alternative modalities of what he called 'foreign operations', such as licensing, tacit collusion, joint ventures and so on (Dunning and Pitelis, 2008).[2] Accordingly, Hymer posed the question 'why internalise?', for the case of the MNE, much in line with Coase's (1937) similar question for the national firm.[3] Hymer attributed the benefits of FDI to the advantages of the control it conferred on firms. He proposed three reasons for the choice of FDI. The 'removal of conflict-Rivalry' between firms in international markets, and the 'exploitation of the (monopolistic) Advantages' of firms were the two major reasons. 'Diversification of risk' was the third, less important one for Hymer, because it did not involve control. Through FDI, firms could both reduce the forces of *R*ivalry in international markets, and exploit their monopolistic *A*dvantages better than through the open market. That was possible for numerous reasons related to 'market failure' (or intra-firm success), to include the avoidance of bilateral oligopoly, difficulties of finding licensees in foreign countries, honest or dishonest differences in the perceptions of the value of the advantage and so on. All these have predated more recent literature, as documented in Casson (1990), Horaguchi and Toyne (1990), Pitelis (2002b), and Dunning and Pitelis (2008).

While the Coasean question 'why internalise?', was already present in 1960, Hymer only explicitly pursued Coase's arguments later, in a 1968 article. He also quoted Coase in Hymer (1970 and 1972).[4] Post-Hymer developments of the MNE concentrated on the 'why internalise the advantages?' question. Various important contributions emphasised different reasons. Buckley and Casson (1976) focused on the public good character of 'intangible assets', which are susceptible to 'market failure' if they are not exploited internally, while Williamson (1981) stressed post-contract holdups, in the case of 'opportunistic' licensees and investments in specific assets.

Post-Hymer internalisation theorists did not address the issue of location. Dunning (1958) had done so, and indeed Hymer discussed locational factors under various guises, for example, exploitation of foreign assets, better demand conditions abroad and so on (see Dunning and Pitelis, 2008). Location is most crucial, indeed a *sine qua non* of the theory of the MNE (Dunning, 1998). One reason is that, in effect, most questions on the MNE are also applicable for the case of non-MNEs. Penrose (1987) criticised both Hymer- and Coase-type application to the theory of the MNE, for failing to distinguish between intra-country and international expansion. For inter-country expansion the crucial issue of course, is the investment in different countries. This is a locational issue. In addition, it is an issue that involves location under different cross-border regulatory jurisdictions (Pitelis and Boddewyn, 2009). In this context, the whole debate on 'why MNEs?' can usefully be subdivided into three subquestions. First, why internationalisation? Second, why integration/internalisation? Third, which location (which in this case means which country)?

In Hymer (1970, 1972, 1976) 'why internationalisation?' ('why foreign operations?' in his words), is explained in terms of push and pull factors, such as external market opportunity, product life-cycle considerations, and differential demand conditions (for example, mature domestic markets) (see Pitelis, 2002a). Such considerations, especially when viewed in line with other 'locational' considerations by Hymer (see Dunning and Pitelis, 2008) also provide an indirect answer to the question 'which country?' Instead, the 'internalisation school' did not focus on the questions 'why internationalisation?' and 'which country/location?' It is John Dunning's *OLI* that 'envelops' all three aspects. In the OLI, *O* stand for Ownership advantages specific to the firm (which need not be monopolistic, but could also be due to efficiency). *L* stands for Locational advantages, and *I* for Internalisation advantages. The main idea is that given O, L will explain the choice of location, and I the choice of modality. In terms of our questions, L explains 'which country?' (and up to a point 'why internationalisation?') and I, 'why internalisation?' O is a necessary (but not sufficient) condition for both 'internationalisation' and 'internalisation'.

OLI has served and is serving an important role in the literature in part because of its paradigmatic nature, and in part because of the agility and ability of its proponents to incorporate new ideas and developments, as well as to propose new ones (Dunning, 2000, 2005; Dunning and Lundan, 2006).[5] As Dunning (2001) points out, it is arguable that in its early manifestation, the OLI has paid limited attention to the endogeneity of advantages, in particular the link between intra-firm knowledge generation, O advantages and their relation to L, and I advantages – and thus (up to a point) the OLI underplayed the firm as a strategic actor.[6] Moreover, and similar to the internalisation theories, the quasi-exogeneity of O, L and I also implied that the framework could benefit from a more dynamic, strategic, entrepreneurial and knowledge-learning-based foundation.[7] We contend that Penrose's contribution to the theory of (the growth of) the firm can serve such a purpose. At the same time, however, a learning-based perspective goes beyond extant theory of the OLI, by introducing a cognitive and entrepreneurial agency dimension, missing from the OLI (Spender, 1994).

A Knowledge-Learning-based Approach

A founder of the knowledge-learning-based theory of the firm is Edith Penrose (Penrose, 1959 [2009]; Spender, 1994; Pitelis, 2000). Penrose was one of the earlier contributors to the MNE – her 1956 article in the *Economic Journal* appeared prior to Hymer's PhD thesis. As discussed by others (for example, Kay, 1999; Pitelis, 2000, 2004, 2007c; Rugman and Verbeke, 2002; Dunning, 2003), Penrose dealt extensively with MNEs and MNE–country relationships in general (for example, the 1956 article), and in particular in the context of the 'international oil industry' and Arab countries. In the context of this work, Penrose was one of the earlier contributors to issues of 'transfer pricing', 'dumping' and 'infant-firm' arguments (in support of some protectionism).[8] All these are also of importance to the issue of economic integration (see next section). However, Penrose did not address the question 'why MNEs?' *vis-à-vis*, say, licensing or exports; therefore, she did not deal with the 'nature of the MNE'. Similarly, her 1959 classic book, *The Theory of the Growth of the Firm* (TGF hereafter) did not address the issue 'why (national) firms?' either.[9] (Moreover, Penrose did not explore in any detail the implications of her TGF contribution for the MNE.[10])

The fundamental insight in TGF was that intra-firm knowledge generation (through learning) generates excess resources. These motivate managers to expand, as 'excess resources' can be put to (profitable) use, at (near) zero marginal cost. This endogenous knowledge/growth dynamic is realised through managerial 'productive opportunity' – the perceived dynamic interaction between internal resources and external/market opportunity (Penrose, 1959 [2009], Chapter V).

Despite limitations,[11] we claim here that Penrose's insight has implications on the OLI, our three related questions, and the need for a more endogenous, dynamic and strategic theory of FDI and the MNE (Dunning, 2001). In addition, Penrose's knowledge/learning perspective adds cognitive and entrepreneurial elements, currently missing from the OLI, of interest to theory, managerial practice and public policy. We explain these below in the context of Dunning's triad:

- *O(wnership)* In TGF, O advantages are not monopolistic, at least as far as their process of derivation goes. They are efficiency advantages by definition, as they are the result of an endogenous knowledge/innovation process. O advantages only become monopolistic when firms attempt to capture value by, for example, bases, raising barriers to entry, using restrictive practices and so on. All these are discussed in Penrose (1959 [2009], mainly Chapter VII). In addition in Penrose there are also explicit references to both efficiency and monopolistic advantages. For example, Penrose observes:

> A firm may attempt to entrench itself by destroying or preventing effective competition by means of predatory competitive practices or restrictive monopolistic devises that relieve it of the necessity of either meeting or anticipating serious competitive threats to its position. In such circumstances a firm may grow for a considerable period depending on the demand for its products, harassed neither by price competition nor by the fear that competitive developments will make its products or processes obsolete. Examples of growth over long periods which can be attributed *exclusively* to such protection are rare, although elements of such protection are to be found in the position of nearly every large firm. (Ibid., p. 100; original italics)

Monopolistic advantages are in line with Penrose's claim that while the process of expansion is definitionally efficient, the resulting state need not be – as when MNEs try to capture value through monopolistic practices. This idea introduces the important distinction between process and state-type advantages, the latter being potentially monopolistic as originally suggested by Hymer.

- *L(ocation)* Penrose did not deal with L in TGF. In her preface to the third edition (Penrose, 1995) she claimed that all the theory of the MNE requires is to suitably adapt her TGF ideas, and account for the existence of different nations. This would require accounting for international differences in regulatory and tax systems, different laws and cultures and so on (Penrose, 1959 [2009]: xv). Penrose did not pursue this much further, leaving it to other scholars to do so. (We shall return to this later, when discussing I.) Nevertheless, the Penrosean perspective has important implications on resource/asset/knowledge/innovation seeking and augmenting locational advantages for FDI. As firms are bundles or resources creating knowledge, it is 'natural' for them to locate where existing resources/knowledge is such that it can add value to firms' existing resources, knowledge and technological bases and (thus) operations. This implication from Penrose's work is in line with Dunning's discussion of asset and institution seeking Locational advantages (for example, Dunning, 2001, 2005), and more recent attempts to build a theory of the meta-national (for example, Doz et al., 2001), which consider MNEs as pursuers of global learning, knowledge acquisition and upgrading.
- *I(nternalization)* Penrose did not deal with I advantages in the specific context of the MNE.[12] However, she dealt extensively with integration, which she considered as an earlier (and more accurate) term for 'internalisation'.[13] Accordingly, her views on internalisation should be looked at in her analysis of integration. For example, one argument she offers for horizontal integration is the acquisition of valuable managerial resources (partly in response to the 'Penrose effect' – limits to growth due to limited intra-firm managerial resources) (Pitelis, 2007c).

Concerning vertical integration, according to Penrose, one reason for it is the superior knowledge, and (thus) ability of firms to cater for their own needs, as they have better knowledge of these (Pitelis and Wahl, 1998 and Pitelis, 2007c, discuss these points in more detail).

Applying such ideas to the case of the MNEs would suggest resource/knowledge-seeking superior firm capability-induced FDI.[14] The last mentioned is similar to

> Kogut and Zander's (1993) subsequent 'evolutionary' contribution to the MNE (see also Verbeke, 2003, for a critical account).[15]

By bringing to centre-stage the role of learning, the knowledge/learning-based view of FDI and the MNE has important implications for the interaction effects between O, L and I. Moreover, by incorporating cognition and agency, it calls for a more entrepreneurial, forward-looking approach to FDI, the MNE (and more widely), one that tries to account for anticipated change and to act on its basis.

Starting with interaction effects, these have not been given much attention in early literature (Dunning, 2001). They are crucial. O, L and I are dynamically interrelated. For example, L advantages once realised serve as O advantages. Similarly, I advantages are O advantages too (namely, Hymer's (1972) view that 'multinationality *per se*' is an advantage, the standard view that vertically integrated firms may possess higher market power and so on; see Pitelis and Sugden (2002) for more on such advantages). In turn, I advantages are related to L and O advantages in that the last two pose the question what and where to be internalised, respectively. In addition, in the context of a learning perspective, L and I advantages are endogenously selected as O advantages in the very process of firm growth. Crucially, moreover, O, L and I can be or are shaped by firms' own decisions. Managers' 'productive opportunity' is in part a result of their own efforts to shape the firms' internal and external environment.[16] In this context, 'productive opportunity' helps to both endogenise and shape O, L and I. This helps to provide a more endogenous, dynamic, entrepreneurial and forward-looking strategic theory of FDI and the MNE.

Another aspect of the learning perspective, often missed in the literature, is that it helps to explain whether, what, when, where and how to integrate/internalise. This is a crucial limitation of the transaction costs approach, especially Williamson's (for example, 1981) version. Despite his advocacy of 'bounded rationality', in his account, firms are always able to answer 'make or buy' through a solution of a global optimisation process that includes transaction (and production) costs. If anything, solving this problem can be more difficult than the standard neoclassical problem of (production) cost minimisation–profit maximisation. Penrose's endogenous (perceived and imperfect) intra-firm knowledge generation idea provides an answer to the question whether to 'make or buy' (but also what, when, where and how). These issues are beyond the scope of both transaction cost economics and early OLI, as they involve learning. They are of importance.

By relying on learning the emergent knowledge-learning-based OLI is more concurrent/synchronic and also forward looking yet procedurally (as opposed to globally, or even boundedly) rational than its earlier cousins. It implies that proactive growing firms must at any given point in time rely on their endogenously generated extant 'productive opportunity' to make imperfect L and I decisions not just on the basis of what reality is perceived to be now, but also on the basis of anticipated change. This may require making apparently 'suboptimal' decisions now, which are expected to turn out to be superior in the medium or longer terms, if and when conditions have changed in the way managers have expected, hoped for and importantly, aimed for! Such decisions, moreover, often need to be made simultaneously. A firm contemplating expansion, may have the option of horizontal, vertical or conglomerate expansion, domestically or cross-border. Its decision is based on existing knowledge, resources and advantages and its implementation represents simultaneously a locational, internalisation and ownership-related advantage (or disadvantage as the case may be).

The Penrose-inspired learning-based OLI is by its very nature more concurrent and at the same time forward looking. By helping explain O, L and I endogenously, paying more attention to firms' efforts to shape O, L and I, and by recognising the close links and interactions between the three, the knowledge-based OLI also needs to account for anticipated and aimed-for change. It is therefore both more agency based (thus entrepreneurial) and forward looking.

The learning-based OLI is also more in line with concepts such as 'born-global' firms and 'meta-nationals'. Both are phenomena of limited empirical occurrence (see Verbeke and Yuan, 2007) yet of high conceptual interest. Born-global firms need, more than already established firms, to simultaneously consider O and L (and perhaps also I), while meta-nationals can be seen as global Penrosean resource/knowledge seekers/optimisers.

In terms of the three questions posed earlier in this chapter, the knowledge-learning-based approach explains 'why internationalisation?' in terms of firms' 'productive opportunity', 'why internalisation?' in terms of 'superior relative intra-firm ability for resource-knowledge transfer as well as resource/knowledge acquisition', and 'which country?' in terms of perceived relative [dis]advantages of countries as seen from the perspective of firms' productive opportunity, and for exploitation and acquisition of resource/knowledge (and institutional) advantages (see Dunning, 2005, for the latter).

Three following propositions follow. First: in considering FDI, MNEs attempt to simultaneously optimise the O, L and I advantages. Second: entrepreneurial managers may consciously take what they perceive to be suboptimal decisions today when/if they expect these decisions to prove superior under perceived changing future conditions. Third: once imperfect decisions are made, entrepreneurial managers will aim to shape the perceived 'productive opportunity' of their firms to make their decisions succeed.

All three propositions seem to be well in line with current practice of MNEs. For example, by recently undertaking FDI in the UK, through acquisition of the RMC Group, the Mexican MNE, Cemex, chooses a *location* that confers on it an *ownership* and an *internalisation* advantage simultaneously.

As *The Economist* observes,

> The acquisition of the RMC added new expertise in ready-mix which was important, and more large-scale construction projects were beginning to be undertaken in Mexico, and Cemex's international competitors began to muscle in on the company's domestic market. (2005, p. 88)

This quotation also shows that Cemex's choice is not necessarily the optimal one in terms of a pure net present value calculus of today's conditions. Instead, it is based on expectations of change with regard to both impending changes in the sector in Mexico and emerging competition. Clearly, once Cemex has taken its decision it will also have to make the best of it by trying to influence the very changes it expects will take place, in the direction of the decision it has already taken. All this is very consistent with, and follows naturally from, the learning perspective. In contrast, Cemex's approach is more difficult to explain in terms of transaction costs, power/efficiency, and resource-based reasoning alone, and therefore in terms of the constituent element of the OLI.[17] Clearly Cemex is only one example, yet possibly representative of the behaviour of other MNEs.

To summarise, in today's knowledge-based, semi-globalised economy, knowledge-learning-based OLI is in a better position to:

1. help explain the derivations of O, L and I advantages endogenously;
2. pay more attention to firms' efforts to shape/create the O, L and I advantages (and (through) their 'productive opportunity');
3. help explain whether, what, when and how to internalise (thus create) I (and L) advantages;
4. emphasise the interaction between O, L and I;
5. emphasise the forward-looking nature of decisions on O, L and I;
6. explain apparently suboptimal decisions, taken on the basis of entrepreneurial managers' assessment of anticipated change; and
7. assert/predict that entrepreneurial managers will try to influence change so as to suit their decisions; once they have taken them.

All these help to develop a more endogenous dynamic, strategic, cognition-based and entrepreneurial forward-looking theory of FDI and the MNE.

3 ECONOMIC INTEGRATION, COMPETITIVENESS AND CATCHING-UP: THE ROLE OF FDI AND FIRM CLUSTERS

Economic integration between nations is effected when countries which are currently worse-off improve their economic performance at a faster rate than that of the current leaders. In this context, an analysis of economic integration requires us to address the issues of 'competitiveness' and 'catching-up'.

The concept of competitiveness is both elusive and controversial, especially when applied to nations. For example, Krugman (1994) lamented the 'obsession' of policy makers with the issue of 'national competitiveness', claiming that this obsession can be dangerous. One of Krugman's critiques refers to competition between firms and nations. Firms do compete, in his view, for example for market shares, and this competition is zero sum. In contrast, nations do not compete in a comparable way, and the outcome is positive sum: when one benefits, the others do too. For Krugman, the best measure of national economic performance is total factor productivity (TFP) – a proposition also supported by Porter (1990).

Krugman's views have been subjected to a battery of criticisms, see Aiginger (2006a, b) for a recent account, albeit not so much on his views on competition. These, we believe, are not immune to criticism. Following, for example, Allyn Young's (1928) work on increasing returns, we appreciate that competition between firms is one fundamental way through which markets are created and expanded, suggesting that inter-firm competition need not always be a zero-sum game. On the other hand, when nations compete through strategic trade policies, Krugman's own work shows that the outcome need not be positive sum (Krugman, 1986, 1989). Fundamentally, however, competition and competitiveness are not synonymous. In its more generic sense, competitiveness refers to the ability of an economic entity to outperform its own 'peer' group, in terms of a shared objective. For example, if the objective is to improve a country's per capita income in terms of purchasing power parity, and if other nations share a similar objective, a country that outperforms the others in terms of this objective can be defined as more 'competitive'. This competitiveness could be achieved through apparently rivalrous actions (for example, strategic trade policies), cooperative actions, a combination of the two (co-opetition), or just no interaction whatsoever; a country can outperform another without necessarily engaging in trade with it, or even in trade. In fact, such a generic definition of competitiveness can be applicable to individuals, firms, regions, even universities and courses, such as MBAs, as we well know. What changes is the peer group and thus the shared objective (which, for example, in the case of MBA courses, would be to outperform other universities with a comparable MBA course, ranked on the basis of a widely accepted index). A useful characteristic of this definition is that it has immediate implications for catching-up. For example, if an existing developing country is more competitive than the leading nations, this leads to catching-up.

Arguably, one can distinguish four major extant approaches/frameworks on competitiveness and catching-up: the neoclassical economic theory-based approach, the Japanese practice-based one, the 'systems or innovations' view and Michael Porter's 'Diamond'. Despite some overlapping (especially between the last three) we aim to show below that there are sufficient differences, too, between the four models/frameworks, to qualify them as separate.

The neoclassical view has a very long and distinguished history; the issue of the nature and determinants of the Wealth of Nations was central in Adam Smith (1776), while the importance of international trade in this context was a main concern of David Ricardo (1817). In its modern developments, (exogenous) growth theory includes the landmark contribution of Solow (1956) while, more recently, endogenous growth theory includes scholars such as Romer (1986, 1990) and Lucas (1988). The main difference between the two types of view is that 'endogenous' growth theory tries to account for the (endogenous) role of 'technical change', human capital and 'increasing returns', which were previously treated as exogenous variables (see Fine, 2000 and Solow, 2000 for critical assessments). In international trade, neoclassical theory built on Ricardo's idea that free trade, based on comparative productivity advantages, can benefit all nations. The well-known Heckscher–Ohlin–Samuelson (HOS) model relies on comparative advantage (abundance) in factor endowments, and confirms the Ricardian ideas under conditions of non-increasing returns (see, for example, Samuelson, 1962). More recently, however, strategic trade theorists, such as Paul Krugman (1987, 1989) question the predictions of the HOS model, for the case of imperfect competition, increasing returns, spillover effects, and first-mover advantages. In such cases, Krugman shows that strategic trade policies (in support of some sectors and firms) could at least theoretically favour a nation that leverages them (see Krugman, 1992). On the other hand, strategic trade policies can lead to conflicts over the division of benefits, and are plagued by the possibility of 'government failures' (in identifying the right sectors/firms), and possible retaliation, leading to a potential lose–lose situation (Boltho and Allsopp, 1987). In the case of high adjustment costs, characterising the case of inter-industry trade (more common in cases of countries at different levels of economic development), the aforementioned problems could be accentuated (Krugman, 1989, 1992). Deraniyagala and Fine (2001) provide a critical assessment of the theory and evidence of trade theory and policy.

