

# **COUNTERPOINT**



## From Corporate Strategy to Interventionist Trade Policy: Two Critical Missing Links

by

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### 1. Introduction

One major “counterattack” against the perceived recent dominance of “free trade dogma” is based on the approach to corporate strategy loosely associated with the Boston Consulting Group (BCG) and the Harvard Business School. The core contention is that an active industrial policy aimed at supporting specific organisations and sectors of the economy will confer “dynamic” or “strategic” benefits upon the nation, benefits that would be missed under a regime of free trade. This essay highlights two critical conditions that are largely unrecognised in the debate but which must be satisfied for the “business strategy” approach to support an interventionist trade policy. I say “largely unrecognised” because while nominal recognition of the conditions is made on occasion, they never receive the attention that they must in order to buttress a protectionist trade policy. To the business strategist cum free trade critic who responds with “we already knew that” to the problems raised in this essay, the response is, “you conveniently forget them when making policy recommendations”.

No writer in this heavily tilled field has the right to take the reader’s time without outlining some basic ground rules. Throughout, I will assent to two fundamental tenets of the business strategy approach: first, that scale economies, both static and dynamic (learning effects) are of paramount importance in determining which producers will come to dominate a given market; and second, that such market dominance, if achieved, will bring large benefits to all members of the organisation (in the case of international trade, the nation as a whole). Both of these could be challenged on their own but I will accept them here. I will also eschew the assumption generally attributed to economists that all actors are entirely self-interested, perfectly rational, and able to predict the future with great precision. I will, however, insist on the *even-handed* assumption that people display approximately the same degree of self-interest and computational skills in the private and public sector. Thus, I will effectively assume that moral fibre and cognitive skill do not systematically differ between Canberra bureaucrat, corporate

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manager, or bank loans officer. This consistency is often missing in extreme free-trade and extreme protectionist views, with evil and/or stupid behaviour assumed in one institutional setting, and altruistic and/or clairvoyant behaviour in the other.

Despite this rather tortured and abstract listing of assumptions, my concerns are entirely practical. The problem is to select and implement a strategic trade policy that stands a reasonable chance of meeting its avowed objective of improving living standards.<sup>1</sup> The first under-appreciated problem is that of reliably identifying niches in the world economy that will systematically deliver above-average rewards in the presence of competition for such niches. The second is whether and why the political process represents the best way to identify and exploit such opportunities.

## 2. The Problem of Competition for the Field

Few people doubt that some industries, variously called “technologically sophisticated” or “high-value-added” or “elaborately transformed manufactures” are more attractive than other industries or lines of business, all else equal. But that final qualifier (the infamous “*ceteris paribus*” of mainstream microeconomics) is never satisfied. The fact that an industry or pursuit can be described as “attractive”, without qualification, means that it is attractive to many other businesses and nations. As Alan Wood (1992) puts it: “The strategic industries being selected are the same from Sweden to Brazil, from Argentina to Australia, which hardly suggests a particularly profitable future for those investing in them.” There is fierce competition to enter an attractive industry, a fierceness that necessarily increases with the attractiveness of the industry. Once the cost of entry is taken into account, there is no a priori reason to favour *any* particular industry, product line, or even area of Research and Development. To baldly assert that we should focus government funding on “growing” or otherwise “attractive” sectors makes as much sense as to advise a home-buyer, about whose personal attributes we know nothing, that he/she should choose the largest and most luxurious house in the fastest-growing area of the country. This would be sensible advice only if the prices and convenience of all homes were the same,

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1. In focusing on living standards, I will ignore the disturbing implications of Scott's (1989) goal of achieving “competitiveness” by which, in his words, he means: “to raise incomes as rapidly as competitors do”. A military “sneak-attack” could be justified on these grounds so long as the likely destruction to our “competitor” is greater than the damage we would sustain. A complete ban on international trade by the USA would also likely achieve this end, as the losses to American citizens would be large but smaller than the loss to Japanese citizens who rely more heavily on international trade. I trust that Scott has no such negative-sum scenario in mind but is simply using the income growth of some referent group of nations as a measurement device.

which, of course, they are not. People are matched to homes according to their incomes, wealth and desires.

The housing metaphor is useful but is perhaps too neat, because competition for the right to occupy the premises is directly reflected in a single, observable index: the purchase or rental price of the home. The “fee” for entry into various lines of business is rarely so obvious except in the case of, e.g., taxi licences. But this does not mean that the entry fee is zero, as is often assumed. Those currently enjoying a position in the industry have either paid the fee or avoided it by dint of inheritance or cleverness. Those who have yet to enter must still pay the fee. Without detailed and specific knowledge of the industry involved, there is every reason to believe that the cost of entry will dissipate any future gains. These costs need not just be money cost; they include painful hours of analysis, failed experiments, prostration before unsavoury customers, etc.