Concerning the competitiveness of a nation, the implications of exogenous growth and the HOS model, on the one hand, and the endogenous growth theory and new trade theory, on the other hand, can be at odds. Exogenous growth theory and HOS assert that perfectly competitive markets, alongside free comparative-advantage-based trade, can optimise national and global resource allocation, therefore lead to competitiveness and convergence (see Verspagen, 2005). Convergence follows directly from the implied negative relationship between the growth rate of capital stock and the initial level of capital stock. This 'absolute convergence' is not empirically confirmed (see Barro and Sala-i-Martin, 2004). On the other hand, while 'conditional convergence' and/or 'club convergence' could be more likely for countries sharing comparable key fundamentals, like saving rates, underlying long-run growth rates and capital stock depreciation, recent evidence does not seem to be in support of either of them (Baddeley, 2006). The role of government intervention in the context of exogenous growth – HOS theory – is rather modest with regard to addressing problems of market failure (such as imperfect competition), ensuring no barriers to trade, and aiming for temporary increases in the growth rate by increasing investments in plant, equipment, human capital and R&D (see Solow, 1997).

The implications and predictions of endogenous growth and new trade theories are more complex and more open to government intervention, especially in their interaction. For example, endogenous growth theory views increasing returns and (thus) imperfect competition as a contributor to growth, while the new trade theory regards the same factors as reasons for possible strategic trade policies. In combination one can foresee a situation where governments promote imperfectly competitive markets in order to promote growth at the national level, while at the same time protecting their imperfectly competitive sectors and firms, in order to gain advantages from (strategic) trade. The above are not the only policy implications of the two theories, yet such implications are consistent with them, while they are inconsistent with the exogenous growth–HOS views.[18]

An implication from the above as regards the neoclassical theory of competitiveness is that it consists of two major variants with different assumptions, and inconsistent prescriptions. Perhaps more importantly, the neoclassical theory is ill-equipped to deal with the creative role of markets (as opposed to their allocative functions, once they exist). This renders it of limited use to analysing issues of competitiveness and catching-up (see Kaldor, 1972; Audretsch, 1989; North, 1994; Amsden, 1997; Nelson and Winter, 2002). In the words of Nobel laureate Douglass North (1994): 'Neoclassical theory is simply an inappropriate tool to analyze and prescribe policies that will induce development. It is concerned with the operations of markets, not with how markets develop. How can one prescribe theories when one doesn't understand how economies develop?' (p. 359).

Concerning 'old growth theory', Robert Solow (1997) almost admits as much, but suggests that one should turn 'more naturally to Max Weber than to a modern growth theorist' (p. 72), in order to explain the role of institutions, attitudes and 'modernisation' (versus 'growth' of an already modernised economy). Solow goes on to suggest that the fundamental differences between old (exogenous) and new (endogenous) growth theory, are that the former aims to explain trend-lifting, not trend-tilting growth (growth policies that simply lift the trend as opposed to increasing the rate of growth *per se*). The latter is achieved by endogenising technological change, but also at a potentially huge cost of hard-to-test assumptions, too much importance on the role of investment decisions on growth rates and fragile, too powerful and rather dangerous conclusions. In his conclusion 'the forces governing the scope of the potential trend – the sustainable rate of growth – are complex, technological and even a little mysterious. What we do know how to do is to lift the potential trend by a few percent. Even if the slope remains as before, that is a fine achievement' (ibid., p. 92).

The macroeconomic policy prescriptions deriving from the analytical foundations of the neoclassical perspective have been encapsulated in the various versions of the Washington and post-Washington-type policy advice to developing and transition economies (see Shapiro and Taylor, 1990). Their record has been at least questionable (see Stiglitz, 2001; Rodrik, 2004; Dunning, 2006; Serra and Stiglitz, 2008).[19]

A second approach to competitiveness and catching-up is that adopted by the Japanese government during the post-Second World War reconstruction effort. While more pragmatic than theory based, the approach has subsequently been 'deconstructed' by both Japanese and Western scholars in a way that unearths the theoretical insight of the Japanese policies (see, for example, Amsden, 1989; Best, 1990; Shapiro and Taylor, 1990; Wade, 1990; Pitelis, 1994). In addition, variants of the Japanese approach have been adopted by the various 'tiger' economies of East Asia, justifying, we feel, the term the 'Japanese'–East Asian approach (Pitelis, 1994, 2001).

An important characteristic of the Japanese approach is an interventionist stance of the government in close contact/partnership with industry, and with the explicit aim to restructure the economy in a way that creates competitive advantages, as opposed to simply accepting existing comparative advantages. In this context, elements of the industrial/competitiveness strategies of the country, devised and implemented in Japan by the Ministry of Economy, Trade and Industry (METI, formerly known as MITI), included: the targeting and support of specific firms and sectors (which were perceived to be important in terms of high value-added, high-income elasticities of demand and oligopolistic with high profit margins). These sectors and firms were at first protected from international competition, through managed-trade policies. Intra-sector competition was managed too, in the sense that in each sector the major players should be not too many, but not too few either (so as to avoid collusive practices, but also to avoid resource dissipation and create critical mass). In effect that was managed locally based big-business competition. To ensure technology transfer, in the absence of FDI (which was discouraged), MITI encouraged an aggressive policy of buying licences from foreign firms. To ensure competition from below to big players, thus a relatively level playing field, MITI required that firms purchasing licences would make them accessible to smaller players (Hill, 2006). In addition, Japanese firms pursued a corporate strategy of growth and market share acquisition, not short-term profit maximisation (see Best, 1990).

In the above context, a number of other characteristics of the Japanese approach included new innovative methods of doing business (for example, just in time), human resource management, worker participation, and others such as total quality management. All these have been widely discussed in the literature and were felt by many (for example, Amsden, 1989; Best, 1990; Shapiro and Taylor, 1990; Wade, 1990; Grabowski, 1994; Pitelis, 1994) to have contributed to the remarkable performance of the Japanese economy, up to the late 1980s when it was leading global markets in sectors such as electronics, semiconductors and automotives (see Hill, 2006). Variants of the Japanese approach were adopted by the tiger economies, such as South Korea, Taiwan and

Singapore (see Chang, 1994; Pitelis, 1994) and, more recently, by the Chinese government (Nolan, 2001; Lin, 2004) and other tiger economies, such as Thailand, Malaysia and Indonesia (see Jomo et al., 1997) and Vietnam (Chesier and Penrose, 2007). A difference to the Japanese approach, of interest to the current chapter, is that smaller economies, such as Taiwan, Singapore and Malaysia, did not discourage, but rather encouraged FDI, albeit in a way that was perceived to be aligned to the overall competitiveness strategy (Pitelis, 1994; Jomo et al., 1997).[20]

There is extensive and heated debate on the effectiveness, or otherwise, of the Japanese approach, including the possibility that the subsequent decline of Japanese economic performance could be attributed to this original interventionist model (see Pitelis, 2001). The simple fact is that it is not easy to tell. Moreover, even if we accept that the Japanese approach was successful, other factors might also be in play. These include the effectiveness of the political–bureaucratic structure (less government failure, so to speak) as well as cultural, institutional and macroeconomic issues (see Shapiro and Taylor, 1990 and Pitelis, 2001). We do not wish to re-enter this debate here. However, we do wish to point out that many of the fundamental presumptions of the Japanese competitiveness strategy did receive theoretical support, from one source or another. For example, the emphasis on big-business competition, the pursuit of market share, the emphasis on innovation of all types (including organisational, managerial and human resources) and the pursuit of long-term profit through market share, are all in line with the work of scholars such as Schumpeter (1942), Penrose (1959 [2009]), Chandler (1962), Baumol (1991) and others, and even more recent endogenous growth theory-based approaches, see Romer (1986) and Lucas (1988). A focus on targeting of 'strategic' sectors is in line with early development economics thinking on 'infant industries' and more recent 'new trade theory' (see Kaldor, 1972; Krugman, 1987, 1989; Shapiro and Taylor, 1990). The emphasis on domestic competition is in line with arguments by Porter (1990) – see below. The support of small and medium-sized enterprises (SMEs) and clusters seems to find accord with almost all economic perspectives, albeit for different reasons (for example, entrepreneurship, agglomeration economies, cluster-building, locally based development, challenge to multinationals and so on) (see Porter, 1990; Krugman, 1991a, b; Henderson, 2005).

It is clear, too, that mistakes were made, and I believe that the failure of the Japanese to gradually give more space to market forces, could indeed partly explain subsequent difficulties. This is also in line with theoretical prescriptions, concerning the identification of the 'optimal' mix between planning and markets and between market, hierarchy and cooperation.[21] Important for our purposes here is that the Japanese-East Asian perspective could be seen as a developmental–competitiveness approach in its own right. It has clear implications for catching-up – indeed the whole philosophy and purpose of the approach is to catch up through creating and capturing value faster than other countries – as well as implications for FDI and country size, to which we return below.

A third approach to competitiveness involves work under the evolutionary, resource and systems-perspective and (varieties of) comparative-capitalism banners. Much of this has been encapsulated in the 'systems of innovation', agglomeration and clusters and varieties of capitalism-related literature (see Lundvall, 1988; Krugman, 1991a,b; Freeman, 1995; Nelson, 1995; de la Mothe and Paquet, 1997; Fagerberg et al., 2005; Jackson and Deeg, 2006; Lundvall, 2007 and Jovanović, 2009 for a recent summary, assessment and proposed extensions). A main characteristic of the evolutionary and systems-based views is a focus on intertemporal efficiency effected through innovation, combined with the belief that innovation is best promoted not by an exclusive focus to free and competitive markets, but by big-business competition and systems-wide linkages that involve markets, hierarchies (firms, governments), cooperation and competition, non-governmental organisations (NGOs) and more wider social capital-promoting institutions and organisations (see Freeman, 1995; Jackson and Deeg, 2006). The strength or otherwise of the innovation system depends on the linkages of the whole system and on government policies, and institutions that promote innovation. Markets are but a part of the system, albeit an important one (see Stiglitz, 1989). They need not be competitive, indeed big-business competition may well have innovation-promoting advantages (see Nelson, 1995 and/or Nelson and Winter, 2002). In addition, the existence and promotion of agglomeration and clusters by SMEs can be a potent means to promote linkages, diversity and (thus) innovation (see Fagerberg et al., 2005; Metcalfe, 2002; Wignarajah, 2003).[22]

It is arguable that the systems perspective is focused more on value creation through innovation than value capture (therefore catching-up), albeit not in all cases (see, for example, the discussion of catching-up in Freeman, 1995). It can be argued that the promotion of an innovative economy will help engender superior economic performance, therefore superior competitiveness and (thus) catching-up. However, this does not fully account for the possibility that value creation need not always be captured by the innovators (Teece, 1986; Research Policy, 2006) – we shall return to this later. In addition, the 'agglomeration' element of 'clustering' may well engender inter-regional and international divergence (see Krugman, 1991a,b).

It is arguable that dissatisfaction with competitiveness models motivated Michael Porter (1990) to identify a gap to be filled. This is one way to explain why someone should be writing a book in 1990 on a topic that goes as far back as the origins of modern economics (Adam Smith's *Wealth of Nations*, 1776), and so extensively discussed since. Porter's 'Diamond' approach suggests that the coexistence of appropriate factor conditions, demand conditions, firm and sectoral structure and strategy and related and supporting industries, engenders a 'Diamond' and/or 'clusters' of economic success–competitiveness.

Many of the elements of the Diamond are present in extant works, for example 'factor conditions' in the HOS model; demand conditions in Vernon's (1966) work on the 'product life cycle', related and supporting industries, in the works of Marshall (1920) and work on clusters (see Best, 1990; Edquist, 2005), industry structure and rivalry in the works of industrial organisation (IO) scholars (see Tirole, 1988). However, Porter added new insights and dimensions, notably firm strategy. This draws on strategic management and Porter's earlier works (Porter, 1980, 1985), and it is a breakthrough *vis-à-vis* neoclassical competitiveness models, which usually focus on macroeconomic considerations at the expense of firm-level analysis. The last mentioned is critical, as it can help shift focus on value capture (a main concern of firms) and (thus) up to a point, catching-up.

In addition to the above, interesting in Porter's work is the re-surfacing of agglomeration and clusters (in the form of related and supporting industries), and in their interaction with other parts of the Diamond, an emphasis on specialised, rare and hard to imitate factors (which is very much the theme of the RBV of firm strategy – see Wernerfelt, 1984; Barney, 1991; Peteraf, 1993), his emphasis on the importance of local as opposed to distant (such as international) rivalry, and a focus on demanding and sophisticated consumers (not just undifferentiated aggregate demand, as in the Keynes, 1936, tradition). All these are quite impressive and help explain Porter's successful journey from IO to strategy to national competitiveness policy scholarship and advice.

Concerning FDI, the four models have different implications and/or recognise different roles for it. In the neoclassical HOS model of international trade, FDI can be one of the mechanisms whereby factors and resources are transferred from where they are abundant to where they are scarcer, thus contributing to catching-up (see Stiglitz, 2001). In the Japanese Far Eastern approach, FDI is a means to an end – it is used to serve the end of catching-up. In some cases, when technology transfer can be effected without FDI, alternatives are chosen; for example, licensing in Japan, joint ventures in the earlier phases of Chinese opening-up to international markets (see Nolan, 2001). When FDI is deemed to be necessary for industrialisation, it is encouraged, but placed as much as possible within the context of the industrial strategy objectives, as in Singapore, Korea and Taiwan (Shapiro and Taylor, 1990; Chang, 1994; Pitelis, 1994; Jomo et al., 1997; Amsden, 2009). In the systems perspective, FDI is seen as part of the system – it may help strengthen already extant linkages, but could also be of limited import, if footloose and stand-alone (see Freeman, 1995). Finally, in the Diamond, FDI is seen as a measure of success, indeed outward investment is claimed by Porter (1990) to be no less than a sign of 'competitiveness'. Others, for example, Dunning and Pitelis (2008), question this optimism, seeing both positive and negative elements. In addition Dunning (1993), as well as Rugman and Verbeke (1993), extended Porter's approach to include the potentially important role of FDI in affecting the determinants of the Diamond. There has also been extensive work on the potential interrelationship between FDI and clusters (see, among others, Rugman and Verbeke, 1993; Freeman, 1995; Pitelis, 2001; Cantwell and Iammarino, 2000; and Pitelis et al., 2006).

There are few direct implications from the above models on the issue of country size, with the possible exception of the endogenous growth theory, where market size facilitates growth. On the other hand, the ability, for example of Japan and China, to make MNE entry into their markets conditional on licensing or joint ventures could well be attributed to the attraction to MNEs of the large size of the market of these economies, alongside the bargaining power that this attraction afforded to them. In contrast, the pursuit of more proactive inward investment strategies by smaller players (for example, Taiwan, Malaysia and Singapore), could be attributed to the fact that their market size was not by itself a sufficiently attractive proposition for MNEs – so more proactive FDI policies were required to foster development.

In the next section, we build on extant theory to develop a competitiveness framework that aims to address some problems of existing theories. In particular, none of the competitiveness frameworks or approaches discussed here has an explicit link between competitiveness at the micro (firm), meso (sectoral, regional) and macro levels; there is no explicit discussion of the issue of value capture for catching-up, versus value creation (which may be captured by others), and (thus) the interrelationship between value capture for catching-up strategies and value-wealth creation strategies. Indeed, some models of national competitiveness are ill-equipped to even address such issues, as they tend to rely on macro categories, at the expense of the micro level (for example, strategic management), where value capture is far more prominent. In this context, we feel that work on national competitiveness could benefit from insights derived from the international strategic management literature, when applied, suitably modified to the national level. Last, but not least, work on international business and strategy can also have useful implications on the choice of developmental model by countries.

4 A NOVEL FRAMEWORK FOR COMPETITIVENESS AND CATCHING-UP

The limited discussion of micro-(firm-level)-foundations and the lack of an explicit focus on superior value capture capabilities (which can lead to catching-up) are two major limitations of extant theory.[23] Both can be addressed by strategic management scholarship, which on the other hand (excepting Porter and some scholars of the systems approach), is mostly alien to competitiveness theories, which are mainly macro based (see Nelson and Winter, 2002).[24] To go beyond noticing this, it would be useful to identify factors that engender value and wealth, at the firm level, but also the meso and macro levels, when suitably understood and aggregated/augmented.

The concept of value, first, is very loaded in economics and management (see Dobb, 1973, and Bowman and Ambrosini, 2000, respectively). To avoid entering the interesting, albeit as yet unresolved, debate on the nature and theories of value, we focus instead on the much better understood concept of 'value added'. Of course, this still incorporates the word 'value', a definition of which seems inescapable (yet is missing and/or highly contested in the literature, see Dooley, 1990). For our purposes, we propose to define value as perceived worthiness of a product or service to a (potential and/or target) user. In this context, value added is the additional value conferred on a product or service by an economic agent, be this an individual, a firm, a sector or a nation. Value added can be potential or realised. It is potential before users have been convinced to pay a market price to purchase the product or service, and it is realised once the product or service is purchased. Value added may never be realised if consumers lack the power to purchase (effective demand) and/or when sellers are outcompeted by rivals who possess substitute products, and/or superior competitive advantages (such as complementary assets and capabilities, see Teece, 1986). This renders a discussion of value realisation and value appropriation/capture strategies critical.

Value added is engendered in two fundamental ways: one is through increased efficiency and/or productivity, therefore a reduction of the cost of production; the other is an increase in the perceived utility worthiness of the product or services through 'differentiation'.[25] This can be due to real factors, such as increased functionality and/or aesthetic appeal, or to 'imaginary' factors, effected for example through advertising. There are long debates on these issues in IO and strategic management (see Tirole, 1988; Grant, 2005); usually real and imaginary elements coexist, and it is arguable that through innovation, cost reductions and increased appeal (product differentiation) can take place simultaneously (see Pitelis and Taylor, 1999, who propose a 'value for money' strategy that integrates Porter's 1985 two major 'generic strategies' – cost leadership and differentiation).

The crucial question is what are the major determinants of value added at the firm level, and to what extent do the same or similar determinants exist at the meso and

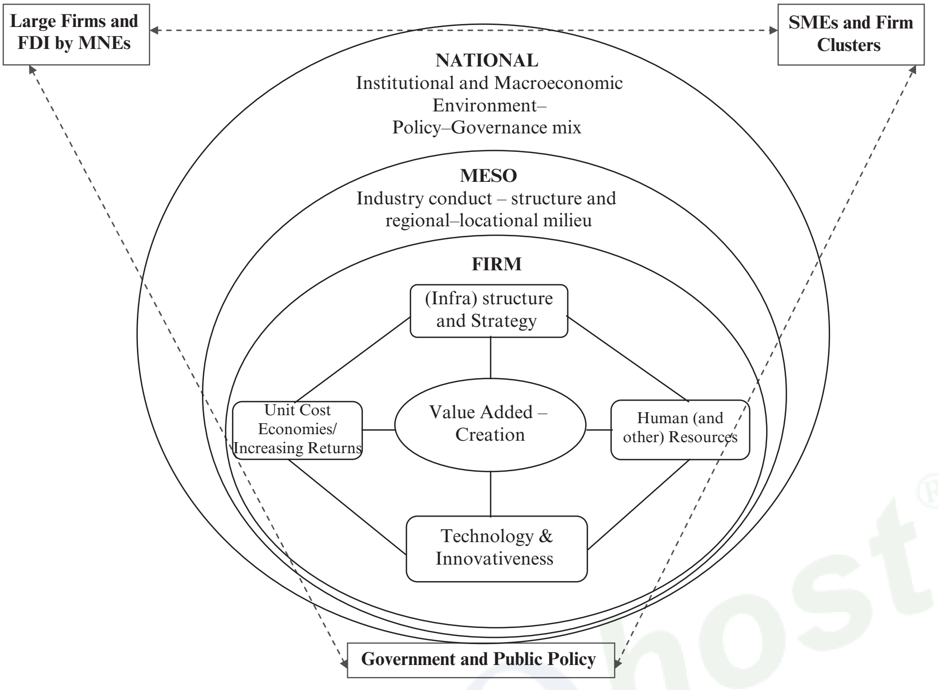

Figure 1.1 The wheel of value: wealth creation at the firm, meso and macro levels

macro levels, so as to build on the firm-level microfoundations, in order to derive the determinants of the wealth of a nation? Drawing on extant theory of economics and management, Pitelis (2004) suggests that four major factors interact to explain value added (through efficiency and/or differentiation) at the firm level: firm strategy and infrastructure; unit cost economies/increasing returns; resources, notably human ones; and technology and innovativeness. The importance of all four factors is well rehearsed in the literature, which involves virtually all all-time classics in economics and management. Important, however, in this framework is that the same four factors can be reinterpreted to apply to the meso (region, industry, sector) and macro levels (ibid.), thus allowing a relatively smooth aggregation, based on microfoundations.

The emergent 'wheel of value' is shown in Figure 1.1. The 'wheel' has the added advantage that one can examine in its context, the role of FDI, clusters and government (policy) as well as their interrelationships, as these interact and impact on all three levels. For example, the figure shows that large size, and FDI by MNEs as well as clusters (by SMEs and/or MNEs), and the 'government' (policies) are interrelated (with clusters attracting FDI and FDI creating and/or being linked to clusters, and government policy affecting and/or being affected by both), and they all impact on the determinants of value added. The impact, however, need not always be positive or beneficial. FDI can do harm, or good; clusters can lead to congestion effects, or wither away (see Martin and Sunlay, 2003; Jovanović, 2009); governments can be corrupt and/or ineffective and (thus) create (as opposed to solving) market failures (see Krueger, 1974; Shapiro and Taylor, 1990; and Stiglitz, 1998 for discussions).

Identifying the major determinants and actors of potential value added need not lead to realised value and wealth. This is where strategic management becomes crucial in informing policy makers. In particular, the determinants of value added in the wheel of value impact on potential value, not realised value, with one exception: that of firm (sector, industry and/or national) strategy. At the macroeconomic level, there has been limited interest in the issue of strategies for capturing value. Instead, in IO and strategic management, there is extensive discussion on strategies for value realisation/capture. There are four major types of such strategies: integration, diversification and cooperation strategies; 'generic strategies'; entry deterrence strategies (through strategic or 'innocent' technological barriers to entry); and 'firm differentiation/heterogeneity' strategies (see Pitelis, 2009 for an account). There is some overlap and extensive interaction between these strategies (for example, Porter's 1985 'generic strategies' include two out of the four barriers to entry of Bain, 1956, namely product differentiation and cost advantages). It is also arguable that such strategies are co-determined and co-evolving. Nevertheless, crucial about them is that in their interaction with product promotion and competitive strategies they help firms to realise potential value as profit, and capture more value than their competitors (sometimes even by capturing potential value created by their competitors, see Research Policy, 2006 and Pitelis, 2009).

It is arguable that such strategies for value realisation and value capture are applicable at the meso and national levels, albeit to different degrees. For example, countries can use strategic trade/protectionist policies. In addition, countries (and regions) may adopt regional/national differentiation strategies by strengthening, engendering and/or promoting their comparative or competitive advantages. In some cases, integration (or disintegration) strategies are adopted by nations (for example, the reintegration of Germany, or the de-integration of countries from the former Soviet Union). Regional integration of countries, such as the European Union (EU), the North American Free Trade Area (NAFTA) or the Association of South East Asian Nations (ASEAN), is common. The concept of generic strategies is also of much relevance to nations, which may choose (or turn out) to be cost leaders (for example, China in manufacturing, India in information technology (IT) services) differentiation (for example, Italian design), or niche strategies (for example, Switzerland in banking and/or watches). More complex cases could involve attempts to combine elements of niche (cost leadership and/or product differentiation) in specific activities (such as, for example, Finland in the case of mobile telephony). Such strategies, in addition, can be partly history determined, partly the result of policy initiatives, or usually a combination of both, such as the Finnish case (see Hill, 2006). Shapiro and Taylor (1990), Freeman (1995) and Fagerberg et al (2005) provide discussion of various cases.

An awareness of the determinants of potential value added and the factors that can help realise/capture value can provide useful insights to policy makers who seek to achieve superior economic performance to that of their peers. At the broadest possible level, a superior ability to create and, especially, capture value in international markets is tantamount to superior economic performance by a particular nation. The mix of market/hierarchy/cooperation, private–public–hybrid, institutional, micro- and macroeconomic policy, and the effectiveness and innovativeness of institutions, organisations and policies, will tend, in their interaction, to help the 'leaders' and 'laggards' in this game (see Abramovitz, 1986 and, for a critical survey, Fagerberg and Godinho, 2005). It is not possible to go into further detail on exact policies here. This would, in effect, be the economic equivalent of searching for the 'holy grail' (but see Shapiro and Taylor, 1990; Solow, 1997; Rodrik, 2004; and Serra and Stiglitz, 2008 for more on this).[26] Instead, our aim here is to draw on the discussion above in order to discuss the relationship between FDI and economic integration in the context of our framework and discussion.

5 COMPETITIVE ADVANTAGE, COMPETITIVE POSITIONING AND VEHICLES FOR COMPETITIVENESS AND CATCHING-UP

Countries need to diagnose their comparative advantages, and reach a decision on whether they wish to 'compete' on their basis, or to try to develop new competitive advantages, in activities which they perceive to have more potential for the country and in international markets. Countries, that is, need to diagnose their 'productive opportunity' (Penrose, 1959 [2009]) (the dynamic interaction between their internal resources and competencies and the external opportunities and threats). Sometimes, potential advantages are latent and hard to identify. For example, in many transition economies post-1989 in Eastern Europe, people found themselves with ample time at their disposal and few opportunities for employment. Many were educated with mathematical and computing aptitudes. Some originally used these for quasi-illegal or outright illegal IT-related activities. In time, accumulated expertise could be applied to legitimate activities, and help create IT clusters (for example, in Romania). It was already possible to diagnose this latent IT cluster in the early 1990s, and indeed it was diagnosed in some studies (see Pitelis, 1997). The desired mix of comparative and competitive (comparative-to-be) advantages for each country and for each case requires in-depth investigation and cannot be decided on a priori grounds without analysis on the ground.

Once the comparative or competitive advantages have been diagnosed, selected and pursued (in the case of competitive ones), the next decision is the positioning stance. Building on our earlier analysis, countries, like firms, could choose to position themselves along the relative cost-differentiation ('image') spectrum. This is shown in Table 1.1.

In the relative cost-differentiation spectrum, the best position to be in is low cost/high differentiation. This is normally effected by countries with a high innovation culture and performance – with strong 'systems of innovation', so to speak. This allows them to simultaneously reduce costs (through organisational and institutional innovation), and produce products, services and an 'image' (country differentiation) of a leader, an

Table 1.1 The relative costs/differentiation ('image') matrix and country positioning

		Relative differentiation ('image')	
		High	Low
Relative Costs	Low	Competitive	Stuck in the middle (in need of direction)
	High	Stuck in the middle (losing ground)	Non-competitive

innovator, a quality player. Small European players such as Sweden and Finland may be cases in point (see Freeman, 1995; Fagerberg et al., 2005).

Countries with high costs and low differentiation are laggards, they produce expensive goods and services, and the image of the country is one of low quality. High relative costs can be due to low innovative capability, poor infrastructure, lack of increasing returns, and poor organisational and institutional configuration. Greece in the 1980s is an example.

Countries with high costs and high differentiation are likely to be developed ones with high technical and operational competencies, but without a strong innovation system, at least not at the moment. These countries can have relatively high costs, because, for example, of high labour costs, themselves the result of distributional and welfare policies, that resulted from a 'glorious past'. Lack of innovative capabilities can be the outcome of organisational and institutional sclerosis, an insistence on doing already proven things in already proven ways. This lack of curiosity and innovation could result in this 'stuck in the middle'/question-mark position. It is likely to characterise developed economies that somehow have lost their incentive to compete and innovate. Germany in the 1990s may be a case in point; as is Britain in the 1970s (and likely in the 2010s).

Low-cost, low-differentiation economies are also stuck in the middle, but are likely to be at an earlier stage of their development, perhaps transition or emerging economies. Here unit costs can be low because of very cheap labour and resource costs, but the lack of differentiation/comparative or competitive advantages also place them in the question-mark category. Eastern European transition economies are cases in point.

There can be intermediate situations, for example, in more recent years, the positioning of many South European countries, for example Greece, South Italy, Portugal and Spain, has been characterised by a *sui generis* model – that of low costs/moderate or even high skills/competencies. Relative costs have been kept low, through the creation of the so-called '€1,000 generation', usually well-educated, skilful and competent graduates who, however, have to work (often far in excess of the 8-hour working day), for €1,000 a month (and indeed in Greece or Portugal for as low as €600!). This helps the competitive positions of these countries *vis-à-vis*, for example, low-cost/low-differentiation ones. It is sustained through a *sui generis*, intergenerational transfer of resources (the savings-wealth the parents accumulated in previous years), and/or through multiple jobs (when feasible) and grey-market activities. All these help engender their competitiveness despite the absence of a strong innovation culture/system. At one level, they represent a form of indirect subsidisation of locally based firms and industries, which under normal circumstances (namely, if individuals earned more, the state would tax them and use the taxes to subsidise industry), would be considered as anti-competitive practices, for example by the European Commission. They are a form of indirect taxation of the countries' middle classes.

The relative costs/differentiation matrix does not make an explicit distinction between stages of development although it is likely that countries in the first column in the table are likely to be developed, while the others less so, or emerging. The matrix can be of help to all countries, to identify ways to improve their competitiveness by reducing unit costs, improving differentiation, and strengthening their innovation capabilities. For example, a small country (say, an island economy), with an excellent climate, low costs of labour and little manufacturing (thus production costs too), can aim to effect high-country differentiation (say, as a tourist destination), with good service (which need not require much higher costs, if effected through cultural/educational means) and low costs. Small countries, with ample time to spare, due to lack of employment opportunities, could aim to effect differentiation through emphasising service provision, for example, call centres, IT services and so on. These are in effect 'niche-differentiation' strategies. They are likely to be more appropriate for smaller countries which cannot compete with an across-the-board differentiation strategy.

This prescription is supported by the excellent account by Shapiro and Taylor (1990), who point to the 'importance of specialized, niche-oriented industrial strategies for small, open economies' (p. 869) and go on to conclude: 'There is no reason why production for appropriate niches should not initially be supported by import barriers and export subsidies . . . full industrialization only occurs when infant firms grow up and can compete more or less effectively on international terms' (p. 873).

A third issue that all countries need to assess is the vehicles and policies through which competitiveness can be improved. Discussing specific policies is beyond the scope of this chapter (see, for example, Shapiro and Taylor, 1990; Rodrik, 2004; Fagerberg and Gondinho, 2005; and Pitelis, 2007b for more detailed discussions). By 'vehicles' we mean FDI and clusters, as per Figure 1.1. Both independently can impact on all determinants of value creation (see Pitelis et al., 2006 for a more extensive account). However, the sustainability of value capture requires embeddedness. This means that countries should preferably aim to create linkages between clusters and FDI, so that FDI does not 'fly' when conditions change (for example, costs go up), because margins have also gone up through higher differentiation, effected through embeddedness.[27]

The need for embeddedness is emphasised in the work of Abramovitz (1986), albeit he uses the term 'social capability'. Abramovitz suggests that differences between the levels of development between countries do present opportunities for catching-up and convergence, but only provided that these countries have developed a social capability adequate to absorb existing more advanced technologies. The concept is very similar to that of 'absorptive capacity', on which recent research currently takes place in IB scholarship (see Kottaridi et al., 2006 for an account). From our point of view, the interest lies in the fact that the building of social capability and/or absorptive capacity is something that involves by definition (namely the word 'social') the government and the policy at large – it is not just a matter for the private sector. In addition, in our context here, local development effected through clusters represents one way through which social capability and absorptive capacity can be enhanced. Indeed, the presence of clusters can also be seen as a manifestation of the existence of social capability that can be fostered through appropriate government measures.

The three issues raised above can and should be considered simultaneously. Competitive advantages could be linked to the positioning, clusters should be diagnosed and upgraded and FDI attracted, in a way that is in line with advantages and supports the pursued positioning.[28]

Another consideration concerns adaptation. Detected advantages and positioning should be reviewed regularly to ensure consistency with evolving circumstances/stages of development. For example, in order to attract high knowledge intensive FDI, it may be useful to discourage some FDI, which may require rendering such FDI expensive to firms, through for example a high-wage policy – pursued, for example, by Singapore

(Pitelis, 1994; Lall, 2000; Fagerberg and Godinho, 2005). In addition, care should be taken to achieve a coincidence between what (selected) MNEs require in their quest to optimise locational advantages (see Buckley and Ghauri, 2004), and what the country finds consistent with its advantages/positioning strategy. Such policies may become possible, in an era of 'fragmentation' (see Venables, 2003) that allows MNEs to separate the value chain and choose 'optimal' locations for each part of their production process.

It is arguable that smaller developing countries have advantages in pursuing such a strategy. Small size may help render identification of competitive advantages and positioning easier. It could also help with implementation – for example, diagnose clusters, identify missing linkages, build an innovation system, and effect country differentiation. Countries like Albania (for example, through the 'Albania 1 euro' initiative), Serbia (through its high-tech IT cluster in Vojnodina), Slovenia and even Greece through their nationwide cluster diagnosis and upgrading strategies, help show that relatively smaller size can be an advantage (see Pitelis et al., 2006). In addition smaller countries are less likely to invite retaliatory moves, as they are too small to impact on world prices. Importantly, smaller countries may only be required to make one single choice right, in order to jump-start the process of growth. This could involve developing a single leading cluster and/or MNE, such as Nokia in Finland or Teva in Israel. The success of such companies in turn can allow smaller countries to move more quickly from a comparative advantage to a competitive one. Last, but not least, in an era characterised increasingly by knowledge intensity and the importance of intellectual assets, it is arguable that a smaller country can institute more rapidly and easily a successful programme of skill/capability/knowledge upgrading for its people – sometimes by also drawing on its diaspora. Greece, Israel, Ireland are cases in point.

Another potential advantage of smallness is that it renders community links stronger. This could help with creating conditions of trust that can facilitate clustering (albeit that could be moderated by cultural factors, as 'closeness' can also engender interpersonal rivalries). In any event, however, smallness is likely to lead to higher per capita remittances, due to stronger family links, thus helping smaller transition economies. For example, in an IMF (2005) study, countries with remittances higher than 10 per cent of GDP were invariably smaller ones and included labour-exporting transition economies, such as Albania and Moldova. With remittance flows second only to FDI, this issue is surprisingly under-researched; it could well serve as an extra competitive (albeit transitory) advantage for smaller countries.

Clearly the above is not to suggest that small is only beautiful. It is arguable that a major liability of smallness is that it renders the incentive to be corrupt higher, as it can increase substantially the per capita payoff of corruption. We have argued elsewhere that corruption which involves not only local politicians, but also MNEs, and which can take many different forms, to include regulatory capture, by local monopolies and foreign MNEs and rent seeking, can be a potent brake to development (Pitelis, 2004). It happens that this is more likely to plague smaller countries, which may offset other advantages of smallness. In addition, Nolan et al. (2008) argue that the 'global business revolution' implies that 'firms from low-income countries' access to developed country markets has become increasingly dependent upon entering into the global commodity chains of core firms based in high-income countries' (p. 33).[29] Both this and increasing non-tariff barriers support the observation of new emerging difficulties for catching-up.

6 SUMMARY AND CONCLUSION

We discussed the issue of competitiveness and catching-up in general and for catching-up countries in particular, paying attention to the role of FDI and clusters in this context. We suggested that extant frameworks for competitiveness lack micro-(firm-level)-foundations, which we aimed to provide. In addition, we claimed that competitiveness and catching-up include a value capture (not just value creation) element, usually lacking in the predominantly macroeconomic approaches to competitiveness. In this context, lessons can be derived from strategic management to include the issues of positioning, diagnosis and creation of competitive advantages and alignment between objectives and means to achieve selected strategies. FDI and clusters can serve a country's competitiveness, especially when they are combined and aligned with the country's competitive advantages and selected competitive stance/positioning. Emerging smaller transition economies may implement such strategies. Transition economies could devise strategies for FDI and/in relation to clusters that can be aligned to their created competitive advantages and competitive positioning to serve the purpose of superior competitiveness, and thus catching-up and economic integration.

At the same time the margins of opportunity may be becoming narrower – not least because of the shifting landscape concerning globalisation and global governance (see Dunning and Pitelis, 2008). It is arguable that successful catching-up could be made much easier for emerging economies, were the international community to appreciate that such catching-up is good for global economic sustainability.

Keywords

Foreign direct investment, multinational enterprise, international competitiveness, integration.

JEL Classification

F23.

NOTES

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2. Earlier contributions to the literature included both Edith Penrose (1956) and John Dunning (1958), indeed Hymer (1976) cites both Dunning and Penrose in his PhD thesis. However, neither Penrose nor Dunning had posed the question 'why FDI?' (intra-firm) versus inter-firm foreign operations.
3. Indeed, he had already used the verb 'internalise' in his PhD thesis: 'The firm is a practical devise which substitutes for the market. The firm internalizes or supersedes the market' (Hymer, 1976, p. 48).
4. Hymer's analysis and, even, terminology in this article incorporates most major contributions of the post-Coase transaction cost literature (see Dunning and Pitelis, 2008).
5. Dunning (2005), for example, proposes institution-seeking FDI, an idea in line with the knowledge-based perspective.
6. In contrast to some critics (for example, Teece, 2006), Hymer had examined the historical evolution of O advantages in the context of his '"law" of increasing firm size' (Hymer, 1972), yet failed to see advantages

as a process of endogenous knowledge generation and (thus) firm growth. That task was performed by Penrose (1959 [2009]) and up to a point by evolutionary models of the MNE, such as Kogut and Zander's (1993). Despite significant progress in dynamising and extending the OLI (for example, Dunning, 2001), an application of Penrose's intra-firm knowledge generation dynamic to the OLI has not been attempted before.