The previous paragraph foreshadows one of the great tricks that history can play upon the recipient of “strategic” advice. The adviser [here Chandler (1990) is the clearest case] points to companies and nations that have aggressively invested in particular markets in the past and are now successful. The argument which seems to follow so obviously is that we should devote large amounts of resources towards repeating their successes. Unfortunately, many of the contemporaries of that success story invested heavily and failed. We live in the present and face an uncertain future, and the bare fact that some firms invested, succeeded, and grew provides no guidance at all. The strategist may now legitimately object that I have left out “learning effects”, the possibility to “create” competitive advantage, and the “first-mover” advantages that were enjoyed by the winners of the past. I will answer this by considering two scenarios in which learning effects feature prominently. The argument is identical for any attempt to invest resources in creating future advantages. Consider first the case where all firms (and perhaps their governmental backers) are contemplating entry into an industry where costs fall with experience. Profitability in early stages will be small or negative, while profitability in the future will be large (for those who survive). Now it is certainly true that a first mover in this case would enjoy great advantages, but what reason have we to believe that there is a prime mover and more importantly that we are that first mover? To do so is to assume the proverbial can opener; that our government is better informed and more responsive to this particular opportunity than is any other player on earth.<sup>2</sup> In the absence of any compelling evidence to the contrary, the most defensible scenario is that we are all equally swift. In this case, where we all contemplate entry at approximately the same time, who will win

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2. This is necessary even if the government’s only rôle is to “lead” or “orchestrate”. The problem is: where should “leadership” be exerted? To what end should government “orchestrate” and what “players” should be brought in when?

the battle for dominance? The producer with the *steepest* learning curve, that is, the one who makes the most of experiences which are themselves available to all (and at the same cost)!<sup>3</sup> Learning effects and other opportunities to actively create competitive advantage per se make no difference to the choice of strategy. In order to succeed we must be either more adept at spotting opportunities or faster at learning once in a particular business. The exact same reasoning applies to attempts to capture the “mobile links” in a “value chain”. Such attempts are costly and to the extent that capture is attractive we can expect others to similarly invest resources to this end. The eventual “winner” will once again be the one who make best use of the upstream input, where “best” is stated in terms of capitalised value and includes strategic and learning effects.<sup>4</sup>

The argument of this section is simply that success comes only from doing something better or more cheaply than others. The existence of “dynamic competitive processes” or “history-dependence” does not affect this proposition in the least, once we focus on the relevant problem of what to do now. In a dynamic industry with learning effects, the “winner” must have superior analytical and “opportunity-spotting” skills, or superior learning skills once in the industry. I have been deliberately vague and abstract in speaking of “the industry” for the simple reason that neither I nor any other external analyst know in which industries we have such advantages! Absent detailed and specific knowledge of the special resources and opportunities available, there is no reason whatsoever to believe that it is the software, automobile, or even raw-material-processing industry.

Of course, taken on its own, the preceding is an invitation to paralysis. Someone must choose where resources are to be devoted. All this section has argued is that the existence of learning effects and the possibility of conscious investment to create long-term advantage do not of themselves suggest any particular direction in which our scarce resources (time, capital, ingenuity, etc.) should be devoted. I now turn to the question of who will choose the industries to which our resources are to be devoted.

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3. Some players may well be able to accumulate experience at lower cost, but only if their costs of production and sales, *absent* experience effects, are lower. This is, of course, classical comparative advantage.

4. I will ignore arguments that effectively require us to violate the rights of upstream producers, that is, simply forbidding them on pain of fines or imprisonment from dealing with “foreigners”.

### **3. The Assertion of “Market Failure” is not Sufficient to Recommend Interventionist Trade Policy**

The preceding section focused on the competition between nations; that is, between the Australian government and foreign governments and/or firms in spotting and exploiting future opportunities to create wealth (or export earnings, a misleading but vastly popular proxy for wealth). The other missing link in the argument is why Australian firms do not themselves undertake “strategic” export drives of the type advocated in interventionist tracts. If “capture of mobile links in resource value chains” or “enjoyment of the above-market returns to elaborately transformed manufactures” is in fact such an attractive way to go, why do private businesses not avail themselves of the huge profits that reliably flow from such pursuits? If on the other hand businesses do not find such pursuits attractive (e.g., they pose multiple simultaneous risks rather than “one risk at a time”, to use the language of the most recent AMC report), then why should public funds be used to make these projects suddenly attractive?

One answer that has been offered is that Australian business people are uniquely blinkered in their outlook. They simply do not see their own export profit opportunities as well as the rest of us can. Intervention is required because Canberra bureaucrats and strategy consultants are uniquely able to spot export opportunities. But consultants are hired by private firms when they promise such knowledge, and public servants offer volumes of advice for free. We must then assent to the view that the private sector systematically underestimates the value of such advice, a view that is difficult to defend given the salaries of management consultants.