7. No detailed explanation of intra-firm advantages generation has been provided in extant Hymer, transaction costs and (thus) early OLI-based theories. The intra-firm focus is specific to Penrose (and the subsequent resource-based-view (RBV) scholarship, see, for example, Pitelis, 2006, for a recent account).
8. As discussed in Pitelis (2002a).
9. Although she explicitly distinguished between the firm and the market and discussed the boundaries issue, she went on to focus on growth, not on the issue of the existence *per se*.
10. For a speculation as to why, see Kay (1999) and Pitelis (2000).
11. Notably, the observation that the use of managerial time has positive costs (Marris, 1999) that TGF fails to deal with issues of intra-firm conflict (Pitelis, 2000) and that a number of important assertions by Penrose have yet to be tested (Pitelis, 2006).
12. The nearest she comes in the book to discussing the MNE is the following: 'Often the large firms organize their various types of business in separate divisions or subsidiaries' (p. 156).
13. In private discussions. Note also that Richardson (1972) too, pursued this approach. In essence the two terms are synonymous.
14. Also institution-seeking FDI, a more recent important addition to the OLI (Dunning, 2005).
15. Being capabilities based and very Penrosean in nature, this contribution has acquired prominence. Yet both the Penrosean view of vertical integration and Kogut and Zander's view of the MNE, suffer from a failure to appreciate that differential firm capabilities are tantamount to relative firm superiority on the market (that is, relative market failure). This also raises the question why and in which context the Hymer/Buckley/Casson/Williamson transaction costs-based explanation is of significance. It is interesting to note that in her case study on the Hercules Powder Company (Penrose, 1960) she provides a reason for vertical non-integration of Hercules' customers and of Hercules, in terms of 'oligopolistic interaction' arguments, but also in terms of the superior advantages of specialisation of Hercules.
16. 'Firms not only alter the environmental conditions necessary for the success of their actions, even more important, they know that they can alter them and that the environment is not independent of their own activities' (Penrose, 1959, p. 42).
17. Our support is consistent with Dunning's most recent writings on MNEs as agent of institutional change (see Dunning and Lundan, 2006).
18. Endogenous growth theories can also predict 'divergence', instead of convergence, and that *ceteris paribus* larger countries will grow faster than smaller ones; see Verspagen (2005), who also distinguishes between 'convergence' (which refers to the world level) and catching-up (which refers to individual countries) and discusses the similarities and differences between endogenous growth and evolutionary views. Divergence is also implied by contributions in agglomeration and new economic geography (see Henderson, 2005 and below). Feenstra (1996) suggests that in the absence of knowledge diffusion, divergence is more likely than convergence in open economy models of endogenous growth.
19. For Stiglitz (2001): 'The advocates of the neoliberal Washington consensus emphasize that it is government interventions that are the source of the problem; the key to transformation is "getting prices right" and getting the government out of the economy though privatization and liberalization. In this view, development is little more than the accumulation of capital and improvements in the efficiency with which resources are allocated – purely technical matters. This ideology misunderstands the nature of the transformation itself – a transformation of society, not just of the economy' (p. xiv).
20. For a more detailed and nuanced account of similarities and differences between the various East Asian countries, see Shapiro and Taylor (1990) and Rodrik (2004), and for differences between older and newer 'tigers', see Jomo et al. (1997).
21. For example, it is arguable that a more hands-on approach by government is required at the catching-up phase, while once a country has reached the 'technological frontier', so to speak, more focus on market signals may be appropriate.
22. There is extensive work on 'agglomeration' economies, that draws on the work of Krugman (1987) on new trade, see Krugman (1991a, b) and Henderson (2005) for a collection of papers. Martin (1999) provides a critical assessment. Martin and Sunlay (2003), Pitelis et al. (2006) and Jovanović (2009) also discuss the historical antecedents of agglomeration and 'clusters'-type literature. For our purposes, agglomeration economies by themselves imply divergence, but also the possibility to catch up, by diagnosing and upgrading agglomerations. Kottaridi et al. (2010) provide an empirical test of the role agglomeration plays in attracting FDI, in the context of UK regions; the results are in line with the idea that agglomeration and the location of R&D labs by subsidiaries are positively correlated.
23. For a relatively recent comprehensive discussion on catching-up, see Fagerberg and Godinho (2005)

and Fagerberg and Srholec (2005). The authors deal with most levels of analysis, but not the very micro (strategic management) one, as they themselves acknowledge.

24. Microfoundations, in the sense of optimising behaviour by economic agents, are at the very heart of the neoclassical theory, not least its endogenous growth variety (see Fine, 2000). In this context our claim may sound paradoxical. However, it is simply in line with the well-known criticism by Coase (1937), Penrose (1959 [2009]) and others, that the neoclassical theory treats the firm as a black box. What microfoundations there exist are in terms of profit-maximising black boxes, or the price-output decision of firms – not the creative role of firms and its impact on the macro economy. It is this type of microfoundations that we have in mind, that it is missing and that requires much more work and progress than there exists, including our own limited contribution here.
25. It could be argued that 'utility' suffices and that cost production is of no additional use, as neoclassical economists do (see Robbins, 1935). However, this would preclude one route through which perceived utility may increase; for business this is important. In any event, most neoclassical textbooks use the demand-cost curve apparatus, which incorporates both a utility (through demand) and cost (through the cost curve) element.
26. Shapiro and Taylor (1990) discuss seven 'boundary conditions' that can help devise and implement successfully state developmental policies, country size being one of them (see below). Rodrik (2004) distinguishes between first principles (market-based competition, property rights, incentives, sound money) and the plethora of specific policies that can be in line with the first principles, in an attempt to explicate the failure of 'Washington Consensus-type policies', while salvaging the core of the neoclassical agenda.
27. Jomo et al. (1997) comment on the issue of FDI and sustainability in the context of the development of the first-tier East Asian countries (such as Singapore, South Korea, Taiwan and Hong Kong) and the second-tier ones, such as Thailand, Malaysia and Indonesia as follows: 'While the Northeast Asian economies have been open to foreign investment, they have also been more selective and have emphasised developing national (not necessarily state-owned, except perhaps in Taiwan) industrial, technological, marketing and related capacities. In contrast, most rentier entrepreneurs in Southeast Asia have not been obliged to deploy their rents at such ends' (p. 163).
28. The requisite conditions for achieving these are not easy, and are arguably becoming more stringent for reasons related to technological changes (Fagerberg and Verspagen, 2002), but also institutional and international governance-related ones. At the time of its economic development, for example, Japan could get away with pursuing policies that would be considered as anti-competitive under current World Trade Organization (WTO) regulations, and even received US support to implement them. When Washington Consensus-type free markets, free trade policies are imposed on catching-up countries, this may be viewed as an attempt to 'kick away the ladder' (see Stiglitz, 2001; Chang, 2002; and Fagerberg and Godinho, 2005 for a discussion). Boltho and Allsopp (1987) showed that in the 1980s protectionism in the form of non-tariff barriers, was on the increase. On the other hand, the WTO can help participant countries to gain market access, partly offsetting these problems.
29. Recent research by Monteiro et al. (2008) suggested that 'subsidiary isolation' can hinder knowledge transfer to more 'isolated' MNE subsidiaries. One could surmise that more isolated subsidiaries are likely to be those in more distant, smaller developing economies.

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2 An enlarged EU, institutional challenges and European competitiveness

John H. Dunning and Jeremy Clegg

1 INTRODUCTION: OPPORTUNITIES AND CHALLENGES

There are both exciting opportunities and daunting challenges facing an enlarged European Union (EU) in its bid to promote a higher rate of growth, and to enhance its global competitiveness.[1] The aim of this chapter is to explore the effects of enlargement on the EU's prospects for attaining its economic goals.

This chapter is structured as follows. We shall concentrate on just three linked questions regarding the competitiveness of firms and the productivity of countries. First (Section 2), how far is the Union, and its member states, sufficiently motivated to raise competitiveness? Second (Section 3), has the EU got the appropriate governance and decision taking incentive structures? Third (Section 4), how might understanding the role of foreign direct investment (FDI) help us to answer the previous two questions? Section 5 concludes.

The fact that, aside from Malta, Cyprus and Slovenia, the 2004–07 accession countries were formerly centrally planned means that, as transition economies, the link between institutional change and economic re-birth has been a very explicit one.[2] For the existing 15 EU members pre-2004 – often referred to as the 'old EU' – the economic role of the new EU member states (the 'new EU') could be viewed in the role of acting as internal 'power packs' for the rest of the Union, in terms of market growth opportunities and, to a certain extent, lower-cost labour – though in manufacturing this role may have largely been ceded to China.[3] In this chapter we give special attention to the role of FDI in adjudging the impact on competitiveness, as FDI is by its nature a litmus test for the attractiveness of a location for profitable investment.

So, how might the EU best upgrade its economic performance? While the direct effects of the fifth enlargement upon the EU as a whole are necessarily modest, if only for arithmetic reasons, the impact of accession is likely to be greater for the new entrants owing to their small size (and for the other EU and non-EU countries most competitive with them). Enlargement may nevertheless confer indirect and dynamic impacts on the EU as a whole. We argue that this enlargement, however big or small its impact, has pinpointed some of the key economic and cultural differences and associated challenges to existing and new members, and has contributed to the impetus to reform and restructure EU institutions and policies to be fit for a union that may eventually grow to some 30 or more member states.

Table 2.1 presents some basic facts on the old and the new EU. These figures, at one and the same time, point to both the achievements of enlargement, and also to the scale of the challenge. The size of the divide between incomes in the new and the old EU is considerable. In 2004 the fifth enlargement countries' GDP collectively added up to just over

Table 2.1 EU15 and the EU enlargement 12, 2004 to 2008

	2004	2005	2006	2007	2008
EU E12/EU27 GDP at current market prices, percentage	5.41	6.02	6.40	7.02	7.86
EU E12 GDP/cap at current market prices (€)	5,536.43	6,433.45	7,229.60	8,397.58	9,511.16
EU15 GDP/cap cap at current market prices (€)	25,972.71	26,756.27	27,988.29	29,231.72	29,144.93
EU E12 GDP at current market prices (€ m)	573,516.3	665,686.2	747,333.2	867,629.2	982,710.1
EU15 GDP at current market prices (€ m)	10,033,270.7	10,395,525.4	10,933,947.6	11,489,932.8	11,523,371.4

Note: EU E12 denotes the EU enlargement 12 countries joining the EU in the fifth enlargement.

Source: Eurostat (2009b).

5 per cent of the EU27 total. By 2008, this had grown to just under 8 per cent, testifying to the very tangible relative growth that has occurred in the newly acceded countries, but nevertheless demonstrating that the collective economic weight of the enlargement countries within the EU remains very small. In 2004 the new enlargement countries' average income per capita was around a fifth of the EU15 average. By the end of 2008, it had risen to just under one-third – a considerable rise, but nevertheless a level well below the established members.

The very palpable differences between countries in terms of their levels of development, it can be argued, are a legacy – an outcome of history. Otherwise quite similar countries in terms of natural assets can only have come to diverge so markedly as a result of differences in institutions and quality of governance. The extent to which enlargement and European integration can be mustered to produce better outcomes is a focus of this chapter.

There are numerous definitions of what an institution is, or might be. However, North (1990, 1991, 2005) offers '[h]umanly devised constraints that shape human interaction', 'rules of the game' and 'the structuring of human interaction'. These fairly abstract definitions can be condensed into more recognisable formal categories, such as constitutions, contracts, laws, property rights and rules. In addition, there are informal constraints on human interaction such as social norms, codes of conduct and behaviour. The role of institutions in North's classification is to reduce uncertainty, which is a barrier to interaction and economic activity, and therefore to reduce transaction costs – the costs of doing business. It is the characteristics of institutions that then impact upon the quality of governance – the manner in which a country, or firm, is governed.

In the context of the EU, regional integration implies that countries with backgrounds of different types of capitalism and/or institutions, will experience some degree of convergence, or, at the very least some tendency towards isomorphism at the micro, or firm level, in which firms and individuals come to conform in their behaviour, as an outcome of EU-level institutions, and the quality of governance that flows from this. The strategic response of firms – particularly multinational enterprises (MNEs) – to these institutions, both national and supranational, is at the centre of our discussion, along with the effects that arise from these firms' actions and investment decisions.[4]

2 THE MOTIVATION TO RAISE COMPETITIVENESS

Looking back at both the initial *raison d'être* of the EU and its precursors, and the evolving expectations of its constituent members, it is clear that, since its inception, its values, institutions and goals have undergone continuous change. Competitiveness, as we currently conceive it, was not necessarily at the centre of the formation of the EU. The logic of the composition of its founding membership was essentially political – designed to ensure the avoidance of a future war between former antagonists. Issues of growth and competitiveness came to the fore in the 1970s and 1980s with concerns over the EU's comparative international performance. More recently, the focus has turned to social, environmental and security issues, and to meeting the challenges of globalisation.

How far is the Union, and its member states, sufficiently motivated to raise competitiveness? How far does it have the will to do so? For taking action and engaging in the needed reform and restructuring programmes is not without its costs. Some sceptics of European integration would argue that, almost since its inception – to a greater or lesser extent – the EU (and its predecessors) has either chosen not to meet the economic challenges head on, or has been prepared to trade off some degree of improved productivity to satisfy other, for example, social and environmental, goals, as if these were alternatives to economic performance. If the original six, then nine, 10, 12 and 15 member states have not so wished, or were unable to meet, these challenges, what hope is there that the 27 might do so?

It is worth noting at the outset that the 12 new members of the EU are more pro-market in their economic philosophy than many of their established (continental) EU partners.[5] This may reflect both their stages of development, and their past – but still relatively recent – experience of central planning. The addition of these new members makes the EU more heterogeneous not only in its income levels, but also in its social, cultural and ideological characteristics, and in its range of national goals, and therefore makes it more difficult to establish a common set of criteria for the attainment of 'optimum' competitiveness. Some would argue that the failure of the European Commission to achieve as much in the economic sphere as planned in the years after the millennium, specifically with regard to performance and competitiveness, has led to a displacement of focus towards a more social agenda.[6] While it is an open question as to whether one should assume that an increase in a nation's productivity necessarily increases national well-being, for the new accession countries in economic transition with their low GDPs per capita, the answer is more likely to be in the affirmative.[7]

There are good reasons for believing, however, that even for the pre-2004 EU15, improvements in economic performance would not necessarily have to be at the expense of other goals. Within the EU there is evidence of a bevy of avoidable 'technical' or 'institutional' misuses of the ways in which human and physical resources and capabilities are created or upgraded. According to the findings of a high level study group of European scholars and analysts chaired by André Sapir (Sapir, 2003), about one-third of the difference between the (lower) EU per capita GDP and that of the USA can be attributed to lower European productivity, another third to shorter working hours, and a final third to lower employment rates. While, in part, each of these differences might arguably reflect the different utility or value functions of European and US consumers, managers and workers,[8] there is most certainly a considerable element of 'technical' or 'institutional' inefficiency, which arises from deficiencies in either the incentive structures or the managerial response to these, both at a macro and a micro level.

The Lisbon Strategy, as set out by the March 2000 European Council, exemplifies the challenges faced by a heterogeneous EU. The Strategy was intended to make the EU into the world's most dynamic and competitive economy by 2010. The original targets covered research and development (R&D) effort, entrepreneurship, completion of the internal market, reduction of regulatory burdens, macroeconomic policy coordination, and educational investment. In November 2004, an EU review committee chaired by Wim Kok issued a highly critical report concerning progress (European Commission, 2004). While the Lisbon Strategy was relaunched in 2005, with a narrower focus on growth and jobs, it is now accepted that it will not achieve its professed goal.

It is not our intention in this chapter to rehearse the plethora of research undertaken on the reasons why EU member states collectively and individually record lower levels of productivity and firm-specific competitiveness, than does the USA; or indeed, why there is substantial divergence among EU countries.[9] However, we do suggest that the role of the institutional and policy environment affecting business is central to explaining differences in competitiveness and performance outcomes between countries.[10] This is supported by the view that there is sufficient technical knowledge in the EU to close the greater part of the productivity gap between it and the USA (Sapir, 2003). The main exception identified by the Sapir study is in the EU's capacity to innovate and upgrade its human capital performance;[11] though even here, the challenge is probably not so much one of a deficiency of indigenous resources and capabilities, but of a reluctance or inability of European institutions to offer the appropriate support and incentive mechanisms for such resources and capabilities to be properly created and used.

In order to understand how disparate the EU is, and why ambitious agendas at the EU level are so fraught, we need to turn to independent indicators. In this connection, the link between good economic governance and competitiveness could not be made clearer than in the World Bank's Doing Business Indicators project.[12] This identifies the 'ease of doing business', as influenced by the regulatory costs that are incurred by – particularly small and medium-sized – enterprises wishing to start and run businesses in each of (by 2009) 181 economies. These indicators measure the burden of selected business regulations, and rank each country along 10 dimensions. The intention of the World Bank is that the publication of these results puts pressure on economies to reform and so improve their governance, structures and institutions and, in the process, become more competitive and improve performance. The irony is that in many of the more advanced economies of the EU, regulatory burdens on business are heavier than in the less-advanced enlargement countries. While it is possible that the existing EU15 member states might be influenced by enlargement to liberalise further, in the face of the fiercer competition experienced in some areas and sectors, the two questions we must ask are, 'how heterogeneous is the EU for business', and 'what difference if any, has enlargement made'? Table 2.2 presents some interesting results.

The rankings in Table 2.2 suggest that the variation within the group of 12 EU enlargement economies is not appreciably different from the variation between this group and the EU15. There are fifth enlargement countries which have rankings not appreciably different from the rankings of some long-established EU members, while the highest-ranked enlargement countries, such as Estonia and Lithuania, would appear to put to shame countries such as France, Italy and Greece. As the Doing Business project only published its first results in 2004, it is difficult, unfortunately, to infer any impact of EU accession on the enlargement economies' rankings.

The contrasts between member states' 'ease of doing business' might be taken as evidence of different values as well as of different levels of efficiency. However, most (though not all) elements of the Doing Business exercise imply little or no prejudice to non-economic goals.[13] While the short run of data means it is difficult to infer whether EU enlargement has had any impact on rankings, the abiding impression is that the EU, as a location, remains at least as heterogeneous after enlargement, as it was before. Projecting forwards using the current and potential candidate countries, this conclusion does not change although, as it stands, further enlargement would tend to lower the EU's average ranking, according to these indicators.

3 GOVERNANCE AND DECISION-TAKING STRUCTURES

The last decade of the twentieth century saw growing understanding of the part played by institutions (primarily national) in economic development and restructuring. This was due largely to the intellectual insights of scholars such as Douglass North (1990, 1994, 1999, 2005), Joseph Stiglitz (1998, 2002), Amartya Sen (1999), and Oliver Williamson (2000) and to increasing empirical evidence – especially from the transition economies – on institutions' importance (Dunning, 2004, 2005). It has become recognised that the content, quality and flexibility of a nation's institutions, and of the values and belief systems underpinning such systems, are a critical determinant of economic growth and restructuring.

The espousal of free market values, pro-competitive legislation and domestic industrial liberalisation in countries such as the USA and the UK during the 1980s exerted a powerful demonstration effect. Liberalisation of state-owned industries, the privatisation of incumbent monopoly operators, and industry-specific legislation to create competition, heralded an era emphasising the quality of government, institutions and regulation, rather than its quantity (Clegg and Kamall, 1998). This natural experiment in liberalisation shows that institutional changes led by shifts in values and aspirations to raise economic performance can be highly transferable from one country to another. For economies with a history of being entirely run by the state, the EU offers a blueprint for institutional change and liberalisation, contributing to powerful political and economic

Table 2.2 Doing Business rankings in Europe, 2004/05 to 2007/08

Country/Group	2003/04	2004/05	2005/06	2006/07*	2007/08*
EU15 E10 average	–	38	43	41	45
Cyprus	–	–	–	–	–
Czech Republic	–	41	52	56	75
Estonia	–	16	17	17	22
Hungary	–	52	66	45	41
Latvia	–	26	24	22	29
Lithuania	17	15	16	26	28
Malta	–	–	–	–	–
Poland	–	54	75	74	76
Slovakia	18	37	36	32	36
Slovenia	–	63	61	55	54
EU25 E2 average	–	70	47	47	46
Bulgaria	–	62	54	46	45
Romania	–	78	40	48	47
EU27 C2 average		106	108	77	83
Croatia	–	118	124	97	106
Turkey	–	93	91	57	59
EU27 C6 average	–	78	76	82	78
Albania	–	117	120	136	86
Bosnia and Herzegovina	–	87	95	105	119
Iceland	–	12	12	10	11
Macedonia (FYROM)	–	81	92	75	71
Montenegro	–	92	70	81	90
Serbia	–	92	68	86	94
EU15 average	12	30	31	29	32
Austria	–	32	30	25	27
Belgium	16	18	20	19	19
Denmark	12	8	7	5	5
Finland	14	13	14	13	14
France	–	44	35	31	31
Germany	–	19	21	20	25
Greece	–	80	109	100	96
Ireland	15	11	10	8	7
Italy	–	70	82	53	65
Luxembourg	–	–	–	42	50
Netherlands	13	24	22	21	26
Portugal	–	42	40	37	48
Spain	–	30	30	38	49
Sweden	9	14	13	14	17
United Kingdom	7	9	6	6	6

Notes:
* For 2006/07 and 2007/08 the rankings are taken from the *Doing Business 2009* report, covering the period June 2007 through May 2008. Earlier years' data are taken from annually preceding reports.
– signifies that data are not available.
EU15 E10 and EU25 E2 denote the first and second waves of the fifth enlargement, respectively. EU27 C2 denotes current candidate countries in negotiation, and EU27 C6 is a future projection.
For 2004/05 the same rank is applied to both the Montenegro and Serbia economies, but the average is calculated on the basis of a single country.

Sources: World Bank (2004–2009).

incentives to join the EU. The conditions to be met by accession countries are highly revealing of how far institutional change is at the core of European integration.

The '*acquis communautaire*' is the cumulated body of EU law at the point at which countries negotiate accession. The key areas in which candidates were required to be satisfactory for the fifth enlargement are summarised in Box 2.1.

The scope of institutional change required of accession countries can be gauged by the breadth of the EU *acquis*, and the scrutiny applied to the requirements of accession.[14] In the case of Bulgaria's entry in 2007, the final monitoring report by the Commission in September 2006 stipulated tough conditions, with close monitoring on the remaining areas of concern.[15] The fact that Turkey, which applied as long ago as 1983 to join the EU, continued to have its candidacy frustrated by its failure to establish a fully functioning democratic system, demonstrates the traction that EU accession requirements possess over the quality of candidates' institutions and quality of governance.

However, the impact of membership on accession countries' competitiveness can be negative as well as positive. A problem arises where competitiveness and the economic performance of domestic firms has relied, for example, on cheap labour and a lack of regulation. Joining the EU then has the potential to undermine such advantages, by requiring the implementation of regulations that immediately add administrative costs, for example, as had been contended in the case of the Social Chapter attached to the Treaty of Maastricht. Where such losses are short term, new members might calculate that in the medium and long term the economic benefits of upgrading of the economy through trade and FDI, and non-economic benefits, should more than outweigh the losses.

After focusing on accession, it is necessary to emphasise that for the EU as a whole there remains a continuing challenge. There is a growing appreciation that, beyond the requirements at formal accession – which all existing member states must continue to satisfy according to European law – institutions tend to be more culturally embedded and sometimes more difficult to coordinate or change, certainly when compared with technical knowledge and organisational capability. The EU is no exception. The Sapir (2003) study is not alone in accepting that a good deal of this type of institutional restructuring and upgrading is needed, both on the part of the individual member states, and at the EU level as a coordinating economic and social entity.

A rough classification of the kind of incentive structures that need to be considered is set out in Figure 2.1. Some require changes in formal institutions (for example, constitutions, national laws (as opposed to EU law), enforceable regulations, fiscal incentives); others, a reconfiguration or modification of informal institutions (for example, conventions, norms of behaviour, voluntary codes of conduct and moral suasion). In the present context, it can be argued that certain of these (for example, trade and competition policy, intellectual property rights, and some kinds of product standardisation) are best dealt with at an EU level. Others, for example, innovation and education policy, and tax legislation are, perhaps, more appropriately tackled at a national or subnational level, though, sometimes within EU guidelines and/or with EU financial support.[16]

The areas within which the need for institutional reconfiguration can be identified in an enlarged EU are (i) economic structural transformation, (ii) economic and social convergence, and (iii) coherence (in objectives, levels of decision taking and policy instruments

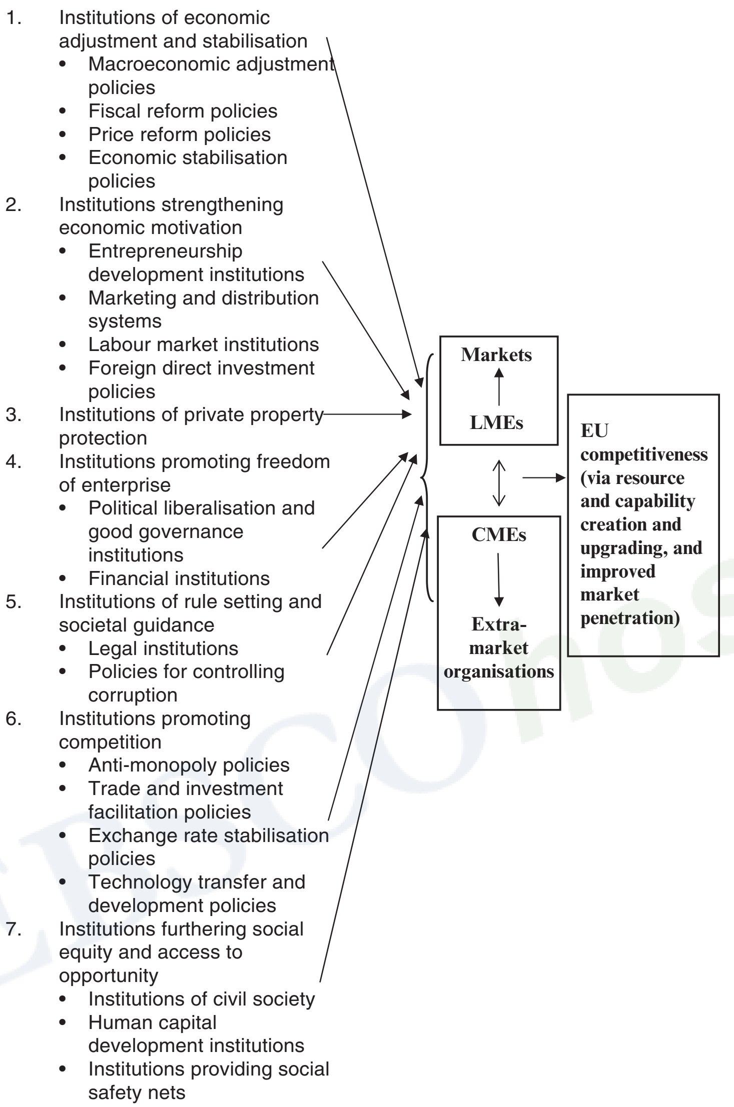
BOX 2.1 THE REQUIREMENTS OF CANDIDATE COUNTRIES – THE ACQUIS COMMUNAUTAIRE

- The candidate's democracy must be totally accepted by all elements of the political process. They must enjoy the protection of stable institutions, the rule of law and the rights of minorities must be protected. Although some of these elements may be debatable in some of the newly acceding countries, there is commitment to full compliance.
- The market economy must be fully functioning. This does not preclude state ownership, which is still prevalent in several existing EU members (notably France), but it does require the institutions of the economy to be stable and effective.
- They must share the ideals of the Union at all levels. This does not mean that they have to participate in all areas from the start, but the aim must be evident.
- The countries must implement the 31 chapters of the EU *acquis* (fifth enlargement of 2004/07), which is the exhaustive list of regulations that together make up the rules of operation of the EU. The 31 chapters are:

1. Free movement of goods
2. Free movement of persons
3. Freedom to provide services
4. Free movement of capital
5. Company law
6. Competition policy
7. Agriculture
8. Fisheries
9. Transport policy
10. Taxation
11. Economic and Monetary Union
12. Statistics
13. Social policy and employment
14. Energy
15. Industrial policy
16. Small and medium-sized enterprises
17. Science and research
18. Education and training
19. Telecommunication and information technologies
20. Culture and audio-visual policy
21. Regional policy and coordination of structural instruments
22. Environment
23. Consumers and health protection
24. Cooperation in the field of Justice and Home Affairs
25. Customs union
26. External relations
27. Common Foreign and Security Policy (CFSP)
28. Financial control
29. Financial and budgetary provisions
30. Institutions
31. Others

Note: For the prospective sixth enlargement, there are 35 chapters, for which negotiations commenced in 2005 with Croatia and Turkey.

Source: Authors and European Commission (2009c).



Note: LMEs = liberal market economies; CMEs = coordinated market economies.

Source: Authors.

Figure 2.1 Institutions underpinning and affecting EU competitiveness

of the EU). It is within these areas that the greatest challenges arise, due to heterogeneity among member states in terms of different ideologies, values and prioritisation of objectives, all of which may feed through to influence the ease of doing business, discussed earlier. Any enlargement of the EU inevitably complicates further harmonisation and coordination procedures, and will demand new levels of tolerance where these differences cannot be resolved. As the 2003 study on the future of the EU concluded, without coherence, even harmonised macro and micro technically oriented economic policies stand little chance of success (Sapir, 2003).

These arguments underpin the major challenges to the governance of the EU itself, as exemplified by the rejected EU Constitution, and by the EU reform treaty, known as the Treaty of Lisbon, designed to address the way the EU functions. Again, we confine ourselves to the issues as they appear at the EU level, rather than at the level of individual member states, though to some extent this precludes discussion of the important issue of what precisely should be the scope of the EU's competences. However, we are focusing here on the economic dimension of the EU, and this is inevitably impacted by the EU's ability to function effectively as a whole. The fact is that the EU's institutions were designed for a very much smaller number of member states than it currently has. That reform was needed has not been so much in question. Rather the debate has raged over the type of reform. To a significant extent this controversy has been precipitated by the enlargement of the EU, as its efficiency as an institution is thought by many to have suffered with the growth in membership. The 'thin slicing' of the Commission's workload into ever more directorates-general has been a case in point. Therefore, the reduction in the number of commissioners under the Treaty of Lisbon can be seen as an imperative to address a predicament created by enlargement itself – and not simply by the latest one. The fifth enlargement of the EU has acted as a catalyst to institutional change at the EU level to address areas of inefficiency which reduce the EU's capacity to deliver policy, and so to promote long-term competitiveness. EU-level reform of this nature is necessary to provide the framework for much-needed policy coherence, to achieve convergence between the member states, with their wide range of development levels (European Commission, 2009a).

Such macro-level institutional change to deliver policies appropriate to the corporate sector is necessary to enable the 'private' economic integration that goes hand in hand with micro-level corporate institutional change. It is interesting to note that differences in development between the new EU and the old EU are not associated so much with differences in their economic structures as with differences in the knowledge intensity and incentive structures found within any particular good or service sector.[17] This then suggests that it is within broad industrial groups that the impact of EU enlargement on European competitiveness is most likely to be focused; and that, at least for the foreseeable future, the main improvements and institutional upgrading of productivity will be concentrated in the low to medium technology-intensive goods and service sectors of the new entrants. In other words, the accession countries are engaged in a process of technological and corporate institutional catching-up with their established EU counterparts (Wysokinska, 2003).

This has important implications for the role of FDI in the development process of the new member states. These countries, as economies in transition, have been, and are, in a particularly favourable position to benefit from inward FDI. Although, as we have seen, collectively they do not add great economic weight to the EU, they do offer the potential to upgrade the EU's competitive capacity, through the greater observance of comparative advantage, internally to the EU, and between the EU and the rest of the world. The next section focuses on the role of FDI in mediating these changes.

4 THE ROLE OF FOREIGN DIRECT INVESTMENT

This section considers the relationship between FDI and competitiveness – be it broadly or narrowly defined – in the EU, and the ways in which FDI might help both the use and allocation of resources, capabilities and markets, through contributing to institutional change and the upgrading of governance.

FDI is a specific type of new market entry and, at its best, carries with it full potential for both direct and indirect productivity and performance gains for domestically owned firms in the host country (Caves, 1974; Gorg and Strobl, 2001, Svetličič, 2003; Buckley et al., 2007b). It can contribute to addressing the investment gap faced by transition economies, and by developing countries in general (Bellak et al., 2008). There are parallels between FDI as a form of new entry and new entry by domestic entrepreneurs – both have to face the costs of doing business that are specific to the location of the economy in question. This accounts for the observation that inward FDI is statistically directly related to greater ease of doing business (European Commission, 2009a, p. 111). Further, the theory of FDI and the MNE argues that foreign firms face additional 'costs of foreignness' in the host location compared with indigenous firms, and that to succeed in a foreign environment the MNE must enjoy some form of monopolistic advantage over indigenous firms (Hymer, 1960). Accordingly, we do indeed find that FDI tends to be the dominant form of new entry immediately following host liberalisation, as has been the case in emerging economies such as China, following the 'Open Door Policy' since 1978 (Buckley et al., 2002). With increasing global competition, however, the importance of this liberalisation–FDI entry dividend effect may be declining for all countries. Bellak and Narula (2009), for example, have argued that the experience of the former centrally planned fifth enlargement countries has been that increasing global competition has acted as a brake on the size of the positive response by foreign investors to domestic liberalisation and EU membership.

Taking the EU as a whole, however, enlargement still raises the opportunity for (i) greater intra-EU division of labour – both vertical (for example labour versus capital costs) and horizontal (for example, economies of scale) with resulting benefits of specialisation; and (ii) better exploitation of inter-regional comparative advantage – of both indigenous institutions and resources and capabilities, following the principles of trade creation (Cantwell, 1987; Witkowska and Wysokinska, 1997). Wider and deeper economic integration offers new opportunities for greater FDI and more MNE activity – both of an intra- and inter-regional kind (Dunning and Robson, 1988). And there is plenty of research evidence – particularly from China and the transition economies – to suggest that, given the right institutions and policies, inbound and outbound FDI does upgrade both national and regional competitiveness.[18]

How then might this inbound and outbound FDI affect the EU? We shall offer just five observations.

First, there is strong evidence that over the past four decades, US direct investment has helped induce a more entrepreneurial and competitiveness-enhancing spirit in European domestically owned industry, particularly in the UK (Dunning, 1998).[19] At the micro level, there is also evidence that inbound FDI introduces some much-needed institutional upgrading at the corporate level. The injection of US-style governance – in the shape of incentive structures and enforcement mechanisms, relating to managerial, procurement and marketing practices, human resource development and budgetary policies, entrepreneurship, networking and inter-firm relationships – into various European countries in the post-Second World War period, played an important role in European economic recovery (Kipping and Tiratsoo, 2002). The pro-competitive and market-integrating effects of US FDI also stemmed from its investors leading in the adoption of pan-European strategies – indeed, in the early days of the European Economic Community it was FDI from outside the EU that contributed most to European integration (UNCTC, 1990; UNTCMD, 1993; Clegg, 1996; Clegg and Scott-Green, 1999).[20] In the recent period of 2001/07, some 75 to 80 per cent of inbound FDI stocks into the newly joined members of the EU has originated from other parts of Europe (EU15) and as little as 5 to 8 per cent from the USA, on a declining trend (Eurostat, 2009a).[21] The likely impact of intra-EU inbound FDI on the goals of the 12 members joining in 2004 and 2007 is that it will continue to promote, initially at least, the market-based capitalism originally engendered by US FDI (and favoured by the new EU) rather than the varieties of capitalism native to the continental European old EU.[22]

The second point is apropos of the direct effect on the creation and use of indigenous resources by the new members, and how this impacts on the rest of the EU. Since the (pre-accession) association agreements between the EU15 and the new members, the main focus of inbound FDI to these economies has been on the staple and infrastructural industries, including natural resources (such as oil and gas), labour-intensive, and simple knowledge-intensive manufacturing, and the service sector (including tourism). A comparison of the sectoral distribution of inward FDI into the countries of the EU, according to the classifications of old and new EU (Table 2.3) shows that FDI is differentially concentrated by industry at any one time, but following a linked development profile.[23] This time signature means that while inward FDI typically starts with a focus on vertical resource-based, or efficiency-seeking, types of FDI, for example encouraged by privatisation schemes such as in telecommunications, as host incomes rise, market-seeking inward FDI naturally comes to take a growing share.

The Enlargement 12 hold inward FDI stocks in manufacturing of around the same proportion (30 per cent) as the EU15 states recorded in the mid-1990s at the time of the fourth enlargement. Both old and new EU proportions of manufacturing inward FDI have been declining, mirrored in a rise in services' FDI.[24] The shifting structure of FDI is captured well over the last 15 years, during which there has been a more than 50 per cent reduction in the share of manufacturing FDI into the EU15 (between 1995 and 2006) from 32 per cent to a little over 12 per cent, accompanied by a rise in the importance of services from just over 58 per cent to a little under 80 per cent (much of it linked to the rise of FDI in financial services). Against this backdrop, we can readily see how complementary the FDI patterns in the Enlargement 12 are *vis-à-vis* the EU15. In 2004 just under 37 per cent of the newly acceded countries' inward FDI stock was in the manufacturing sector, invested largely – and prior to accession – by EU15 countries, particularly in motor vehicles manufacturing and mechanical engineering. However, just two years later the proportion of manufacturing inward FDI had fallen to under 30 per cent of the total, as the new EU economies adjusted rapidly towards the dominant economic structure of the EU27, led by a rise in inward services' FDI stocks, from a little over 52 per cent to just under 67 per cent. The new EU therefore

Table 2.3 *EU15 and the EU Enlargement 12 inward FDI stocks, 1995–2006 and 2004–2006, percentage distribution*

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
EU15												
Agriculture and fishing	0.08	0.08	0.10	0.08	0.05	0.04	0.03	0.05	0.04	0.03	0.04	0.03
Mining and quarrying	7.69	7.10	3.99	3.29	1.97	1.66	2.26	1.37	1.35	1.37	2.76	2.87
Manufacturing	32.00	31.60	34.36	35.57	20.56	18.08	18.21	18.09	17.16	16.34	13.72	12.59
Electricity, gas and water	1.03	0.98	2.35	1.47	0.87	1.10	0.98	1.21	1.06	1.35	1.39	1.43
Construction	0.29	0.51	0.70	0.62	0.37	0.42	0.45	0.46	0.38	0.29	0.19	0.43
Total services	58.65	59.42	58.05	57.99	74.40	76.86	75.98	77.10	77.06	77.09	75.92	78.74
Not allocated	0.26	0.31	0.44	0.98	1.78	1.85	2.09	1.66	2.88	3.44	5.31	3.22
Total value (€ m)	858,920	973,876	1,123,828	1,467,375	2,372,487	3,272,587	3,728,547	3,854,005	4,283,914	4,626,200	5,418,919	6,118,698
EU E12												
Agriculture and fishing										0.41	0.39	0.31
Mining and quarrying										1.03	0.87	1.21
Manufacturing										36.87	35.38	29.67
Electricity, gas and water										4.54	4.47	4.85
Construction										1.42	1.31	1.47
Total services										52.29	54.50	66.74
Not allocated										2.77	2.22	–5.25
Total value (€ m)										220,165	271,777	371,777

Note: EU E12 denotes the EU enlargement 12 countries joining the EU in the fifth enlargement.

Source: Eurostat (2009a).

Table 2.4 Chinese outward FDI stock into Europe, percentage distribution, 2003–2007

Country/Group	2003	2004	2005	2006	2007
E12 as a percentage of EU total					
Bulgaria	0.14	0.27	0.39	0.37	0.16
Cyprus	0.00	0.00	0.15	0.09	0.05
Czech Republic	0.08	0.22	0.19	1.22	0.69
Estonia	0.00	0.00	0.17	0.10	0.04
Hungary	1.39	1.07	0.39	4.46	2.73
Latvia	0.41	0.32	0.22	0.19	0.02
Lithuania	0.00	0.00	0.54	0.33	0.14
Malta	0.09	0.07	0.19	0.16	0.07
Poland	0.69	0.57	1.71	7.24	3.45
Romania	7.05	5.79	5.13	5.15	2.48
Slovakia	0.03	0.02	0.01	0.01	0.18
Slovenia	0.00	0.00	0.02	0.12	0.05
EU15 as a percentage of world	1.15	1.10	1.22	1.38	2.25
EU27 as a percentage of world	1.27	1.20	1.34	1.70	2.50
World total value US$ millions	33,222.22	44,777.26	57,205.62	75,025.55	117,910.50

Note: EU E12 denotes the EU enlargement 12 countries joining the EU in the fifth enlargement.

Source: UNCTAD (2009b) from data supplied by the Ministry of Commerce of the People's Republic of China (MOFCOM).

appears to be following the EU15 in embracing the role of the service economy which, as noted earlier, may be accelerated as a result of competition from countries such as China.

Third, we would expect each of the kinds of FDI identified to increase technical and allocative efficiency both in the acceding countries and in the EU as a whole, assuming limited investment diversion. The accession of the Southern European members in the 1980s has shown that there is likely to be some relocation of less knowledge-intensive activities away from the more advanced parts of the Union and towards the newer members with their lower wages. We would also expect the newly acceded countries to attract FDI from smaller MNEs, and from firms originating in developing countries. On this latter point, the evidence does indicate that developing country MNEs have been turning to investment in certain enlargement countries to exploit their comparative advantages. Table 2.4 shows that, while collectively the EU27 is a very minor part of China's outward investment strategy (at less than 3 per cent of its global total) by 2007 the 12 newly acceded countries collectively attracted over 10 per cent of the EU's total – a greater proportion than their share of GDP. Individually, three countries lead the group: Hungary Poland and Romania. These transition economies have been especially attractive to Chinese firms, largely because of their deep privatisation and liberalisation (Hungary), large market (Poland) and business environment (Romania). There is evidence that for Chinese firms, 'ease of doing business' and risk should probably be measured in different terms from those appropriate for Western and advanced country investors, for whom qualities such as transparency are more important.[25]

Fourth, inbound FDI is unlikely to deliver its full potential in the long term unless there is sustained and holistic institutional reconfiguration by the organisations of the newer member countries. As the newly acceded members to the EU have a GDP per capita well below the European average, failure to fully upgrade their institutions will create a natural ceiling on the inflow of FDI, and a limit to the improvement in the productivity of these countries' resources and capabilities. Research on the European transition economies as a group very clearly shows that the poorer the country, the more is institutional upgrading an essential prerequisite for new FDI inflows (EIU, 2003). Of the national institutional and governance liabilities shown to be the most important deterrents to FDI, especial mention may be made of corruption, inadequate protection of property rights, ineffective competition policy, and too much red tape and bureaucracy. Certain new members, as noted earlier, such as Estonia, have made the most progress in this regard. However, the argument that the new EU, as a group, faces a challenge in upgrading its attractiveness to inward FDI needs to be explored empirically.