A more defensible route begins from the sensible position that strategic exports are not undertaken because they are in fact less likely to be profitable than are other pursuits. The “free-trade” argument along these lines would be that the major competing use of corporate resources is in lobbying for further protection, which has in the past proved far more profitable than attempting to serve the customers of the world. The case for intervention would rest on the existence of “market failure” along the following lines: although large-scale investment aimed at securing exports of “elaborately transformed manufactures” is not attractive to private firms (and this is not due to any systematic cognitive shortcoming), such investments represent the best use of scarce resources from the social point of view. Huge benefits from export spill over to the community and are not reaped by the firms that choose to export. Moreover, these spillover effects are larger for elaborately transformed exports than for any other activity in which business can engage.

The above market failure or externality argument is seductive as it allows one to escape the discipline of economic thinking (particularly the “no free lunch” admonition) without a great investment of time or research. All one must do is to assert that markets fail in order to make a “respectable” economic case for a myriad subsidies and special favours. It is also highly misleading. The first

problem is simply that market failure does not follow from the fact that one finds a given outcome distasteful. I would like to borrow two hundred thousand dollars at a three per cent interest rate to finance a wine cellar, and the fact that I cannot do so is evidence of proper market functioning rather than failure. Even the closing of a large industrial complex that throws hundreds out of work is only a market failure *if* the costs borne by the workers exceed the benefits this closure would confer on the firm's shareholders and the workers and managers in the firm's other divisions (these parties are people too!).

Even granting the existence of market failure, it must still be the case that government/political process will somehow arrive at a better solution. That is, the question of why government failure should not be more severe than market failure must be addressed. To take the example of the "risk fund" proposed in *The Global Challenge*, we need to take seriously the question of how its administrators will "sort through" a flood of superficially attractive proposals. Certainly, it is the case that the decision-makers will "learn" as they go along. But this is also true of entirely private actors. One does not have to maintain that all interest groups and other participants in government are "irredeemably selfish" to have serious doubts that the public sector will learn *faster*. The most defensible assumption is that parties are equally selfish in the private and public sectors (or to provide compelling reasons and evidence why public spirit should be more rampant in the public sector; clearly there are cases of both narrow greed and vast generosity in both spheres). The question is then whether we expect better choices on average to be made by those who have their own money at stake than by those who use resources conscripted from taxpayers. It is certainly not sufficient to "point to the rôle of government in the most successful contemporary states" for evidence (Marsh 1991). Not only has government played its most prominent rôle in the most abject *failures* of the century (USSR, Eastern Europe, North Korea, etc.), but a study by the Industry Commission (1990) makes a strong case that government was as much a hindrance as an aid to developing East Asian Economies. Perhaps it is true that we can learn something about how a governmentally operated "risk fund" should be run from the "successes" in East Asia and Japan. This argument must be pursued with far more energy and care and must also recognise the great dangers of state intervention.

Let us finish by looking at a particular case of "market failure" that is often invoked to support subsidy and protectionist programmes: that of "capital market failures". The idea is that many good projects die in their infancy from neglect by the banks and venture capitalists. This view of capital markets drastically understates the richness of private funding arrangements, by focusing exclusively on short-term "project finance". The rôle of the *internal* capital markets of many of our large corporations is neglected, a startling omission for a business strategist cum management consultant. The managers of these firms, we are taught by the BCG approach, strategically subsidise some divisions to achieve benefits for all the firm's stakeholders. Although the BCG portfolio approach tends to neglect the

opportunity cost of capital and probably inclines top managers excessively towards growth (Berle and Means 1932; Baumol 1965; Jensen 1986), this posture can also serve to maximise long-term rewards to shareholders, employees, bondholders, etc., (Fershtman and Judd 1987; Aoki 1990; Garvey and Gaston 1991). What is critical here is that the BCG portfolio manager does not have the power to conscript resources, that is, does not have the power to tax. Workers join voluntarily, shareholders and bondholders voluntarily invest, etc., because the approach generates enough wealth to attract them. The critical issue that must be addressed by the proponents of strategic subsidies is why and how this process must be supplemented by the actions of a “portfolio manager” who has the right to forcibly extract capital in the form of taxes. This issue suffers from such “benign neglect” that the position of the protectionist can be characterised as little more than pious hope.

#### 4. Conclusion

By now it is generally acknowledged that the protectionist “emperor” is left completely naked by the approaches adopted in the McEwen era. This essay has argued that attempts to reclothe him with arguments based on “dynamic competitive advantage” still only gain the emperor admission to a few secluded harbourside beaches. Hopefully, it has also suggested the sort of cutting, measuring, fitting, and tailoring that remains before the emperor is presentable at an informed policy debate.

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