The nature of the challenge faced by the newly acceded EU members is captured in Table 2.5. The table presents figures on the intensity of inward FDI into EU27 host countries, expressed as the ratio of the inward FDI stock to host GDP, as a percentage. The average intensity of inward FDI into the EU27 has followed a growing trend, and in 2007 stood at 18.7 per cent. There is a wide variation around this, with Luxembourg leading the EU, with an inward FDI stock value that is 134.6 per cent of annual GDP.

The table also presents some figures from the FDI Potential Index published by UNCTAD (2008a), which is an exercise to measure the attractiveness of host countries to FDI.[26] The Index relies on variables that can be quantified for the greatest number of economies using readily available data, starting in 1992. As a result, it does not explicitly include social, political, governance and institutional factors, although it does include a composite risk indicator to capture country risk. The FDI Potential Index is built of economic determinants and policy and business facilitation determinants. To the extent that a country does not realise its potential, then we might infer that other factors, including institutional and governance factors, may be hindering the measured economic-related ones that are attractive to FDI. From the table, we can see that, with very few exceptions, the new enlargement countries have a lower FDI potential rank than the EU15 states. Even a country such as Hungary, the new EU country with the most intense inward FDI, does not have a potential index rank significantly higher than its peers. From this it is reasonable to infer that the domestic investment environments of the new EU – at least in developed country investors' eyes – are in need of upgrading.

Fifth, we turn to consider the kind of FDI that the newer member states might seek to attract, and what specific actions they might take to this end.[27] The quality of inward investment is a term which is used to connote the favourability of FDI towards domestic

Table 2.5 Inward FDI stocks as a percentage of GDP, selected years, 1996 to 2007, and FDI Potential Index Rank for 2006

	1996	2000	2004	2005	2006	2007	FDI potential rank 2006
EU6							
Belgium	:	:	:	:	:	:	15
France	12.9	19.4	29.2	32.4	34.4	38.9	18
Germany	7.8	24.5	24.2	24.2	25.3	28.1	6
Italy	5.8	10.2	11.6	13.3	15.1	16.0	31
Luxembourg (Grand-Duché)	89.2	114.8	132.7	119.4	134.6	134.6	5
Netherlands	31.8	62.7	71.3	74.5	72.2	86.7	13
First enlargement							
Denmark	12.3	41.3	43.4	47.6	46.8	47.4	23
Ireland	:	123.7	102.3	85.5	67.0	68.9	16
United Kingdom	19.0	29.4	29.1	38.9	44.6	42.0	3
Second enlargement							
Greece	:	:	11.3	12.5	14.1	15.9	37
Third enlargement							
Portugal	17.8	28.2	34.1	36.0	43.0	47.5	49
Spain	17.4	26.7	34.6	35.9	35.8	39.0	25
Fourth enlargement							
Austria	7.8	15.8	:	24.1	32.8	:	26
Finland	6.9	19.7	27.7	29.6	31.2	33.5	14
Sweden	12.5	38.1	50.4	49.4	55.1	57.9	8
Fifth enlargement							
Bulgaria	:	5.2	37.3	53.6	69.4	87.9	59
Cyprus	:	:	49.5	53.7	71.2	76.8	47
Czech Republic	:	38.6	47.6	51.3	53.4	58.8	39
Estonia	:	46.6	76.4	86	73.7	74.2	34
Hungary	:	:	55.8	59.0	102.3	121.1	41
Latvia	:	26.1	30.0	32.3	35.8	35.0	42
Lithuania	:	20.3	25.8	33.2	34.9	36.2	38
Malta	:	60.4	66.0	76.0	97.7	102.7	55
Poland	:	19.8	31.1	31.4	35.1	38.4	43
Romania	:	:	24.6	27.4	35.3	34.6	69
Slovakia	:	22.0	47.3	51.8	57.4	50.5	53
Slovenia	:	:	20.6	21.4	22.0	27.7	33
European Union (27 countries)	:	:	15.2	16.6	17.1	18.7	:

Note: Stock data are not available for Belgium.

Source: Eurostat (2009a and b).

goals. There are two basic approaches to fostering an environment in which high-quality FDI can be attracted. First is to work towards a host environment in which institutions are conducive and supportive of high-quality inward FDI, whatever the comparative advantage of the domestic economy. The second is a more *ad hoc* approach, which accepts that, for some period, the domestic institutional environment may not be as desired. In this case, international treaties my partially substitute for the host institutional deficit. These treaties are commonly known as international investment agreements (IIAs) and are used to protect or promote inward investment. These agreements are therefore associated with host countries with weak institutions, where the requisite economy-wide institutional upgrading is not in prospect, but where, even so, the host wishes to either maintain, or increase, its complement of inward FDI.

In the European context, because member states' FDI policy, as opposed to trade, has lain within the competence of individual member states (Karl, 2004) there has been scope for the use of such agreements to raise the quality and quantity of inward FDI. There are two types of IIAs, namely bilateral investment treaties (BITs) and preferential trade and investment agreements (PTIAs) – which have a broader coverage of economic cooperation. Of these two the evidence suggests that PTIAs do influence inward FDI, while the influence of BITs is less clear-cut. A survey by UNCTAD (2008b) shows that only a minority of IIAs include explicit investment promotion provisions. The focus in these agreements is primarily on the protection of existing investments rather than on the promotion of new investments through liberalisation, for example, promotional agreements that provide for pre-establishment national treatment. Nevertheless, it is common for the contracting parties in IIAs to hope for an increase in FDI to follow. This is relevant to the changes embodied in the Treaty of Lisbon. Although FDI is clearly listed as an EU competence in the Treaty, and it is clear that investment liberalisation is covered, it is not yet clear whether this extends to investment protection.[28] Member states hold divergent views on this question, and therefore it will be worked out over time. In the interim, the new member states may seek to attract FDI using IIAs to bolster any progress that they might make with regard to their domestic institutional environment.[29]

The final question must be to what extent have the member states benefited in terms of performance from the EU. The collective benefit for the enlargement economies of joining the EU is placed at around 2.1 per cent of GDP above the growth of existing EU members.[30] In estimations, the addition of variables to capture the legal system, freedom of trade, and the quality of regulation in product, labour and financial markets reduces this premium, but it remains at no less than around 1.7 per cent (European Commission, 2009a, pp. 40–41).[31] Interestingly, this premium appears very unevenly distributed between the enlargement countries. Although the Commission research does not remark on this, as we would expect, those countries with the greatest ease of doing business tended to enjoy better than predicted GDP growth following accession, while those ranked lower experienced the reverse. The two exceptions were the second-wave countries of Bulgaria and Romania, which performed above expectations. This interesting facet is suggestive of a prima facie link between the FDI decisions of firms and the expectation of improvement in host institutional factors. There are no *ex post* estimates of the impact of the fifth enlargement on the 15 'old EU' members collectively. We can only note that estimates for individual EU15 members range from a fractional fall for one member state, to up to a 2 per cent gain, which is suggestive of a modest collective growth benefit (ibid., pp. 47–8).

5 SUMMARY AND CONCLUSIONS

The evidence suggests that the accession countries, in joining the EU, have already taken the single biggest step that they can towards enhancing their competitiveness and to raising inward FDI and its contribution to their development.

We have suggested that the fifth enlargement of the EU has offered only modest opportunities for the immediate enhancement of European competitiveness as a whole, partly on account of the existing inefficiencies in the institutions of the EU, and partly because of underlying policy failures to promote competitiveness. Given the size and scope of the Union, it is true that, if only for arithmetic reasons, the greatest part of the impact of EU widening has already been felt through the fifth enlargement.

We might wonder why it is that there is such great disparity between the member states of the enlarged European Union in terms of indicators such as the ease of doing business, yet growth rates suggest the newly acceded countries to be performing consistently better than the established members. The answer is likely, at least in part, to lie in the fact that the Enlargement 12 is simply catching up. The opportunities that are offered by these new markets are sufficiently great that even those with the weakest institutions, poorest governance, and most inadequate implementation of liberalisation have not yet been impacted by binding constraints on inward FDI, particularly if bolstered by developing country investment. In contrast, the more advanced member countries have long experienced these constraints.

However, there are two discrete impacts of enlargement, which may generate long-term gains. First, the imperative for reform and restructuring owing to the sheer size of the membership, given that the institutions of the EU were built for a much smaller number of member states. Second, because of the economic and social disposition of the newer member states they, along with other economic and institutional reforms now being considered by the policy makers in Brussels and Strasbourg, are a force upon the EU to consider its rationale, some of its basic objectives, and the incentive structures necessary to support the achievement of these objectives.

Therefore, it can be argued that the fifth enlargement has catalysed the EU into action on the matter of reform and restructuring. Over the coming years, the EU is likely to focus especially on the methods or processes by which the wealth-creating entities of the member states might enhance the competitiveness of their resources, capabilities and markets, but to do so in a way which is consistent with the Union's social programme. A renewed emphasis on the social dimension by the European Commission could be taken to mark a point beyond which the EU will not go in the pursuit of productivity, performance and international competitiveness for its own sake. However, in furthering this focus, we believe that the particular economic, social and cultural characteristics of the new members, with their preference for economic performance, will prove invaluable as a counterbalance, and in widening the geographical perspective of the EU – and indeed helping it to become more outward looking in its ideology and policies.

SUMMARY

This chapter argues that the countries which joined the European Union in the fifth enlargement are engaged in a process of technological and institutional catching up with the existing members of the EU.

The logic of EU expansion is well understood in terms of economics: the extension of the founding four freedoms of the European Economic Community to a wider range of countries. Although the direct effects of accession are inevitably relatively greater for the new entrants owing to their small size, enlargement may nevertheless confer noteworthy indirect and dynamic impacts on the EU as a whole, through acting as a catalyst in crucial respects associated with the institutions and governance of the EU, and therefore with its long-run competitiveness. From a discussion based on some of the key processes at work, and on the behaviour of foreign investing firms, we suggest that the effects of enlargement can be significant and important for the both the 'old' and the 'new' EU.

Keywords

European Union (EU), competitiveness, multinational enterprise (MNE), foreign direct investment (FDI).

JEL Classification

F15, F21, F23.

NOTES

1. Throughout this chapter the term European Union, or EU, is used to refer to the EU and its predecessors.
2. The European Commission regards the accessions of 2004 and 2007 as two waves of the same fifth enlargement (for example, European Commission, 2009a, p.18) and this is the approach adopted in this chapter. However, for reasons of inference we distinguish the two waves where it is sensible to do so.
3. Under the pre-existing association (Europe) agreements between the new members and the EU15, much of the effects of enlargement actually predate the dates of accession (European Commission, 2009a).
4. For a comprehensive discussion of the relationship between economic growth, institutions, the MNE and FDI, see Dunning and Lundan (2008, pp. 300–314).
5. In this sense, their philosophy is more aligned to that of liberal market economies, for example, the UK, than the managed market economies of France, Germany and Italy (Hall and Soskice, 2001).
6. See the emphasis on social cohesion in European Commission President José Manuel Barroso's *Political Guidelines for the Next Commission* (European Commission, 2009b).
7. Here we might note research suggesting that more material possessions do not necessarily lead to more happiness or contentment among individuals (Worcester, 1998; Cooper et al., 2001; and Layard, 2003).
8. As revealed, for example, by the composition of output, working conditions, leisure preferences, and higher value placed on social goods. Any study of competitiveness should surely take account of these.
9. For some of these, see Sapir (2003), IMD (2004) and Jovanović (2004).
10. See World Bank (2009, p. vi).
11. According to the Sapir (2003) study, in 2000 some 50.3 per cent of the population in the USA completed higher education. This is over one and a half times that in the EU. In 1999, total expenditure on tertiary education as a percentage of GDP was 3.0 per cent in the USA and 1.4 per cent in the EU, while in the same year R&D, at 2.6 per cent of GDP in the USA, was over a third higher than that in the EU (at 1.7 per cent) (Sapir, 2003, pp. 30–35).
12. *Doing Business* (DB) is an annual World Bank–International Finance Corporation (IFC) publication,

launched in 2004. The ease of doing business measure is the simple average of an economy's rankings in each of the topics/dimensions covered. Higher values of the measure indicate more efficient regulation and stronger protection of property rights. There is also a very clear correlation between the Human Development Index (UNDP, 2009) and the ease of doing business (see figure 1.6 on page 4 of World Bank, 2005).
13. One exception might be the hiring and firing of labour.
14. The chapters of the *acquis* are closed individually, as the acceding countries introduce the necessary laws and oversee their effective implementation.
15. These included the justice system, the fight against corruption, police cooperation and the fight against organised crime, money-laundering, integrated administrative control system for agriculture (IACS), transmissible spongiform encephalopathies (TSE) and financial control.
16. Although the locus of governance may be contextual between countries, sectors, different institutional demands, and over time.
17. As discussed later, there are significant differences in the industrial distribution of FDI between the new and the old EU, which supports the contention that FDI is most intense in those industry categories where the scope for catching up is greatest.
18. As, for example, is illustrated in Wang et al. (2004) and Dunning (2005).
19. Econometric research on FDI into China supports the existence of a mechanism for such effects. The nationality of origin of FDI influences the pattern of spillover impacts on domestic industry, leading to a 'signature' in the pattern of growth in the productivity and capabilities of local Chinese firms, while the type of ownership of the host domestic firm also plays a role (Buckley et al., 2007b).
20. Research by Rugman and Collinson (2005) on a sample of 118 European MNEs from the largest 500 firms worldwide finds that these firms have an average 62.8 per cent of their sales in their home region, which argues strongly in support of their view that FDI is foremost a regional phenomenon. Aggregate FDI data similarly demonstrates that just under 68 per cent of the EU27's inward FDI stocks (to 2007) are sourced 'internally' from the advanced investing countries of the EU15, confirming intra-EU FDI as the driving force for the integration of the European economy.
21. This contrasts with a modest Canadian rise to just under 3 per cent, and an increase in source diversity in the form of a rise from unspecified other countries (from some 10 per cent to a little under 20 per cent) (Eurostat, 2009a).
22. Particular market and extra-market functions may follow different brands of capitalism. For example, it is quite possible for a particular country to embrace market-based capitalism (*à la* USA and UK) in respect of trade specialisation and labour markets but choose continental European capitalism in respect of health and education (Amable, 2003).
23. Useful lessons may be drawn from the experience of (i) the Asian 'tigers', coupled with the 'flying geese' and 'industrial catching up' models put forward by Terutomo Ozawa (1992, 2000, 2009); (ii) the earlier accessions of Greece, Portugal and Spain to the EU; and (iii) the reunification of Germany in 1990.
24. The advanced member states have participated in extensive service sector FDI, largely driven by the privatisation of utilities, notably telecommunications network operation and value-added services (Clegg and Kamall, 1998).
25. A study on the geographical signature of Chinese outward foreign direct investment (OFDI) by Buckley et al. (2007a) suggests that, by Western standards, Chinese MNEs are 'risk lovers', that is, preferring host countries with higher country risk, possibly because such business environments are more familiar to the home Chinese environment, and because of the priority given to investment in natural resources in developing countries, with higher risk profiles.
26. The FDI Potential Index was not published in UNCTAD (2009a), although the project continues.
27. Daniel Rondinelli (2005) in an excellent paper identifies eight areas of institutional reform which economies engaging in structural change need to address. The precise form of incentive structure and reinforcement mechanisms for furthering these institutions will depend on what they are intended to accomplish, and country-specific circumstances.
28. Article 207 (1) refers to FDI, and the Commission, and some member states, hold that this covers both FDI protection and promotion. If so, it would mean that the EU would be able to conclude agreements that include comprehensive investment rules, in much the same way as the USA concludes free trade agreements with partner countries. To date the Commission has not been responsible for general investment liberalisation, though has negotiated agreements covering investment in services, such as mode 3 of the General Agreement on Trade in Service (GATS), which falls under the Community's competence for external trade established by the Treaty of Rome (see Woolcock, 2008).
29. The EU, under the Treaty, may extend its negotiation of IIAs with third countries and, while the focus regarding investment might be on EU FDI in third countries rather than into the EU, there may be scope for investment promotion.
30. A study by UNCTAD (2010) drawing on Zimny (2004) concludes that FDI inflows into selected EU

countries, following previous enlargements, resulted in increases of typically between 1 and 4 per cent of GDP after 3 to 5 years but, in one case, of up to 14.6 per cent of GDP.

31. One might reasonably argue that these variables cannot be disentangled from the benefits of accession, as it is difficult to tell what reforms would have occurred without enlargement. Again, we should note that many of the enlargement-related growth effects occurred before actual accession.

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3 The integration and fragmentation roles of transnational companies

Grazia Ietto-Gillies[1]

1 INTRODUCTION

The popular image sees transnational companies (TNCs) as huge and all-powerful companies based in developed countries and investing in developing countries. This profile may never have been fully accurate and it is increasingly less so.

Most large companies are indeed transnationals. However, an increasing number of smaller companies are also setting up production facilities abroad and becoming transnationals. This trend has been facilitated by developments in the cultural, political and technological environments that are enhancing internationalisation in many spheres of life: from production to consumption, from culture to business.

UNCTAD (2008) gives 78,817 as the total number of TNCs worldwide. Of these, 72 per cent are located in developed countries, a share that has been declining steadily from 91.3 per cent in 1994, to 76.9 per cent in 2000, to 74.3 per cent in 2007 and 72 per cent in 2008. The same developments that facilitate the transnationalisation of smaller companies may also facilitate the branching out of companies from developing countries often into neighbouring countries and within the regional confines.

The volume of foreign direct investment (FDI) has been increasing considerably in the last three decades. A large percentage of it takes the form of mergers and acquisitions (M&As) by companies based in different countries. With regard to the geographical pattern of FDI, the developed countries are both home and host to the largest shares of FDI, that is, they are the main originators and the main recipients of investment by TNCs. In 2007 their share of outward and inward stock of FDI was, respectively, 86.6 and 69 per cent. Though the share of FDI into developing countries (31 per cent) is considerably smaller than that going to developed countries, the inward stock of FDI has a bigger impact on the former, being a higher share of their GDP: 29.8 per cent against 27.2 per cent in developed countries.

The transnational or multinational companies are much talked about as if they were a totally different type of institution from the normal company or firm. Are they? And if they are, what makes them so? The distant antecedents of the TNC can be traced back many centuries either to the Medici Bank in Renaissance Florence or to the seventeenth- and nineteenth-century trading companies from Northern Europe. Many business historians (Cox, 1997; Jones, 2002) agree that the key factor that led to the development of the TNC was the formation of joint-stock companies. None the less a TNC is not just another joint stock company. What are the key elements that make a company a TNC? The defining element is operations across frontiers. But not just any type of cross-border operation. Imports and exports on their own are not operations that identify a company as a TNC. The specific requirement is for ownership of assets abroad leading to direct business operations and for the ability to control those operations. Various issues arise in this context, which will be dealt with in the following sections.

This chapter is structured as follows. In Section 2 we shall consider first the type of control exercised over assets and operations and, second, the strategic behaviour of TNCs and its relationship to control. In Section 3 we shall analyse the relevance of national frontiers and thus of nation-states for the existence and characteristics of TNCs. Sections 4 and 5 will argue that national frontiers may generate scope for specific strategies by TNCs and for specific advantages by them in relation to other actors. In Section 6 the extent to which strategic behaviour can lead to fragmentation and/or integration and the meaning attached to these processes will be considered. Section 7 will analyse how the above issues relate to the process of regional integration. Finally, Section 8 summarises and concludes.

2 TNCs' OPERATIONS: CONTROL AND STRATEGIC BEHAVIOUR[2]

Business operations across frontiers have been established for centuries if not millennia. In fact, most records of early civilisation show signs of trade between different peoples, often across frontiers well before the establishment of nation-states. Imports and exports have indeed been the main type of cross-border business operations. Worldwide, trade is still the most relevant modality of international business transactions though its relative importance – as a percentage of total value of transactions – is declining. TNCs are strongly involved in trade and their overall activities have effects not only on the volume but also on the structure of world trade. Intra-firm, intra-industry and the geography of trade are all affected by the worldwide operations of TNCs (UNCTAD, 1996; Ietto-Gillies, 2005: ch. 19). The last few decades have seen the growth of other business modalities across frontiers in all of which the TNCs are greatly involved: from licensing and franchising to collaborative agreements to subcontracting.

However, the modality that defines a company as a TNC is international production via FDI, that is, via the ownership of assets abroad, be they acquired via greenfield investment or via M&As. For operations abroad to be seen as part and parcel of a company's operations and thus for the company under consideration to be seen as a TNC, the same company must be able to exercise control over its foreign assets and businesses. Control has two main connotations in the context of a TNC.

The first connotation is the equity stake in the foreign enterprise. What percentage of the foreign assets must be owned by the main company for the latter to have control? The International Monetary Fund (1977) guidelines set a minimum of 10 per cent. Equity control is a *necessary condition* but not necessarily a sufficient condition to ensure control of operations and directions of the foreign concern. Equity control by itself does not lead to strategic managerial control if the means of exercising such control are not available – in particular, if the system of communications and the organisation of the business across countries are not suitable for the exercise of such managerial control. This was indeed the case of much foreign business prior to the First World War when there was, in fact, a very considerable amount of foreign investment. There were indeed many enterprises whose assets were owned wholly or in large part by persons or groups or companies in foreign countries (usually in Britain or Holland or the US). However, though the owners had a controlling stake in the businesses they were not in a position to exercise managerial control because of the large distance between home and host countries and the poor transport and communication systems. Wilkins (1988) has termed these businesses 'free-standing enterprises' to highlight the fact that, though they were owned wholly or partially by foreign nationals (whether individuals or groups or companies), they were managed and developed as independent concerns.

The modern TNC is characterised by having both equity control and ability to manage the foreign affiliates at a distance. The relevant type of management in our context is the one related to the setting of strategic goals and the monitoring of performance, rather than the day-to-day operational management.

The ability to manage at a distance is the product of two relevant and interconnected innovations, both of which form the *sufficient conditions* for the exercise of control. First, the technological innovation not only in transport but also in personal communications which, starting with the telegraph and telephone, were greatly enhanced, more recently, by electronic communications. Second, organisational innovations which were made possible (and/or strongly facilitated) by the communication technologies as well as by the experience of firms operating large manufacturing projects – particularly the building of railways – during the nineteenth century.

Developments in the internal organisation of companies have been analysed under two different 'paradigms': 'efficiency' and 'strategy'. Williamson (1975, 1981 and 1984) sees changes in the internal organisation as driven by efficiency objectives; specifically, by the desire to economise on transaction costs, as well as to minimise the pursuit of individual goals within the organisation. Chandler (1962) sees the internal organisation of corporations evolving mainly in response to strategic objectives, in particular growth strategies. Chandler's line is taken up by Hymer (1970), who analyses the relationship between the evolution in the internal structure of the firm and multinationality; in particular, how the former facilitated the latter. Other authors have emphasised the link between control and strategic behaviour (Cowling and Sugden, 1987 and 1998).

Strategic behaviour has many connotations and can be analysed in relation to two specific dimensions: behaviour towards 'what' (a) and towards 'whom' (b). Regarding (a), it is seen in relation to the activities of the firm such as: its products' range; the markets it seeks to penetrate; its production processes; the technologies used; the organisation of the value chain; and the geographical configuration of its production activities. With regard to (b), the analysis is in relation to specific actors such as: rival companies; consumers; suppliers, distributors and subcontractors; the labour force; and governments.

Closely linked to the latter dimension is the relationship between strategic behaviour and power. Zetlin (1974: 1090) argues that power (and control) 'is essentially relative and relational: how much power, with respect to whom?' Companies' power has usually been analysed in relation to market power and therefore with respect to rival firms. However, power may also relate to other players in the economic system and specifically to labour, governments, suppliers/distributors, subcontractors or consumers.

Power and strategies can be used to resolve conflicts between the specific company under analysis and other actors. The conflicts are usually over distributional issues arising from production or market conditions. In the case of conflicts with rivals, the distribution relates to market shares; in the case of labour, the conflict is over distribution between profits and wages; in the case of conflicts with governments, the issue is distribution over the overall surplus and how much should go to the private or public sphere (via taxation or financial incentives or subsidies).

In the next three sections we shall analyse how transnationalisation generates opportunities for strategic behaviour by firms operating across nation-states. The strategic behaviour considered will be specifically in relation to labour and governments rather than directly in relation to rival companies. This is not because the latter is not considered important but mainly because it has been well covered in the literature.

In fact, in the international business literature the strategic behaviour of companies has been considered by many authors in the context of developing theories of why companies operate across frontiers and which modalities they employ. The strategic behaviour towards rivals is considered in Hymer (1960), Vernon (1966), Knickerbocker (1973) and Cowling and Sugden (1987). Sugden (1991) and Ietto-Gillies (2002 and 2005) stress strategic behaviour towards labour. Other authors have followed the 'efficiency' route and developed theories that explain internationalisation activities and modalities in term of cost efficiency and, specifically, minimisation of transaction costs (McManus, 1972; Buckley and Casson, 1976; Helpman, 1984, 1985; Markusen, 1984, 1995; Helpman and Krugman, 1985). Dunning's well-known eclectic framework has elements of both efficiency and strategic behaviour (1977, 1980).

3 TNCs AND THE NATION-STATES

In this section we shall consider the relevance of national frontiers for the activities and strategies of companies. At the semantic level transnationalisation implies the existence of national borders. In this sense we can say that in a world with no nation-states there would be no TNCs, meaning that we would not characterise a company as a TNC just as we do not currently attach a special label (such as 'trans-regional') to companies that operate in many regions of the same country.

This begs the question as to why – in a world in which nation-states exist – we see the need to attach a special label to companies that operate across several of them. It therefore raises the wider issue of the relationship between nation-states and companies and of the relevance of the nation-state for companies. Is there something specific to the nation-state in relation to corporations which is not to be found at the level of regions within a country? The answer to these questions will lead us to examine the evolution of this relationship in – and its relevance for – the context of regional integration. The adjective regional in the last sentence refers to geographic areas encompassing several nation-states such as the European Union (EU) or the North American Free Trade Agreement (NAFTA).

In order to tackle these issues and attempt to answer the questions, let us examine the relevant dimensions of operating across national frontiers. There are three main dimensions to business operations across nation-states: a spatial or geographic dimension; a cultural dimension; and a dimension related to specific regulatory regimes.

The *spatial/geographic dimension* has to do with distance between locations and its relevance is largely linked to transport and transaction costs. The distance between locations in different nation-states is often greater than the distance between locations within the same nation-state. But this is not always the case. For example, the spatial distance between Turin and Palermo is greater than the one between Turin and Geneva. Similarly, the distance between New York and Montreal is less than the one between New York and San Francisco.

The *linguistic/cultural dimension* – particularly the business culture element – affects the operations of companies in terms of transaction, organisational and managerial costs. The cultural distance is usually greater between nation-states than between regions of the same nation-state. But again, this is not always the case. Regions close to the border of two nation-states often have more similar business cultures than distant regions within the same nation-state.

The *regulatory regimes dimension* encompasses the sets of all laws, regulations and customs governing the economic, social and political life of a country. It therefore includes the sets of institutions and regulations governing production, markets and the movement of resources across countries. Each country has a specific regulatory regime and thus a specific set of rules and regulations which often have historical roots. Nation-states differ – sometimes substantially – in terms of their specific regulatory regimes. Regulatory regimes tend to be more – though not completely – homogeneous and consistent within each nation-state than between different nation-states.

The nation-state can be seen as the locus of a set of 'regulatory regimes', that is of a set of specific institutions, rules and regulations which affect people, firms and wider organisations within the borders of the nation-state. Some of these rules and regulations stem from the legal or institutional system, some from government policies; several have more than one connotation, that is, they incorporate legal, institutional and/or policy elements. Specific elements of nation-states' regulatory regimes relevant for businesses are the following: (a) currency regimes; (b) fiscal regimes; and (c) rules and regulations regarding the social security system and in particular different regimes regarding labour and its organisation.

All three dimensions discussed here have cost implications. A company operating across frontiers may face additional costs and risks ranging from transport and transaction costs to managerial and organisation costs. They also include costs specific to the third dimension such as: costs of insurance against risks of currency fluctuations; additional costs of acquiring information about fiscal and social security regulations in other countries as well as information about their labour market conditions; and costs of mastering – and managing in the context of – different laws, regulations and customs.

However, there are also advantages of operating across frontiers. Companies that can truly plan, organise and control across frontiers can also develop strategies to take advantage of *differences* in regulatory regimes across frontiers. This is particularly the case when the strategies are in relation to actors who cannot – or not yet – plan and organise across national frontiers, or not to the same extent as the TNCs. Specific advantages of transnationality can be developed in the following spheres:

- towards labour;
- in negotiations with governments;
- with regard to different currency and tax regimes; and
- in relation to risk spreading.

4 INTERNATIONAL PRODUCTION AND STRATEGIES TOWARDS LABOUR

As already mentioned, most international business literature on companies' strategic behaviour has concentrated on strategies towards rivals rather than on strategic behaviour towards labour. From the perspective of the company and its profitability, the best position to be in is one in which it has power over both its rivals and its labour force; that is, it commands market power and faces a labour force which lacks power – or is made less powerful – because it is segmented and has difficulties in its collective organisation and thus in bargaining.

The two sets of power relations – with rivals and with labour – are affected by two different aspects of the organisation of production: specifically, the market concentration and the internationalisation of production activities. Both market concentration and internationalisation have increased in the decades immediately after the Second World War. However, the last quarter of the twentieth century saw considerable changes in the companies' strategic behaviour with respect to the organisation of production and the production process – specifically, changes in the organisation of the production process within and between firms and changes in the companies' strategies towards the geographical location of their activities. In the late 1970s, 1980s and to some extent also the 1990s, many large companies have been downsizing, that is, outsourcing the production of part of their activities, usually the non-core part but, at times, some core activities as well. This meant that whereas the decades following the Second World War have seen an increase in the internalisation of production activities, the later decades of the century have seen the opposite process: many large firms have subcontracted part of their activities to smaller firms who are usually independent in terms of ownership though, often, dependent in terms of strategic control of their activities (Cowling and Sugden, 1987). The same late decades of the twentieth century have also seen acceleration in the expansion of activities abroad by large companies, some on an internalised basis and some outsourced to smaller firms in foreign countries.

The explanation of these historical patterns can be aided if we see them in the context of possible strategies of companies towards labour. The concentration of production leads to oligopolies and thus to market power. However, it may, at the same time strengthen the power of labour because labour employed within the same ownership unit – that is, within business enterprises all belonging to the same company – may find it easier to organise and take action compared to a situation in which it is dispersed across units belonging to different owners.

With regard to the international location of production, labour has, traditionally, found it easier to organise and resist when working within the same country. Proximity, shared condition of labour and shared contractual obligations lay the foundations for easier organisation and resistance. Moreover, shared historical, cultural and social environments give labour a stronger feeling of solidarity. On the whole, the differentials in the actual and potential for labour organisation and for bargaining power are higher between countries separated by institutional, political, cultural, legal and governmental borders than within each border. We can identify areas of 'labour organisation regimes' as those geographical areas within which – *ceteris paribus* – labour finds it easy to organise itself effectively due to shared cultures, contracts and working conditions.

We can therefore identify two main dimensions in the organisation of production: (a) an ownership dimension by which we mean to capture whether or to what extent the firm internalises its production activities or uses external, arm's-length transactions with other firms for part of its value chain activities; and (b) a geographical dimension which tends to capture the extent to which production activities take place within the same location or nearby ones, or the extent to which they are dispersed in several locations. In the latter context, of particular relevance is whether the activities are located in different nation-states for the reason explained in the next two sections; or (c) a mixture of ownership and geographic dimension. The last is a combination of dimensions (a) and (b). Thus companies within a sector may – *ceteris paribus* – face a more powerful labour force when the same is employed: (a) within the same company/institution rather than being dispersed into many; and (b) within the same country.

It is in the interest of companies to develop strategies that increase their power towards labour while not diminishing – and possibly increasing – their power over rivals. Possible strategies in this direction involve the *segmentation/fragmentation of labour* while retaining their market power. Two specific types of fragmentation strategies are possible and have been followed: (i) organisational fragmentation through the externalisation of some activities; and (ii) geographical (by nation-state) fragmentation through the location of production in various countries characterised by different regulatory regimes.

These two strategies are not incompatible and they can be implemented together. The first strategy (organisational fragmentation) involves the company in the externalisation of labour through outsourcing (such as subcontracting arrangements) which allow considerable control of production without the added responsibility for the labour employed.[3] The second strategy involves the spread of production in countries, areas not linked by common labour organisation regimes, that is, areas that have different trade unions and/or different labour and social security laws, regulations and standards. These elements make the organisation of labour and its resistance to the demands of capital more difficult.

Two consequences derive from this, both relevant for TNCs' strategic decision in terms of the location of international production. First, that – *ceteris paribus* – companies may seek to locate in areas of weak labour organisation regimes; thus FDI would flow – *ceteris paribus* – from areas of strong labour organisation regimes towards areas of weak regimes.

Second, even if the differentials in labour organisation regimes across nation-states are not high, the *dispersion* of employment across many countries – though within the same company – *fragments the employed labour force* and thus makes its organisation more difficult and its bargaining position weaker. Such dispersion gives a stronger position to companies *vis-à-vis* labour compared to a situation in which the growth of production within the same company were to occur all or most within a single country. Thus, we have a situation in which the internationalisation of production *per se* may generate advantages for companies.

The fragmentation/segmentation of labour can take place on the basis of organisational dispersion, thus leading to the various degrees of externalisation of production: from full outsourcing and use of market transactions to varying degrees of control through subcontracting and similar arrangements; from the employment of labour full-time and on permanent contracts to the casualisation of labour (Ietto-Gillies, 2002: ch.

3). Fragmentation may also take a geographical (by nation-states) route. This involves the dispersion of production over many nation-states, countries/areas, albeit within the internal, hierarchical organisation route. Some degree of both geographical and organisational dispersion and fragmentation is also possible, for example, through international subcontracting. The two strategies reinforce each other in the labour fragmentation potential and therefore in the difficulties they generate for the organisation and resistance of labour in its bargaining with capital.

The organisational pattern of production that arose from the late 1970s onwards – outsourcing and increased international location – can be seen as a strategic reaction by companies to the increased power of labour in the decades after the Second World War. The latter being aided by the concentration of production into large units often developed in the same site or in spatially close sites.

Before leaving the issue of possible strategies towards labour we must deal with some caveats. Are outsourcing strategies and international location of production to be interpreted only in terms of strategic behaviour towards labour? The answer is emphatically: no. There are many other reasons why companies want to outsource (such as the achievement of more flexibility of supply to demand conditions or the lowering of fixed costs) and want to locate abroad (such as proximity to markets or sources of materials or of labour). However, whatever the reasons – and there are likely to be several – one of the outcomes is that both outsourcing strategies and international location of production lead to a weakening of the employed labour and thus to a strengthening of the power of management towards the workforce they employ.

Another caveat arises from the assumption on social security regimes. We assumed that they differ between nation-states but are fairly homogeneous within each nation-state. In reality there can be considerable differences even within regions of the same country such as regions of the UK or states within the US.

5 REGULATORY REGIMES AND TNCs' WIDER ADVANTAGES

Differentials in regulatory regimes can be turned into advantages, some of which are actor specific and others are not. Among the former are advantages towards labour considered in the previous section. Having production locations and business activities in several nation-states can also give the company a strong bargaining position towards governments of the nation-states and their regions. TNCs can – and do – play off governments of different countries or regions against each other with the objective of raising the offer of incentives for the location of inward FDI (Oman, 2000; Phelps and Raines, 2002). If a company has production facilities in many countries, its threat of relocation becomes very credible and can be used as bargaining power to gain high incentives.[4]

Moreover, the existence of multiple sourcing channels (whether actual or potential) in the various countries also gives the TNCs a powerful bargaining position towards suppliers. Are there also advantages to be gained towards rivals? As already mentioned, international location can be in response to a variety of strategies including those in relation to market penetration and expansion and in relation to sources of materials and labour. Moreoever, any advantages towards labour and/or governments deriving from location strategies and leading to higher profits can be turned into indirect advantages towards rivals as it increases the potential for higher market shares.

Among those strategies and advantages that are not actor specific are the following. Nation-states as loci of regulatory regimes are also loci of specific currency and taxation regimes. Operating across several such regimes puts the company in a position to: (a) maximise its returns from exchange rate fluctuations; and (b) minimise its worldwide tax liability via the manipulation of transfer prices, that is, prices charged for the exchange of goods and services within the firm but across national frontiers (Ietto-Gillies, 2005: ch. 20).

Moreover, the locational diversification of technological and production activities allows the company to learn from its environment and thus to increase its ownership advantages (Cantwell, 1989; Castellani and Zanfei, 2006; Frenz and Ietto-Gillies, 2007), on which more in the next section.

A further advantage is connected with risk spreading. A strategy of dispersion of production and multiple sourcing can also be a diversification strategy which allows the spreading of risks of disruption to production due, for example, to political upheavals or industrial disputes in any one country. Disruption to production can also come about through other problems such as natural disasters. Most risks linked to the latter are not nation specific but are more likely to be specific to the physical and geographical environment. However, the ability of countries to cope with them and to minimise risks and costs for business is, to a large extent, nation specific and thus specific to the social, economic and political environment and not just to the physical environment. Thus a strategy of fragmentation by nation-states may also become a strategy of geographical diversification in order to spread risks deriving from the social and political as well as the geographical environment.[5]

Do companies derive only advantages from a strategy of fragmentation of production across different nation-states? The answer is certainly negative. First, because the fragmentation strategy may lead to higher unit costs if it requires operating below the most efficient size in some, if not all, locations. Moreover, the diversity of regulatory regimes across which TNCs operate may, in itself, generate extra costs and uncertainties. For example, different currencies generate transaction costs; exchange rates fluctuations may bring losses as well as gains; operating across different cultures and institutional contexts may result in higher transaction, organisational and managerial costs.

6 TNCs AS AGENTS OF INTEGRATION AND FRAGMENTATION

So far we have explored the fragmentation side of TNCs' activities, whether they are the result of deliberate strategies or not. But TNCs have been hailed as agents of integration across countries. Indeed, they may be considered as the main agent in the globalisation process which is the process of integration par excellence (Ietto-Gillies, 2002: ch. 10). So, are TNCs agents of fragmentation or of integration? The answer is that they are both and it all depends on the perspective we consider. In the previous two sections we took mainly the perspective of labour and of governments and came to the conclusion that strategies of international location are likely to lead to the fragmentation of labour, of governments and other relevant actors – such as suppliers – in their dealings with TNCs' management.

It can also be argued that a strategy in which various segments of the value chain are located in different countries leads to the fragmentation of the production process. But such strategies are often referred to as 'strategies of international vertical integration'. Are we seeing integration or fragmentation with regard to the production process? The production process itself is locationally dispersed and thus fragmented. However, such a location strategy facilitates integration among countries linked by the value chain.

The integration role of TNCs can, in fact, best be analysed by taking the perspective of countries rather than of production processes and/or labour force. Are nation-states being integrated – linked together – more or less by the activities of TNCs? The answer must definitely be more for the following reasons. First, because the activities give rise to flows of products, capital, human resources, services and skills.

Second, because the activities also involve exchange of knowledge, technology and innovation, including organisational and managerial innovation. Various units within the company – be they the headquarters or subsidiaries – form an internal network within which there is exchange of knowledge, innovation and technology (Hedlund, 1986; Hedlund and Rolander, 1990; Zanfei, 2000; Castellani and Zanfei, 2002; Frenz and Ietto-Gillies, 2007). The exchanges are often facilitated by movements of highly skilled personnel whose flows have been increasing worldwide (Salt, 1997; OECD, 2002).

Moreover, each company unit will be in contact with the innovation context and system of the country in which it operates. The unit learns from these locational contexts and then transmits the acquired knowledge to other parts of the company via the latter's *internal network*. Often the learning from the locational context and system is heightened by formal innovation-based collaborative agreements leading to *external networks* (Frenz and Ietto-Gillies, 2009). Other external networks can also lead to learning and acquisition of knowledge such as the networks linking subsidiaries to their local suppliers and customers. The two types of network, internal to the company and external to it, operate together to enhance the diffusion of knowledge and innovation, with significant effects for the local businesses, the TNCs and the various countries (home and hosts) in which they operate. Thus the geographically fragmented configuration of production activities increases the scope for integration across countries via the diffusion of knowledge and innovation.

Third, the learning process from the location context to the company is paralleled by an inverse process: knowledge and innovation spill over from the company's units to the local environment in which they operate. The mechanisms through which this happens may be movement of labour between businesses or acquisition of products and components or contacts with suppliers, distributors and customers. Whatever the mechanism, the spillover effects have integrating effects between various countries linked by the internal networks of the TNCs.

Fourth, the production process organised internally to a company though across countries will bind the countries together more than if independent companies in each country were to organise segments of the value chain. It is a deeper integration process involving exchange of personnel and knowledge as well as responding to common goals and strategies.

Fifth, the labour force in one country may become more dependent on decisions and activities taking place in other countries. They may also become dependent on the skills used in other countries. Lastly, governments and their policies in several countries may become linked by the impact of strategies of TNCs operating within them. There are also implications for the effectiveness of economic policies.

7 TNCs AND REGIONAL INTEGRATION

In Section 6 it was argued that the activities of TNCs tend to integrate countries; the more so the higher the level of those activities. We have also argued in Sections 3–5 that TNCs' activities generate fragmentation. These integration and fragmentation processes occur whether the countries are considered as being part of specific regions or not. In the case of regional integration, the activities of TNCs contribute to the so-called 'integration from below' – that is, integration promoted by the activities of micro actors (Pelkmans, 1984).[6] There is also, usually, a parallel process of integration from above – that is, via the policies of the governments of member states.

How does the process of regional integration from above affect the activities of the TNCs and the processes of integration and fragmentation set in motion by them? Will it enhance or diminish the scope for TNCs' strategies resulting in their own generated integration and fragmentation? Conversely, do the TNCs' strategies enhance or hinder the regional integration process?[7]

In order to analyse how regional integration may affect the *strategies* of TNCs and the location of production, we need to look at the various perspectives offered to companies by a given region. They are in terms of the region as: (a) locus of distances between various points within it. This affects transport costs for materials and final products; (b) locus of areas of resources availability including human resources and the range of skills offered. This affects the costs of production; (c) locus of knowledge and innovation which can be tapped into. There is evidence that one of the reasons why some countries attract inward FDI is, indeed, their good innovation environment (Driffield and Love, 2003); (d) locus of markets. In this respect key elements of differentiation between locations are their level of income per capita and the level of competition; (e) loci of different national regulatory regimes with respect to fiscal, currency and social security regulations as seen in Sections 3–5 where we argued that their impact is due to the ability of companies to devise strategies for benefiting from the *differentials* between the national regimes; and (f) the region – such as the EU – as a locus of specific regulatory regimes applying to all its member states.

The loci elements considered above are not static and fixed in time but vary and interact with one another dynamically. Skills and knowledge develop and so do markets. The development in the economic and business context leads to changes in the regulatory regimes of nation-states and the region. The companies' activities and, particularly, their investments are key elements of such changes and interactions.

In the short term the elements that determine the loci (a) to (d) are largely independent of whether the region we are analysing is politically and economically integrated or not. However, in the longer term, integration may lead to changes in the elements described under (a) to (d) as well as those in (e) and (f).

Firms take account of elements in (a) to (d) in planning the location of their activities.

They also take account of (e) and (f), and this is where the depth of regional integration and the various stages it goes through may have a direct impact on the location of production. Indirectly, the impact will also be felt through the effects of integration on elements within (a) to (d).

While firms' strategies are linked to all six (a–f) loci elements, the issue of integration from above relates, directly, to (e) and (f) only. So, one question is: how do TNCs' strategies relate to various stages and depths of regional integration from above? Deep integration starts with the opening-up of markets for capital, products and labour. Products can move across freely and so does capital and – up to a point – labour. This affects the ease of market penetration and the availability of skills. Whether production will be located near resources or the latter moved to production locations will largely depend on transportation costs and the location of markets. The intra-regional FDI motivated by the aim of circumventing trade barriers will diminish as intra-regional markets can now be supplied by exports from the home country. However, it will increase extra-regional inward FDI as TNCs from outside the region will now have the opportunity of a larger market within which their products can move freely provided they are produced in one of the member countries.[8]

Integration of markets may or may not be followed by integration in regulatory regimes. It is with the differentials in these that we dealt in Sections 3–5. What if these differentials come down as integration deepens? Abolition of differentials in currency regimes – that is, adoption of a single currency – cuts down transaction costs and thus facilitates transnational activities.

Integration at the level of markets for products and financial assets and the freer movements of labour across frontiers is likely to help business in general. These developments lead to lower transaction costs as well as to high supply of labour – often skilled labour – in several EU countries.

Where we have seen and continue to see strong resistance by companies is in terms of possible integration in fiscal and social security regimes. The latter includes issues such as length of the working week and pension rights. These are elements in which there are still very considerable differences between EU countries and great resistance to moves towards common norms. They are also the elements in which differentials between countries – though they may entail some transaction costs – are likely to bring companies considerable benefits in terms of the following.

In the case of fiscal regimes, scope for taking advantage of different corporation tax regimes in member states by a strategic location of subsidiaries; scope for the manipulation of transfer prices designed to reach a tax-efficient geographical configuration of reported profits; and scope for taking advantage of different countries' wider financial incentives for the attraction of inward FDI.

In the case of social security regimes, lower labour costs and, generally, increased power of companies towards labour. It is interesting to note that successive British governments have always opposed the European Social Charter and any attempt at harmonising 'labour and fiscal regimes' within the EU. They have also repeatedly assured the employers' association that they will continue to do so in the future.

To what extent and for how long can there be resistance to integration in fiscal and social security regimes across the EU? It is difficult to tell as political processes are always influenced by many, often unpredictable, events. None the less, changes in social and technological environments are likely to have an effect. As people move around more freely and communicate more cheaply and speedily, the awareness of conditions in different member countries increases. This may increase the pressure for more consistency across member countries. Moreover, electronic communications increase the opportunity for coordination and planning across nation-states for actors who, so far, have not coordinated much with regard to issues such as labour and suppliers. There is evidence of some trade unions developing links across nation-states (*The Guardian*, 2007) of the EU and beyond.

However, the current recession is likely to change the context within which the EU integration process takes place, with far-reaching consequences. Recent developments in Britain have brought attention to a new configuration of labour regimes giving scope for additional strategies likely to lead to more not less segmentation of the European workforce. EU regulations stipulate that EU nationals are free to move to – and seek employment in – any of its member countries; moreover, companies may employ labour from any of the EU nationalities within its member states. However, a different article/directive also allows companies to hire labour in other member countries – and move it to a host member country as 'posted workers' – under different contractual regimes from the ones applicable to local nationals in the same host country. The overall result seems to be that negotiated national agreements between workforce and employers in a specific country do not apply to posted workers. The contractor/employer must not pay below the legal minimum wage in the host country but otherwise it can stipulate its own contractual conditions on which, moreover, it appears to have no disclosure obligations. Growing unemployment across Europe means that workers are prepared to move and take up jobs in other countries under worse conditions than are available to nationals in the host country or indeed than they themselves might have in their own country were jobs to be available there.

This is exacerbating divisions among the European workforce. As the 2008–? recession bites and jobs are lost, British workers have come out on unofficial strikes against the preference for posted foreign workers – brought in from Italy and Portugal – over British workers by an Italian oil contractor investing in Britain. The situation is relatively new but not unprecedented, and indeed there are currently British posted workers operating in Italy and employed by the very same contractor. The social tensions may be flaring up now because the recession is deepening.

The outcome is that European labour appears more divided and fragmented than ever – with dangerous nationalistic overtones – while working within the same country.[9] Here again we have clear strategies from TNCs that: (i) reduce labour costs – this is achieved not by investing in low labour cost locations but by using EU regulations to freely move labour to another member state though at contractual conditions more favourable to the company than those it would have by employing indigenous labour;[10] (ii) manipulate contractual arrangements to circumvent national agreements in the host country; and (iii) fragment the overall labour force employed.

This issue has many wide implications in terms of theories, strategic behaviour and policies. Inward investment, far from creating jobs for host country nationals – as books on international business tell us – depletes them. Moreover, it is perceived to be undermining employment terms and conditions and thus to be effectively a vehicle for 'social dumping'. Locational advantages are being replaced or supplemented by advantages of using a foreign workforce under different contractual conditions, thus increasing the segmentation of European labour. Within the same country different contractual conditions may be used, not as a result of organisational fragmentation or locational advantages but as a result of a freely moving workforce under EU integration policies. Moreover, the differentials in labour regimes for host and posted workers are the result of legislation at the level of the region – the EU – rather than at the level of single member states as discussed in Section 4. In other words, the political integration process has created differentials in labour regimes – between posted and host country's workers – which generate scope for new segmentation strategies by TNCs.

Unfortunately, as the recession deepens and companies sharpen their fragmentation strategies, divisions between EU workforces may increase. At the political and macroeconomic levels, the consequences can be quite important: calls for the protection of jobs are bound to be mirrored by calls for the protection of products. Not only may aspirations of European social cohesion be undermined, but so will any hope of fast recovery. The jury is out on the medium- to long-term impact of the recession on European integration. It could lead to a slowdown of the process as calls for protection of jobs and profits increase. However, it could be that the social and political consequences of the unrest may force politicians to close loopholes and review legislation for posted workers. Divide and rule strategies may bring short-term benefits to companies in terms of lower costs and higher productivity. However, when pushed too far – and under conditions of deep and worsening recession – they may lead to worrying social instability; not a welcome situation for either companies or governments.

The TNCs have both an integration and a fragmentation role within the EU. It is up to governments of member states and the EU to develop appropriate policies and strategies that channel TNCs' own strategies towards social and economic desirable goals, including cohesion.

8 SUMMARY AND CONCLUSIONS

Following a brief excursion into the growth of TNCs' activities, the chapter considers the issue of control in relation to strategic behaviour by companies. A discussion of how TNCs relate to nation-states leads to an analysis of the opportunities and scope generated by nation-states for companies that can plan, organise and manage across frontiers. The nation-states are considered in terms of spatial, cultural/linguistic and regulatory regime dimensions.

It is argued that differentials in regulatory regimes between different countries create scope for advantages and for strategic behaviour by TNCs. The strategic behaviour is seen in relation to other actors (specifically labour and governments) as well as other elements such as risk minimisation. An analysis of fragmentation and integration and the role of TNCs in them follows. The analysis is then extended to the role of TNCs in regional integration with a brief discussion of evolving TNCs' strategies towards labour and their consequences in the current recession.

TNCs are seen as having both a fragmentation and an integration role across nation-states. The differentials in social and fiscal regimes within the EU give scope for fragmentation strategies by TNCs and in relation to labour and governments. The social implications of these differentials and strategies, particularly in relation to the current recession, are briefly discussed in Section 7.

Keywords

Transnational corporations' strategies, corporate integration, regional integration, fragmentation strategies, labour and transnationals, governments and transnationals.

JEL Classification

F23, F15.

NOTES

1. I am grateful to Ken-ichi Ando and Miroslav Jovanović for very useful comments on an earlier draft of this chapter, which have led to improvements.
2. Many of the issues considered in Sections 2–5 are developed in greater details in Ietto-Gillies (2005).
3. The issue of strategic control over subcontractors is explored in Cowling and Sugden (1987).
4. Kogut (1983) mentions the threat of relocation as a bargaining power towards governments.
5. Rugman (1979) suggests that the international spread of activities may be a risk diversification strategy on the part of the company.
6. See also Ando (this volume, ch. 5) for an analysis of the integration role of Japanese TNCs in the EU.
7. Dunning and Robson (1987) analyse the relationship between regional economic integration and transnational corporate integration, the latter seen mainly in relation to the organisation of production within the TNC.
8. See Balasubramanyam and Greenaway (1992) and Dunning (1997 a and b).
9. See also Jovanović in this Handbook (Volume I, ch. 11).
10. It should be pointed out that in the specific case currently (February 2009) under media attention in Britain, the Italian contractor claims that the pay of Italian and Portuguese 'posted' workers is not less than would have been available to British workers had they been employed. This may still leave open the issue of overall costs since the posted workers may be moved to the benefit of regimes of the country of origin: an arrangement allowed by EU regulations. It also leaves open the issue of wider contractual terms and conditions such as length of working hours, all of which affect costs.

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4 Multinational enterprises and regional economic integration: rethinking key metrics in international business

Alan M. Rugman and Chang Hoon Oh

1 INTRODUCTION

This handbook serves as a useful occasion to take stock of the literature in international business (IB) as it affects international economic integration. We shall examine the nature of regional economic integration achieved by the world's 500 largest firms, as observed by Rugman (2005). In particular, we demonstrate in this chapter that it is necessary to rethink aspects of the linkage between IB theory and some of the prevailing empirical metrics used in the field. It is argued that there is an unrecognised disparity between country-level theories of foreign direct investment (FDI) and firm-level data on multinationality and performance. We approach this difficult task from the perspective of Karl Popper (1959). We believe that good theory will be developed only by a deductive approach which builds upon the relevant empirical evidence. Therefore, in order to review and analyse IB theories, and to develop new aspects of IB theories, we need to address the related empirical literature on a parallel plane in order to detect complementarities between theory and empirical work.

This chapter is structured as follows. Section 2 examines the role of multinational enterprises (MNEs) in IB research. Section 3 attempts to link IB theory to empirical research. Section 4 addresses theoretical problems with empirical metrics. Section 5 evaluates two metrics of multinationality: scale and scope. Section 6 examines new tests of multinationality. Finally, Section 7 concludes.

2 THE ROLE OF MNEs IN INTERNATIONAL BUSINESS RESEARCH

Although the field of international business is now some 40 years old, it is apparent that tensions remain between economists trained in international trade theory and those now conducting research on FDI in business schools. For example, the 2008 Nobel Prize in Economics was awarded to Paul Krugman partly for his work modelling the role of differentiated products in international trade as developed in his classic article, Krugman (1980). While it is pleasant for those of us involved in research in international economic integration to see such recognition of this work, it is somewhat ironic that the original empirical research on intra-industry trade, conducted by Grubel and Lloyd (1975) was not seen by the Nobel Committee as the definitive original thinking on this subject. This is troubling since the Grubel and Lloyd work on intra-industry trade complements in both timing and context the recognition of the role of the multinational enterprise (MNE) as the key institution driving international economic integration.

The MNE conducts both inward and outward FDI. Such two-way FDI is highly complementary to the two-way trade first identified by Grubel and Lloyd (1975). Indeed, Rugman (1985) demonstrated that the determinants of intra-industry FDI are largely the same as the determinants of intra-industry trade. Analysis of the nature of two-way FDI by the MNE was first demonstrated in the classic work on internalisation theory by Buckley and Casson (1976), at approximately the same time of publication of Grubel and Lloyd (1975). While Buckley and Casson's work has served as the basic theoretical framework for analysis of the MNE ever since, it is interesting that Krugman (1980) needed to develop a separate and more rigorous framework for trade in differentiated products (and for economies of scale, which are explicitly discussed by Buckley and Casson). Perhaps it is unfortunate that Grubel and Lloyd possibly lacked the rigorous mathematical framework required to establish intra-industry trade as the new theoretical, as well as empirical, benchmark for studies of international economic integration, but it is fortuitous that the work by Buckley and Casson has provided a sufficient robust platform for further analytical work on the theory of the MNE by Buckley and Casson (1981), Caves (1981), Dunning (1981), Hennart (1982), and Rugman (1981).

Today, most researchers in IB would agree that the MNE exists as an institution to provide property rights over the international development, processing, and/or marketing of knowledge-intensive goods and/or services. Since knowledge is a public good, the externality of market failure needs to be overcome through internalisation within the MNE. The resulting firm-specific advantage (FSA) in knowledge owned by the MNE needs to be sufficient to overcome the liability of foreignness, first identified by Hymer (1960). More recently it has been demonstrated that most MNEs expand internationally within their home region of the broad triad of North America, the European Union (EU), and the Asia-Pacific (see Rugman, 2005). In this context there remains an inter-regional liability of foreignness such that most MNEs average 80 per cent of their sales and assets within their home region of the triad. Furthermore, there is no evidence that this high degree of intra-regional activity is being replaced by a movement towards globalisation. Here, globalisation is defined as the worldwide homogenisation and commonality of IB activity, a type of definition explored by Thomas Friedman (2005).

In contrast to this work on the FSAs of MNEs, which can use firm-level data to test the relationship between the degree of multinationality and firm performance, economists have remained grounded in the study of country-specific advantages (CSAs). For example, Ricardian and Heckscher–Ohlin–Samuelson theory is based upon the country as the unit of analysis and seeks to explain international trade as being determined by differences in factor endowments between countries. In turn, intra-industry trade of the Grubel and Lloyd (1975) type, and the work based upon Krugman (1980) again builds upon CSAs and industry-level analysis. While there is nothing wrong with this approach it is notable that work in IB studies has moved towards firm-level analysis of the MNE and to explicit consideration of FSAs. Of course, FSAs themselves can be related to CSAs, for example, to explain offshoring of manufacturing due to the relatively cheap labour in China, and offshoring of services due to the relatively cheap skilled labour in information technology (IT) in India. For discussion of the latter, see Rugman and Doh (2008). For analysis of FSAs and CSAs and the elements of the resulting FSA/CSA matrix which is now recognised as the core framework of IB, see Rugman (1981).

In this chapter we shall consider various metrics that examine the nature of intra-industry trade and FDI. In particular we examine the key role of MNEs as agents for such intra-industry FDI, recognising that these firms also account for well over half the world's trade (see Rugman, 1985, 2005). We argue that it is necessary to focus upon firm-level data, that is, the data supplied by the MNEs themselves in their annual reports. We believe that these data are transparent and reliable as these firms are required to divulge relevant accounting and financial information according to rules put in place by regulators of the stock markets in which the firms raise capital. We recognise that such firm-level data will be highly complementary to the industry-level data used by economists in their research on intra-industry trade. Therefore this chapter should serve to supplement and complement others in this Handbook written by economists rather than by specialists in IB studies.

3 LINKING IB THEORY TO EMPIRICAL RESEARCH

Two of the most important contributions to the development of IB theory have been by Ray Vernon (1966) and John Dunning (1981). Vernon's product life-cycle model combines aspects of firm- and country-level analysis. He shows that the international spread of activities by US MNEs follows a pattern, based upon the experience of the immediate post-war period (the 1950s and 1960s). The typical US MNE of the time first opened a foreign subsidiary in Canada, then in Western Europe, and then went to other countries where factor costs (especially labour costs) were lowest. Implicit in Vernon's thinking is that the typical MNE is hierarchical with research and development (R&D) centralised and controlled from the parent firm in the home country.

An essential component of Vernon's theory lies in the country effect of this firm level product life cycle. First, the FSAs are tightly controlled and exploited sequentially in wholly owned subsidiaries in other wealthy countries such as Canada and the UK. Only when the product line matures, and becomes a commodity (such that the FSAs in knowledge have disappeared) does production take place in subsidiaries in less-developed countries. An essential component of Vernon's theory lies in the country effect of this firm-level product life cycle. Second, the US enjoys exports of the technologically intensive product. However, as production shifts to Canada and Western Europe, there tends to be some importation of the product from the foreign subsidiaries. Third, eventually the US imports the product when it is produced at the lowest product cost in the less-developed countries.

In retrospect, it is apparent that Vernon's thinking is extremely limited to its historical context. It assumes that MNEs are centralised and hierarchical. Further, it assumes that the US is the technological powerhouse of the world. Finally, it assumes that most developing countries and their MNEs have no knowledge, skills or technology of their own. Some 40 years later we can observe that all three points have changed. First, we have theories of the network structure of MNEs, in which subsidiary initiatives can generate either location-bound FSAs or non-location-bound FSAs, in the spirit of Rugman and Verbeke (1992). Second, it ignores the importance of the triad whereby